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The European Central Bank

The New European Leviathan?

David Howarth and Peter Loedel

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The European Central Bank

The New European Leviathan?

David Howarth
Lecturer in European Politics
Queen Mary College
University of London

Peter Loedel
Associate Professor and Chair
Department of Political Science
West Chester University

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To Gilly, my lovely wife

To Belinda, Christian, Katarina, and Kyle, thank you for your unending support of 'Dad' – the teacher

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Preface The European Central Bank: the New European Leviathan?

> …the sovereign power, whether placed in one man, as in a monarchy, or in one assembly of men, as in popular, and aristocratical commonwealths, is as great, as possibly men can be imagined to make it. And though of so unlimited a power, men may fancy many evil consequences, yet the consequences of the want of it, which is perpetual war of every man against his neighbor, are much worse.
>
> Thomas Hobbes, *Leviathan* (XX, 136)[1]

Introduction: Hobbes and the European Central Bank

With the 1 January 2002 changeover to the euro complete, one could provocatively argue that the European Central Bank has become the most important institutional creation in Europe since the institutionalization of the nation state in the seventeenth century. While the European Union (EU) may be the larger institutional embodiment of the historical process of supranational governance and European integration in postwar Europe, it is the ECB that perhaps best defines the relinquishing of state sovereignty to an institution with powerful supranational mechanisms of decision-making and enforcement. And while some may contend that the ECB's range of activities are limited to one narrow policy-arena, namely monetary policy, its influence has already spread into other arenas of EU and national policy-making – tax policy, financial regulation, budgetary policy, and macroeconomic policy-making. Acting as a political lever for further European integration, the ECB may just form a core element of an embryonic European super-state.

Whether one agrees or disagrees with this proposition, the creation and operation of the ECB has unleashed a whole range of questions that remain largely unanswered and widely debated. For example, what are the political and economic consequences of the ECB? More importantly, is the ECB emerging as a new European 'Leviathan'?

Has Europe submitted itself, as some would argue, to the rule of a political monster? Are there, in the words of Thomas Hobbes, 'evil consequences' associated with the formation of the ECB? Does the ECB have too much power? If so, can the ECB be controlled? And controlled by whom: member states? Furthermore, within the bounds of a democratic order that must be the foundation of European integration, is the ECB accountable? What about the rights of citizens and national governments alike? Can they provide input into the ECB that adequately reflects the interests and concerns of the member states, interests associations, and the public? This study seeks to address these very difficult questions by providing a comprehensive analysis of the ECB's actions and operations.

It should be made clear that we do not contend that the ECB is a political monster – a Leviathan, in the language of Hobbes. Moreover, we argue that any comparison between the two should be seen as speculative and designed to arouse some hard thinking about the future of the European Union more broadly, and European Monetary Union, more specifically. At the same time, however, some intriguing comparisons between Hobbes' analysis of the Leviathan and the European Central Bank can be made. It is not too much of a stretch to suggest that the ECB looms powerfully large on the political and economic map of Europe – much like Hobbes' Leviathan would loom large on the political development of Europe. Finally, we do recognise the limitations of Hobbes' controversial theory – especially given the powerful critiques of Hobbes over the centuries. However, the dilemma Hobbes faced is similar to the dilemma faced by Europeans today – namely, how to reconcile individual freedom and political authority.

Let us then assume for analytical purposes that the world is comprised of monetary anarchy, currency against currency, and where rules and order – in other words governance – are in short supply. Moreover, let us assume that the people and nations of Europe have long struggled with the negative consequences of currency competition – from repeated postwar bouts of externally produced instability (largely as a result of US dollar politics), as well as internal (European) bouts of instability caused by asymmetry in governance, lack of common rules and institutions, national self-interest, and the inability to enforce common decision-making. While the European Monetary System sought to provide a safe harbour in a sea of monetary anarchy brought on by the powerful forces of globalization, individual members have frequently pursued their own monetary and economic interests – most notably Germany, but also France and Great Britain. Much as Hobbes identified 'competition' as a source of conflict, monetary competition and conflict have defined nearly 40 years of European postwar monetary history.

Given this scenario, how might a modern day Hobbes respond to the current state of European monetary politics? First and foremost, Hobbes was concerned with the power to preserve order. In a world that is 'nasty, brutish, and short' the power of the regime – the Leviathan – to preserve order must be absolute.[2] Without a common power over individuals to settle disputes, human beings become hostile to one another largely because they compete for limited resources, because their mistrust of one another forces them to try to protect themselves by dominating others, and because some people seek the glory of appearing superior to others. Considering the selfish passions of people, their fear of the Leviathan is the only reliable way to keep peace among them. In the immortal words of Hobbes, 'Covenants without the sword are but words, and of no strength to secure a man at all' (Chapter XVII, p. 109). Thus, Hobbes insists on the need for a government powerful enough and feared enough to protect individual rights against the aggression of others.

In addition to the creation of a sovereign with absolute power, laws propagated by the sovereign can facilitate the exercise of individual freedom. The goal is:

> not to bind the people from all voluntary actions; but to direct and keep them in such a motion, as not to hurt themselves by their own impetuous desires, rashness or indiscretion; as hedges are set, not to stop travellers, but to keep them in their way (Chapter XXX, p. 227).

To avoid anarchy in which every individual would be a 'law unto himself', government must have the power to regulate all actions. Moreover, the laws are made to assist individuals, not to hurt each other, but rather to join them together against a common enemy. This image of laws as hedges conveys Hobbes' thought that within the boundaries set by the sovereign, individuals are free to live as they please. While Hobbes might not have meant the unalienable individual rights as put forth by John Locke, self preservation and security push individuals to give up some autonomy in return for protection and order. To achieve the peace that makes civilized life possible, individuals must agree to the restraints – the laws or hedges – on their selfish aggressiveness and desire for competition.

Binding Hobbes' analysis of political order and laws is the social contract. Hobbes' social contract covers not only the institution of a government by those who choose the sovereign, but also the submission of all to a conqueror and a set of rules or laws. When people are conquered and submit to the conqueror out of fear, they have thereby given their consent to that government to reign over them. Moreover, those that submit to the government do so out of mutual shared interest. In other words, governmental coercion is necessary to overcome the prisoner's dilemma; coercion is necessary to avoid the catastrophe that would result if every person (state) were free to pursue its own self-interest. Hobbes' notion of the social contract suggests that it is in the long-term interest of all to live in a society that allows people to enjoy the benefits of peaceful cooperation with each other. People know that to secure this beneficial outcome, they have to protect themselves from the temptation to cheat; and they do this by establishing a coercive government. In order to prevent imminent disaster – namely death – individuals give up some measure of autonomy to the sovereign in return for the protection the sovereign provides. Cheaters will be punished.

It is not too far a leap to take Hobbes' understanding of human nature, self interest, and competition and apply it to European monetary politics. The European Central Bank is first and foremost concerned with the power to preserve monetary order. For the European Central Bank, its power must also be near absolute – as denoted by its overriding preoccupation with political independence and autonomy. Furthermore, the ECB should strike fear into the hearts of member states – pursuing a tough monetary policy stance and demanding fiscal rectitude. Without the ECB's power to settle monetary disputes between Euro-Zone members, it is likely that we would see continued monetary conflict, competition for scarce resources (in monetary terms – ensuring price stability while avoiding the burdens of adjustment of a weak currency), general mistrust among European monetary powers, and the ongoing battle over monetary prestige (strong currency status). While the Euro-Zone members might contend that this prediction is too pessimistic, one could counter that we still see some of these activities even within the European Monetary Union and the ECB.

The Maastricht Treaty lays down the binding laws governing the fiscal and monetary behaviour of member states. Primarily, the monetary laws (Article 105) must be guided toward the goal of price stability, not so that low inflation hurts anyone's particular interest, but rather that society and the economy – and importantly individuals – can proceed along an uninterrupted path of stable steady growth. Given the allusion to hedges in Hobbes' analysis of the necessity of laws, we can see price stability as a hedge against monetary turmoil and economic instability. Even further, particularly from the German perspective, the ECB's independence to pursue price stability can act as a foundation for a stable political order. The ECB acts as a guide, a protector, of European monetary stability, but also the overriding political stability that comes from economic growth and prosperity. In this analysis, the ECB can act as a solid foundation to political union in Europe.

Finally, the Euro-Zone members have given their consent to be governed by the ECB. And the members did so, entering into a binding treaty – the social contract – out of a mutual shared interest in monetary stability and economic growth. To cooperate monetarily required the relinquishing of monetary sovereignty to the ECB. Not surprisingly, European monetary cooperation among nation states has often been analysed in terms of the prisoner's dilemma. The powerful incentive of states to cheat and take advantage of other states is well known throughout Europe's monetary history. The solution, the creation of governance – rules and institutions – that can provide information, enforce decisions, punish cheaters, and demand repeated interaction are at the foundation of the decision to create the ECB. For the Europeans, they have been dealing with this dilemma for the last three decades. In part, they were able to alleviate some of the problems with the ill-fated snake, the more successful EMS, and finally with EMU and the creation of the ECB. It would seem that the ECB has permanently solved the prisoner's dilemma. Other than potential fiscal 'cheaters' (still possible but limited by the Stability and Growth Pact), member states have relinquished their individual right to coin money and regulate monetary policy to the ECB – an ECB sovereign, autonomous, and powerful and reigning in Frankfurt/Main.

It would seem that the ECB fulfills much of the Hobbesian approach to understanding the behaviour of humans – but applied to the behaviour of nation states in an anarchic monetary world. But this brings us back to the question of accountability and the protection of individual and member state interests. How can we reconcile member states' rights with the political authority and power granted to the ECB? We are not quite sure that a perfect balance between these competing goals can be found or that the EU or the ECB have found it either. What we can say is that European monetary policy-making and economic governance in Europe are in a state of transition, a fluid, dynamic situation that will confront policymakers and national governments with difficult choices between the competing objectives of sovereignty and international (European) cooperation.

Objectives of the book

The principal objective of our study is to provide a detailed analysis of the institutional structure and operation of the ECB, and through this analysis reasonably speculate on the Bank's future operation. Our study seeks to understand why the ECB was designed the way it was, how it fits into the overall EU policy-making system, and the debates about its institutional structure. The book explores the history of European central bank cooperation and co-ordination in the context of European monetary integration. The book also examines the preferences of key national actors (in particular French, German and British) that determined both the organization and independence of the ECB as well as the on-going debates about the Bank's design and operation. The complex issues of legitimacy, accountability and transparency – all within the larger construct of political independence – are explored in the context of member state attitudes and the present and future operation of the ECB. By bringing together in a systematic and comprehensive way the various issues of ECB power and independence, we seek to provide academics, students, analysts and the wider public with an accessible overview. With euro coins at present firmly in the hands of nearly 300 million Europeans, it is now even more imperative that we have a broadly encompassing explanation of the powerful ECB.

The book does not claim to make a definitive theoretical statement about the determinants of European integration or the creation of the European Central Bank. While we feel that the ECB should be considered a major step in the emergence of some unique confederal entity still rooted in its member states, we do not seek to explore the contribution of the ECB and EMU more generally in terms of the progress of European integration: this must be the subject of a future study. However, we do argue that the ECB's structure and operation, its successes and potential weaknesses have had and will continue to have an impact upon the shape of future efforts to create new supranational institutions and policies within the European Union. While some may fear the ECB 'Leviathan', the book argues that the ECB can be held accountable – both through existing structures and policies and possible future developments in European policy-making and institutional change.

Outline of the book

The book is divided into seven chapters. Chapter 1 broadly outlines the theoretical and analytical approaches that can be applied to help explain the logic behind the creation of the ECB, its structure, independence and its current operation. Chapter 2 draws out the historical development of European monetary authority in terms of its development as an 'epistemic community'. Starting in the postwar period, through the debates on EMU in the early 1970s and in the period from 1988 to 1991, and the preparation for the launch of the single currency in January 1999, we provide a detailed analysis of the gradual construction of European monetary authority. In doing so, we seek to provide historically-informed insights into the ECB's structure and power. Chapter 3 explores the prevailing attitudes of the three leading member states of the European Union – Germany, France and Britain – towards European monetary authority and the EMU project more generally, in addition to the distinct national traditions of monetary policy-making that have largely shaped these attitudes.

Chapters 4 and 5 complement each other with a focus on the institutional structure of the ECB and an analysis of ECB independence. Chapter 4 describes the European System of Central Banks (ESCB) and the interaction of the ECB with other EU institutions – especially the Eurogroup, but also other institutions, for example, the European Parliament. Chapter 5 then evaluates the institutional structure of the ECB through the analytical lens of political independence. To what extent is the ECB independent from the influence of key political and policy-makers? Does this independence make the ECB unaccountable and illegitimate in the eyes of the public and politicians? Given the European Union's ongoing struggle with questions of transparency and the democratic deficit, can the ECB operate independently without causing further sacrifice on these concerns? While a great amount of literature has already explored this topic, we review the literature and bring it into the context of the overarching theme of the book.

Using the preceding chapters as a backdrop, Chapter 6 evaluates the ECB in action – the actual monetary policy during its first years in operation. Using the concept of credibility as a framework of analysis, this more journalistic chapter traces the monetary steps of the ECB from July 1998 through the official launch of the euro in 2002. Here we focus on the interest rate debates, exchange rate politics and the role of ECOFIN in more detail and evaluate the ECB's 'successes' and 'failures'. We suggest that the ECB – despite some problems in the area of policy credibility – is establishing itself and exerting its power more effectively, especially since the introduction of euro notes and coins in 1 January 2002. Finally, Chapter 7 concludes with a summary of the key arguments of our analysis and the expectations of the future behaviour of the ECB. We also draw out some institutional issues related to the future operation of the ECB as well as the European Union.

Methodologically, this book relies on a variety of approaches – including interviews with officials of the European Central Bank and other leading monetary and political officials from a number of member states, reviews of secondary sources and journalistic accounts, and the employment of statistical data. Interviewees were given anonymity in order to encourage discussion and frankness. Although reliability remains a problem with any anonymous interview, the intent was not to pinpoint specific positions or catch an official slip-up, but rather to elicit open reflections on the role of the European Central Bank and other officials in the respective EU member states. The official positions of the ECB are also readily available from source material and published interviews in the press, and one can visit the Bank's web-site at www.ecb.int.

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Analytical and Theoretical Approaches to the Study of the European Central Bank

> Each (theory) begins [its] analysis from a particular assumption that determines the kind of question that they ask, and therefore the answer they find. They are like … toy trains on separate tracks, travelling from different starting points and ending at different (predetermined) destinations, never crossing each other's path.
>
> Susan Strange, 1994: 16

Introduction: theorizing the European Central Bank

As scholars of the process of European integration, we are aware of the limitations and deficiencies of the state of theory in international relations and comparative politics. Susan Strange's dissatisfaction with the state of theorizing should warn us of the dangers and pitfalls of employing too deterministic a mode of theoretical analysis. The diversity of theories and analytical approaches at our disposal makes the task even more problematic. Europeanist Gary Marks has noted that studying the European Union asks 'us to think anew about political science as a discipline and how its subfields fit together' (Marks 1997: 1). Scholars have been debating the validity of different theoretical approaches since the late 1950s (for a review of the international relations and comparative politics/political economy approaches see Bulmer and Scott (1995) and Rosamond (2000)). Notable works on European Monetary Union (for example, Overturf 1997; Kenan 1995; McNamara 1998; Frieden, Gros and Jones 2000; Eichengreen and Frieden 2001) provide a comprehensive review of various theoretical approaches to the study of monetary integration.

This chapter seeks to explain the strengths and inadequacies of several major theoretical approaches applied to explain the move to and the operation of EMU and the interlinking question of the structure and operation of an independent ECB and ESCB. We explore both the more traditional European integration approaches – drawing upon international relations theory – which have been widely debunked, in addition to some of the newer approaches which draw on the tools of comparative politics and political economy. The former include neo-realism; a revised neo-realism emphasizing 'voice opportunities' and geo-political developments; liberal intergovernmentalism emphasizing margin of manoeuvre in macroeconomic policy-making and the role of powerful business interests; neo-functionalism; and liberal institutionalism and regime theory. These theories tend to focus on the logic of the move to EMU: the creation and design of the ECB is given less consideration. Nonetheless, traditional theories of European integration provide some insight into the logic behind the structure of the ECB and its operation. We also introduce a structural perspective of international political economy which explains both the move to EMU and central bank independence in term of changes in global capitalism. Comparative politics and political economy offer approaches which, while in some cases paralleling the international relations theories, provide potentially greater explanatory power as to the structure and operation of the ECB. These include historical institutionalism; an analysis of the role of 'epistemic communities'; a cognitivist approach emphasizing the importance of ideas; structuralist explanations focusing on features of the European Community and the European Monetary System (EMS); and rational/public choice explanations including rational institutions building, 'garbage can' models, the problems associated with free-riding and principal–agent theory. This chapter embraces the eclecticism adopted by Sandholtz (1993) which challenges the ability of any one theoretical approach to explain the move to EMU, its institutional design and the operation of the ECB. Our examination here is meant to be a brief overview: it is neither exhaustive nor does it fully capture all the subtleties of each approach. Furthermore, with a couple of exceptions, we do not cover the large amount of theoretically driven literature from the discipline of economics: readers are encouraged to consult Eichengreen and Frieden (2001) among other sources. The insights provided by the different theoretical approaches that we cover here reappear repeatedly in later chapters of this book: in our analysis of the historical development of European monetary authority, of national perspectives on monetary policy-making, the operation of the ECB, its relations with other EU institutions and member state governments as well as its future. However, our study is not directed by any one theoretical approach.

International relations theories

Neo-realism and geo-politics

Central to the (neo-)realist analysis are the state, geo-political power and the calculations of states. The move to EMU and the transfer of monetary policy-making power to the ECB thus cannot be explained in (neo-)realist terms because the loss of permanent *de jure* national sovereignty. Grieco (1995) develops a 'voice opportunities' thesis as a problematic attempt to salvage (neo-)realism and explain the logic behind the decision of major EC member states to surrender their control over monetary policy (see also Sandholtz (1993) and Howarth (2002a)). Grieco (1995: 34) writes:

> if states share a common interest and undertake negotiations on rules constituting a collaborative arrangement, then the weaker but still influential partners will seek to ensure that the rules so constructed will provide sufficient opportunities for them to voice their concerns and interests and thereby prevent or at least ameliorate their domination by stronger partners.

Thus governments are willing to surrender their *de jure* control in order to regain a degree of *de facto* control in a policy area where they have little. Germany's EMS partners wanted EMU in order to increase their voice in the determination of monetary policy, given that the asymmetric operation of the EMS forced them to follow German policy. Grieco assumes that dissatisfaction with the operation of the EMS meant the necessary embrace of EMU. His explanation quite reasonably presents the imposition of the German design for the European System of Central Banks (ESCB) as the necessary *quid pro quo* for the surrender of the deutsche mark. A voice opportunities explanation might also emphasize the equal representation of all Euro-Zone central bank governors on the ECB Governing Council as a *sine qua non* in the design of the ECB.

Some neo-realists might now be tempted to insist upon the inherent fragility of the EMU project and the authority of the ECB. When – in the context of prolonged asymmetric shocks that affect the economies of particular Euro-Zone member states more than others – these member states may come to perceive that their interests diverge excessively from the Euro-Zone mainstream and they may choose to leave the EMU. Neo-realists could also point to the continued divergence in national economic policies, regardless of the convergence criteria of the EMU project and the rules of the Stability and Growth Pact, and the difficulty of forcing member state governments such as Italy and Ireland to respect the criteria (see Appendix 2). The risk remains that member states, for purely domestic political reasons, will adopt economic policies which create inflationary pressures for the other members of the Euro-Zone and thus undermine confidence in the value of the euro and the EMU project more generally.

Neo-realism seeks to avoid theoretical complications by avoiding the use of any concepts from comparative or domestic level politics. The lack of attention to internal domestic dynamics of states raises serious concerns about the comprehensiveness or usefulness of neo-realism to understanding European integration and more specifically EMU. Moreover, neo-realism fails to address adequately the role performed by EU institutions such as the Commission, Parliament and the ECB – as supranational bodies with their own particular interests rather than as fora of intergovernmental relations – in the operation of EMU.

Regarding the move to EMU more generally, most theorists (for example, Sandholtz 1993; Moravcsik 1998; Grieco 1995) discount the geo-political changes in Central and Eastern Europe in 1989/90 as a reason for French and German support for EMU. Geo-political changes are entirely irrelevant if the 2 June 1988 agreement between the West German Chancellor, Helmut Kohl and the French President, François Mitterrand, to push ahead with EMU was truly definitive. However, it is important not to discount the significance of these changes. Baun (1995) demonstrates their importance in keeping the EMU negotiations on track. From the French perspective (Howarth 2001 and 2002a), geo-political changes helped to convince many leading politicians of the necessity of EMU to tie Germany to the EU in order to prevent it from turning to *Mitteleuropa* as its zone of influence. It is impossible to determine whether or not President Mitterrand's resolve on EMU would have been enough to force French acceptance without German reunification. However, it is clear that geo-strategic changes helped him to convince a French political class motivated by *realpolitik* and greatly preoccupied by German power (Garcin 1993). From the German perspective (Loedel 1999a) geopolitical changes encouraged Kohl to overcome strong domestic opposition to EMU and the loss of the deutsche mark, and sacrifice domestic monetary independence in order to assuage the concerns of the European partners, in particular the French.

Another geo-political motive – challenging American monetary dominance – motivated French support for an expanded European currency from the creation of the ECU – the European Currency Unit, the precursor to the euro – in 1979 (Howarth 2001). In the 1970s, French interest in European monetary cooperation was initially sparked by the collapse of the Bretton Woods System and the inability of the French to convince the Americans to re-establish an International Monetary System (IMS) which maintained stability between the dollar and European currencies. The French and others sought intra-European monetary stability in order to diminish the impact of dollar fluctuations (and American interest rate policy) upon European currencies and economies. These international monetary power motives should be seen in the context of the larger French geo-political goal of diminishing American economic and political hegemony in the international system. The French also wanted to avoid the creation of a tri-polar monetary world between the dollar, the yen and the deutsche mark. They argued that the mark could never compete with the dollar as an international reserve currency whereas the ECU had more potential. This logic of monetary power and the use of the term 'écu' in France – always spelled inaccurately with an accented small 'e': the name of a mediaeval French currency – helped to make the expanded use of the European currency and the creation of a stronger European monetary authority to manage and promote it acceptable even to some of the most nationalist opponents of European integration. EMU and the creation of a single currency can also been seen from this perspective. Permanently fixed European parities ended the speculation created by dollar fluctuations. It is much more difficult to speculate against the euro given its size.

Liberal intergovernmentalism

Liberal intergovernmentalism – a recent incarnation of intergovernmentalism developed most famously by Moravscik (1993, 1998) – claims that state strategies are based upon power considerations and preferences. Power is dependent upon a number of factors which will determine whether bargaining and issue linkage strategies are successful for governments. Preferences are shaped by macroeconomic considerations focusing upon the competitivity of large national companies in the context of global capitalism, rather than the geo-political power considerations of governments emphasized by neo-realists. According to

Moravcsik (1998) EC member states, led by France, sought EMU in order to increase their 'margin of manoeuvre in macroeconomic policy-making'. He (1998: 412) argues that '[t]he central French economic goal – greater macroeconomic flexibility through restraints on the Bundesbank and multilateral financing of central bank intervention – remained the same regardless of whether the forum was regional, bilateral or multilateral'.

A major weakness of liberal intergovernmentalism in explaining the move to EMU concerns the formation of national preferences. Moravcsik places great emphasis on the role of large industrial interests in France and Germany and correctly challenges claims that business support did not exist (1998: 380). However, this should not lead to the conclusion that business interests created the momentum behind the project. In late 1986, former French President Giscard d'Estaing and former German Chancellor Schmidt established the Committee for the Monetary Union of Europe which included government officials, industrialists and bankers (Collingen and Schwarzer 2002). The directors of several large EC corporations also created the Association for Monetary Union in Europe in 1987. Both were established with the aim to lobby governments to support EMU. However, neither actually did very much prior to the Maastricht Summit. Moreover, pro-EMU ideas had been circulating in banking and business circles since 1969. Sandholtz (1993: 24–5) appears to be correct when he argues that the interest group approach fails to explain why these ideas were heard in 1988–91 and not previously (see also Eichengreen and Frieden 2001). In France, François Perigot, the president of the leading employers' peak association, the CNPF (*Conseil national du patronat français*), came out in support of EMU only in April 1989, and the CNPF did not produce any study on the impact of EMU until after the Maastricht Summit. UNICE, the EC-wide employers' association endorsed EMU only in December 1990 (*Agence Europe* 1.12.90, 5382). For large importers and exporters, EMU was seen as less important a development than the Single Market Programme.[3] In most EC countries, business opinion – as well as public opinion more generally – was positive, but not actively so, which gave governments room to manoeuvre on the matter. Policy was led by the political and technocratic elites, not societal actors. Nonetheless, consistently high levels of business support help to explain why the project was kept on track despite numerous negotiating obstacles. This support provided a useful justificatory weapon for those in favour of EMU which could be wielded against those who opposed the project. According to a January

1989 poll, 86 per cent of EC employers supported the EMU goal although the precise design of the project had yet to be determined (*Quotidien de Paris*, 20.1.89). Liberal intergovernmentalists also emphasize that the 'sound money' (low inflation) orientation of the EMU project corresponds to the preferences of most large European companies which approve the constraints imposed on national governments to maintain a stable macro-economic framework which would contribute to a more positive investment climate in most Euro-Zone member states – with lower real rates of interest.

With regard to the operation of the Euro-Zone, intergovernmentalists might emphasize the extent to which ECB policy-making reflects the struggle among NCB governors who, despite their legally guaranteed independence and obligation to consider the interests of the Euro-Zone in general, tend nonetheless to represent the economic and political concerns of their respective member states. Furthermore, the on-going battle for Executive Board positions for member state nationals clearly reflects the belief – whether valid or not – that obtaining these positions increases national influence or, that at the very least, membership should reflect the relative importance of the different member state economies. Thus, perhaps unsurprisingly, five of the first six Executive Board members (including the President) came from the five largest economies of the Euro-Zone. Likewise, the battle over the replacement of Christian Noyer as ECB Vice-President demonstrates the extent to which Executive Board positions are prized. By April 2002, all the member state governments accepted appointment of the qualified governor of the Greek central bank, Lucas Papademos, with the exception of the Belgians, who sought the appointment of the Belgian senator and monetary policy expert, Daniel Gros. The Belgians abstained on the final vote but also made it clear that they would block the appointment of a Frenchman – probably Jean-Claude Trichet – as the ECB President in 2003, if the next appointment to the Executive Board was not a Belgian (*Financial Times*, 13 April 2002). An even clearer example of the perceived importance of the placement of nationals was the fudged appointment of the first ECB President in 1998. President Chirac – in a minority of one opposing the appointment of Wim Duisenberg – insisted that the first ECB president be a French national and forced the highly unusual compromise that Trichet would replace Duisenberg half-way through the latter's eight year term. Chirac insisted upon Noyer's appointment as Vice-President as a compensatory stop-gap measure to ensure France's hold over a leading position prior to Duisenberg's replacement.

(Neo-)functionalism

The central prediction of functionalism and more modern reformulations known as neo-functionalism is that European integration would be self-sustaining. The theoretical basis for this prediction was the concept of 'spill-over', whereby initial steps towards integration trigger endogenous economic and political dynamics leading to further cooperation (Haas 1958; Lindberg and Scheingold 1970). Functionalism suggests two areas for spill-over: functional and political. Functional spill-over occurs when incomplete integration undermines the effectiveness of existing economic policies, thereby creating pressures for deepening and widening policy co-ordination. Political spill-over occurs when the existence of supranational organizations sets in motion a self-reinforcing process of institution-building. The regulation by such supranational institutions and authorities (notably the European Commission) of the integrative and interdependent European economy requires such oversight. Monetary integration seemed well-suited for functionalist theorizing. As Overturf (1997; 161) notes, integration:

> was more administrative than political in nature, with tasks being performed by groups better described as coordinating agencies than political governments. It would correspond best to a smooth running, rational technocracy, with experts coming together to solve international problems of co-ordination in specific task areas for the benefit of all.

Functional and political spill-over in the area of monetary policy was both eased and encouraged by national central bankers who played a crucial role in reinforcing monetary cooperation among EC member states from the 1960s. Without this cooperation the move to EMU and the reinforcement of European monetary authority would likely have been impossible.

Monetary integration also represents a logical economic spill-over from the trade liberalization of the 1992 single market programme (initiated by the 1986 Single European Act (SEA)) and the massive increase in international/intra-EC capital flows. By the mid-1980s, several monetary economists – led by the Italian Tommaso Padoa-Schioppa (1994; 2000) – popularized the neo-functionalist 'inconsistent quartet' or 'triangle of incompatibility'.[4] According to the 'quartet', a state cannot enjoy monetary autonomy, free trade, free capital flows and fixed exchange rates at the same time. One must be surrendered. With the

Single European Act (SEA) of 1986, the EC member states had committed themselves to freer trade and capital flows, while the objective of the EMS was to minimize exchange rate fluctuations, thus facing participating states with the 'inconsistent quartet'. Only the country with the strongest currency (West Germany) retained its monetary autonomy. As a justification for EMU, the 'quartet' also assumed that, even though the operation of the asymmetric EMS left member state policy-makers little room to manoeuvre and that interest rate decisions followed those of the Bundesbank, the liberalization of capital meant that even tighter convergence in the EMS was not enough to ensure stable parities.

Several theorists, including Sandholtz (1993), Grieco (1995), Moravcsik (1998) and Østrup (1995), challenge functionalist claims of spill-over from capital liberalization to EMU.[5] First, they argue that the 1992 process strengthened the logic behind monetary integration but did not make EMU necessary. These authors argue that decisions about EMU took place prior to the removal of capital controls in 1990. In fact, the decision on capital liberalization was made at the same 2 June 1988 Franco-German summit when President Mitterrand and Chancellor Kohl reportedly agreed to proceed with discussions on EMU. There was no necessary spill-over. However, it might be possible to argue that there was a *perception* of necessary spill-over from the SEA to EMU via capital liberalization. Revisionist neo-functionalists place increased emphasis upon the role of ideas and actors: spill-over is not only about what is necessary but what people believe is necessary. In this way, neo-functionalism can be partially salvaged if 1) the decision on capital liberalization was *seen* as absolutely necessary following the SEA and 2) French and other EC policy-makers *anticipated* spill-over when they agreed to accept capital liberalization. EC governments most likely thought that capital liberalization created an economic dynamic encouraging EMU, in addition to it being the German precondition for starting the EMU negotiations. However, it is unlikely that they agreed to start the negotiating process on EMU *because* they accepted the need for capital liberalization and saw a necessary link between the two. Still, neo-functionalism at the level of perception remains a possibility. Moreover, the recognition of EMU as a long-term objective in the SEA encouraged this perception.

Prior to the Maastricht Treaty, political spill-over involved measures to reinforce cooperation among EC central bank governors. The EMU project through the convergence criteria, embodied further spill-over, restricting the economic policy-making of national governments. This was further reinforced by the Stability Pact, which specified fines for countries which failed to respect the 3 per cent public deficit criterion and forced member state governments to prepare medium term economic guidelines to demonstrate the sustainability of national efforts to maintain low deficits – developments made possible by general provisions in the Maastricht Treaty. In the context of the EMS, economic policy co-ordination among national governments and a degree of economic policy convergence was accepted as a necessary pre-condition for exchange rate stabilization in the ERM. Since the start of the EMU project, the issue of spill-over has been linked closely to the construction of 'economic government' (or 'governance') at the EU level. From the late 1980s, European politicians and economists have disagreed as to the extent to which national economic policies must be harmonized – for example, should there be tax harmonization? – the precise nature of economic policy co-ordination, the profile of the Eurogroup, the rigour with which the Stability Pact fines should be imposed and the relationship between the ECB and other EU institutions. The pressure for further political spill-over has been great, held back by certain member states which seek to retain as much margin of manoeuvre in macroeconomic policy-making as possible despite the constraints of the Single Market and the operation of the Euro-Zone.

Liberal institutionalism/regime theory

Liberal institutionalism – often combined with some form of regime theory – explains the EU, and more specifically EMU, as an international regime. Regimes – defined as the principles, norms, rules, and decision-making procedures around which actor expectations converge on a given issue (Krasner 1983) – can help structure an analysis of the operation of EMU and the role of the ECB. Understanding the regime of European monetary and economic integration involves emphasizing the institutional components of joint-decision-making and the design and enforcement of Euro-Zone rules. Moreover, norms of behaviour can be identified with regard to EMU: the necessity of compromise, the transparency and close co-ordination of economic policy and a careful public discourse to avoid undermining the credibility of EMU.

Thus liberal institutionalism emphasizes the importance attached to the role of institutions and norms in the process of European integration. This approach suggests that institutions 'matter' (Keohane 1989) by affecting the interests of member states and mitigating the relative gains of states (Baldwin 1993). Joint or absolute gains from agreements, the development of long term relationships engendering trust among actors, and expectations of reciprocal behaviour can be achieved through the development of common interests built on institutions. Such approaches also highlight the importance of domestic politics to understanding how choices and preferences are constructed and how common interests can be identified. In short, EU decision-making institutions and the norms and expectations of behaviour within the EU, have produced a sustained pattern of cooperation and integration based on the choices and preferences of state actors.

Liberal institutionalist theory (for example, Axelrod (1984) and Keohane (1984)) would explain the design of EMU in terms of the 'constitutionalisation' of 'sound money' ideas in participating member states through the convergence criteria, the principle of independent central banks and the primary goal of the ECB: the pursuit of price stability. A 'stabilization' regime is created at the EU level in which the ECB plays a core role as policeman. If individual Euro-Zone member states fail to pursue policies that contribute to price stability in the Euro-Zone, the ECB can criticize them publicly (while the Commission can recommend that the Eurogroup do so). Most importantly, the ECB possesses its interest rate weapon to encourage member states to modify their economic polices, to ensure the maintenance of low inflation. However, the ECB must seek to perform its policeman role in an unobtrusive manner which does not damage its relationship with the member states and seek to build a good relationship with them in its presence in the Economics and Financial Committee (with EU treasury and central bank officials), at Eurogroup meetings (with Euro-Zone ministers of finance) and in international fora. Liberal institutionalists examine the current development of EMU in terms of these pre-existing norms: the development of economic policy co-ordination at the European level, the macroeconomic policies adopted in the participating member states, the role of the ECB in relation to political authorities (the Eurogroup, the Commission and the European Parliament) and the ECB's own policy-making are all seen in terms of how they reinforce or undermine the stabilization goals of EMU, the credibility of ECB monetary policy-making and even the legitimacy of the stabilization goals and ECB control. The role of the ECB in the 'international regime' of EMU is discussed further in Chapters 4 (organization and powers) and 5 (legitimacy and accountability). Some member state governments – notably the French – have sought to challenge the norms underpinning EMU and the role of the ECB. France's position on the need to qualify both the stabilization bias of the EMU project and the central bank independence and convergence rules which ensure this bias is explored in the chapter on national perspectives.

Structural changes in global capitalism

Dyson *et al.* (1995), amongst others, argue that EMU and the creation of an independent ESCB should be seen in terms of national central bankers seeking to reassert their control in the context of major structural changes in the global economy which weakened their policy autonomy during the two decades prior to EMU. Thus the interests of central bankers as actors are of explanatory importance – as argued by some applications of rational/public choice theories (see below) – but only secondary as they have been very much shaped, and their influence very much determined, by larger structural factors. Referring to Moran (1991), Dyson *et al.* (1995: 473) argue that the proliferation of institutional investors (particularly from overseas) weakened European central bankers because it undermined their traditional social and cultural cohesion ('cosy networks') with narrow and exclusive domestic financial communities. Furthermore, the rapid increase in international capital flows overwhelmed national capital controls and the domestic reserves that national central bankers could wield in managing exchange rate policies within the ERM, and considerably weakened the effectiveness of traditional monetary targeting (O'Brien 1992 and Porter 1993). In the EMS, the 'inconsistent quartet'/'triangle of incompatibility' set in: participating treasuries and central banks gradually lost their monetary policy autonomy as they sought to limit exchange rate fluctuations, while following Bundesbank interest rate decisions, in the context of increasing financial integration. However, at the same time, the need for increased co-ordination within the EMS and the need to follow the German lead on price stability increased the power of participating central banks in relation to treasuries and governments and increased the importance of price and exchange rate stability and credibility building. The influence of central bankers was reinforced by the market penalties – thus structural factors – imposed on countries that inadequately toed the line. Market penalties helped reinforce convergence towards 'sound money' and support for central bank independence, which could be presented as a low-cost reform to combating the high inflation of the 1970s and 1980s. Globalization and the deregulation of the financial markets increased convergence in national financial structures in West European countries, which contributed to the acceptability of monetary integration. Central bankers also argued that influence over monetary policy could be regained from the financial markets by acting collectively, creating a single European currency managed by a credible independent European central bank.

Comparative political science approaches

Historical institutionalism and epistemic communities

Liberal institutionalism is mirrored in comparative political science by historical institutionalism, which emphasizes path dependency in the construction of EMU: that is, the determination of institutional and policy-making outcomes by the sequence of decisions made over time (Pierson 1996). A path dependency approach to understand the operation of ECB monetary policy since 1999 would emphasize the rules established in the Treaty on European Union and reinforced by subsequent decisions which ensure the continued pursuit of low inflationary policies (Campanella 1995). Policies are thus not the result of ideas, *per se*, or the calculation of the interests of individual members of the ECB Governing Council. Moreover, path dependency leads to the continuity of policy-making which is unlikely to change given the risks this would pose to the credibility of the ECB.

Those academics who emphasize the role of 'transgovernmental relations' in the creation of the EMU project argue that the officials with most influence over monetary policy – notably, central bankers and treasury officials – had become used to working with each other and shared more in common than with their respective national colleagues. The fora for this cooperation were the meetings of EMS central bank governors following those of the International Bank for Settlements in Basle, ECOFIN (ministers of finance), the EC Monetary Committee (becoming the Economics and Financial Committee in 1999, consisting of treasury and central bank officials) and from 1987 the Franco-German economic council (treasury and central bank officials from the two countries). Verdun (1998b and 1999) examines the role of the central bank governors in these various fora as well as the Delors Committee as an 'epistemic community'.[6]

The following chapter of this volume examines the history of European monetary authority in terms of the construction of a powerful epistemic community. The fora listed above were not only additional mechanisms for intergovernmental bargaining (see Rosenthal 1975) but also involved policy learning and socialization which were an important driving force for improved policy co-ordination and monetary integration. Given the central importance of the governors to the success of the EMU negotiations, this would also suggest the importance of this epistemic community to understanding the process leading to the Maastricht Summit. (Verdun (1999) lists four ways – discussed *inter alia* in the next chapter – in which the Delors Committee played an important role in the EMU negotiation process). Applying a structuralist approach (see below) Dyson *et al.* (1995) argue that the development of financial markets into the 1980s facilitated the growing dominance of the monetary experts, who set the agenda of acceptable monetary policy-making and monetary cooperation which governments accepted. Their success owed to their uniform insistence on coherent ideas about monetary policy (low inflation and currency stability). Any government that opted to deviate from these goals faced the sanction of the financial markets which could undermine the stability of the national currency. Verdun (1998b: 190) argues that the integration process could only move forward if conducted along the lines of what monetary authorities had decided as the common line. The interests of the various national monetary authorities were not completely dissimilar from their national governments (as monetary authorities also included finance ministers), but they did not simply fight over perceived 'national' interests. Nor did they come up with a 'lowest common denominator' solution as neo-realists predict which would have been the case with intergovernmental bargaining. The process of policy learning and socialization moulded these monetary authorities. Working within a European institutional framework, they began to look at their interests somewhat differently and sought acceptable European solutions to the problems.

It should be noted that some scholars question the usefulness of the epistemic community approach to explain the move to EMU. Dyson (1994) for one questions the importance of an epistemic community to the spread of 'sound money' ideas across several countries, concluding that this approach to policy-making fails to explain the decision by key member state governments to support the EMU project. Rather 'the national basis for economic policy ideas remained solidly entrenched' (1994: 251). Other scholars focus upon the importance of a domestically based epistemic community which helped to enforce 'sound money' attitudes in several EC member states which in turn made it possible for governments to accept the imposition of the German standard on inflation, the EMU project and specifically the appropriate model for central banks.[7]

The debatable importance of an epistemic community in the move to EMU also raises the problem that the major building blocks of EMU –

'sound money', neo-liberal reform and the independent ECB – were all pursued at an elite level. Prior to the December 1991 Maastricht Summit, these issues were not the subject of widespread political debate or interest group mobilization. In this sense, the move to EMU and its institutional design correspond to much of European integration which is marked by elite driven developments and technocratic policy-making rather than efforts to galvanize democratic participation. McNamara (1998: 174) also points out that 'all this could change … for EMU both exacerbates and makes visible what was previously obscured, that is, the social costs of neo-liberal reforms and the democratic deficit inherent in European integration more generally'. Thus the influence of central bankers in the lead up to EMU and the reinforcement of their power in the Maastricht project point to concerns regarding the democratic deficit which are discussed in Chapter 5.

The cognitivist approach: the importance of 'sound money' ideas

The prevalence of 'sound money' ideas made EMU possible (Dyson 1994; McNamara 1998; Sandholtz 1993; Verdun 1996; 2000b), notably because the acceptance of these ideas enabled the French and other member state governments to accept the institutional design – independent central banks – and rules that entrenched 'sound money' – the convergence criteria and the primacy of price stability – whereas prior to the 1980s most were not willing to do so. Lessons of policy failure in France and other countries (Howarth 2001), the ill-effects of macro-economic and monetary policies that resulted in relatively high inflation, increased the attraction of 'sound money'. Likewise, policy-learning from the success of the German model of independent central banking encouraged governments to accept independence as the best way to reinforce the credibility for tackling inflation and the need to transpose the German model to the European level. 'Sound money' has been embedded in a competitive neo-liberal policy consensus 'based on a pragmatic version of monetarist theory, one that advocates a monetarist emphasis on price stability while departing from monetarism in advocating fixed exchange rates' (McNamara 1998: 173). 'Sound money' is rooted in the rise of neo-classical economics which upholds the neutrality of monetary policy in the long run, the view that the reduction of unemployment depends principally upon supply-side policies and the importance of agents' expectations and thus credibility building for the effectiveness of monetary policy. As the principal measure for building credibility, neo-classical economics advocates the isolation of monetary policy from political influence – which risks sacrificing 'sound money' for other short-term political and economic goals – and independent central banks with the legal obligation to pursue price stability.

Neo-liberal views were shared by the economists working on the Commission's *One Market, One Money* study of EMU. The first ECB president, Wim Duisenberg is a monetarist who has long been known for his emphasis on monetary rigour as Dutch central bank governor. Verdun (1996) looks at how the rise in popularity of neo-liberalism in the 1980s proved conducive to monetarist policy-making, while Gill (1997) shows the strength of neo-liberal ideas in EC institutions, as does Hall (1986) in other international organizations. The economic slow-down and rise in unemployment in the early to mid-1990s in several West European economies, and the demands – coming principally from French governments – for a greater 'balance' in EU economic policies (see Chapter 3) have only moderately threatened the existing consensus. If the move to EMU relied upon the neo-liberal consensus, the successful operation of the Euro-Zone will rely upon the continuation of this consensus.

Marcussen (1998, 2000) examines the important role of three ideational mechanisms in the development of support for central bank independence: central bankers as 'ideational entrepreneurs', Germany as the ideational model and – an idea introduced by DiMaggio and Powell (1991) – ideational coercion. Marcussen seeks to explain why the EU member states not participating in EMU – Britain, Denmark and Sweden – all, nonetheless, opted for central bank independence, even though this was contrary to their monetary policy-making traditions, and why the French chose to do so right at the start of Stage Two of EMU in 1994 rather than wait until 1998. His core argument, however, can be applied to several of the other EU member states and helps to explain the logic behind the independence of the ECB. Marcussen (2000: 23) argues that much of the pressure behind reform was neither economic nor legal but was rather ideational: 'once a causal idea about the positive relationship between central bank independence and low inflation performance has become safely institutionalized in formal treaties, it starts to become difficult to avoid its constraining impact because any deviance from this norm will be considered to be illegitimate'. Ideational coercion – indeed a form of 'peer pressure' – played a role in that if reform was not undertaken, the national policy elites risked being excluded from the EU policy elite. Finally, a cognitivist approach to ECB monetary policy-making since 1999 would insist upon the continued importance of sound money ideas and the peer pressure of central bankers which would have much greater influence over interest rate decisions than national bias. However, unlike path dependency approaches, a cognitivist approach would also accept the possibility of ideational shift in the central banking community and the influence of ideas about effective monetary policy coming from international organizations and academic communities. While the Treaty on European Union mandates the ECB to maintain low inflation, the bank's Governing Council retains the power to determine its own inflation target.

Other theories of central bank behaviour

Before proceeding to structural explanations of EMU and the ECB, we should also mention a couple of the traditional theories of central bank behaviour which fit uneasily into the three categories of comparative political theory (see Dyson *et al.* 1995: 476). Public-interest theories assume some broad consensus amongst central bankers and economists as to what is 'appropriate' policy and thus can be linked to ideational explanations. Public-interest theories attempt to explain the behaviour of central bankers as an exercise in applied welfare economics: avoiding inflation and stabilizing financial markets in the interests of the population (as opposed to the selfish, short-term behaviour of politicians and market operators).[8] Personality theories focus on the influence of important individual central bank governors (Boyle 1967; Friedman and Schwartz 1963: 411). It is clear, that the most powerful central banker of the period during which the discussions and negotiations on EMU took place, Bundesbank President Karl Otto Pöhl was a more conciliatory president than either his immediate predecessors or his immediate successor. Likewise, Pöhl's French counterpart, de Larosière, enjoyed considerable prestige as the former head of the International Monetary Fund (IMF). However, personality theories fail to demonstrate any correlation between the start of negotiations and the arrival of new influential central bank governors or their relations with powerful political figures. The press coverage of the ECB since the start of EMU and the drop in the value of the euro has frequently – but problematically – turned to commentary on the ECB president, Wim Duisenberg's, managerial and communications competence, and has even occasionally entered into the realm of personality analysis.

Structuralist explanations

In addition to changes in global capitalism, Dyson *et al.* (1995: 479–81) point to three structural factors that help to explain the influence of central bankers in relation to governments in the 1980s and the structure of the ESCB agreed upon by member state governments. First, the Bundesbank both had a great deal of influence in the EMU discussions and became the model for the future ECB principally because of its impressive and long-standing record fighting inflation, and the role of the deutsche mark as the most credible EU currency and the ERM's anchor. The Bundesbank also enjoyed a domestic support base and legitimacy denied most other central banks. This enabled the Bundesbank to insist upon the 'economist's' approach to EMU, which involved gradualism, economic convergence and the indivisibility of monetary policy (Smaghi *et al.* 1994). A second structural factor was the powerful position of leading national central bankers in relation to national governments and national bureaucracies. The power of bankers was due either to a tradition of distance and respect (as in Germany and Italy) or close ties and elite networks in the operation of policy (as in Britain and France). Their influence ensured the success of EC central bankers in dominating the formulation of the ESCB's institutional design.

A third structural factor was the limited resources that the EC had at its disposal. The European Commission and other EC institutions were thus relatively weak in relation central bankers during the discussions and negotiations on the ESCB design. Modest EC resources also ensured the unbalanced institutional organization of EMU in favour of the ECB and monetary policy, with the limited construction of the economic policy side of EMU and a political counterweight ('economic government') with which the ECB could enter into dialogue. The small size of the EC budget dictated the construction of EMU which focused on the rules-based approach of monetary policy involving the convergence criteria, a ban on 'bail-outs' for governments, and the development of monetary instruments to achieve price stability. Furthermore, Dyson *et al*. (1995: 480) argue that the in-built regulatory approach of the EC to policy (see Dehousse 1992; Majone 1996, 1999) placed the burden of work for developing EMU on to the Committee of Central Bank Governors and, from 1994, the European Monetary Institute (EMI), where the central bankers designed a project to their liking.

Rational/public choice theories

Some rational/public choice theories of central bank independence which emphasize the aims of politicians seem to have some potential validity, especially given the centrality of political actors in the decision to move to EMU. These include scapegoat theories (Kane

1980) which emphasize the desire of national governments to pass on monetary policy to independent central banks so that blame for policy failures can also be shifted. Another variation on rational choice places emphasis on the desire to eliminate the domestic political difficulties associated with exchange rate adjustments (Bean 1992; Østrup 1995). According to this approach, EMU became necessary when – in the context of liberalized capital flows – the EMS demonstrated its failure to maintain stability despite considerable economic convergence. March's (1986) 'garbage can' model of policy-making applies: national governments sought to transfer responsibility in a policy area that had become too politically difficult to manage. This claim has a certain intuitive appeal: none of those countries most in favour of EMU in the late 1980s – France, Italy, Spain and Belgium – had distinguished themselves over the previous decades by their exchange rate policy successes.

The application of a rational choice approach to weak currency country policies on European monetary *cooperation* – notably the creation of the EMS – makes sense. As these countries (France, Italy, etc.) tended to suffer from speculation, and devaluations were normally perceived to be a sign of managerial inadequacy, governments had a certain political interest in constraining their margin of manoeuvre in economic and monetary policy-making within European exchange rate mechanisms in order to ensure greater monetary stability. However, in the French case at least, the application of the 'garbage can' model to policy-making on EMU and the decision to transfer powers to an independent Bank of France and the ECB is problematic. French policy-makers did seek to transfer control over monetary policy to European institutions because it was politically difficult to manage. However, they blamed this difficulty upon the asymmetric functioning of the ERM in the context of increased capital mobility – which considerably narrowed their margin of manoeuvre in monetary policy-making – not upon their control *per se*. Indeed, the French sought to maximize their *de facto* control as much as possible through the creation of a more symmetric EMS (Howarth 2001).

Opposition to central bank independence was well-entrenched in several EC member states, including the most influential country in favour of EMU: France. Despite ideational pressures pushing in the direction of independence and a relatively recent record of devaluations, in the late 1980s few French politicians and officials in the powerful Treasury division of the Ministry of Finance which controlled monetary policy, considered independence to be either desirable or necessary to enhance the credibility of French policy-making (Howarth 2001; see also the section on France in Chapter 3). Politicians thus did not transfer monetary policy because they felt that it was too politically difficult to manage. Rather, President Mitterrand accepted – in the face of considerable domestic opposition – German conditions on the institutional design of EMU regardless French policy-making tradition. The opposition of most leading French politicians to central bank independence and the attempt to establish a powerful political counterweight to the ECB at the European level, indicates their preference to maintain *as much* political control over monetary policy-making as possible.[9] What the French sought to end were, first and foremost, the politically embarrassing difficulties and economic costs involved in dealing with speculative attacks against the franc, not their *de jure* control over monetary policy. Mitterrand agreed to surrender control over most aspects of monetary policy to an independent Bank of France and ECB *only* when further EMS reform to create a more symmetric system proved highly unlikely and when the Germans refused to modify their position on independence. French efforts to qualify ECB independence since the Maastricht Treaty further demonstrate the problematic nature of claims of 'garbage can' policy-making. Thus the application of a rational choice model to explain the logic behind the support of national policymakers for the transfer of monetary policy-making power to an independent ECB appears problematic. Nonetheless, the attacks by some national governments on the ECB for its policy-making – explored in Chapter 6 – suggest that claims of scapegoating appear to have some limited validity.

The application of public choice theory to the behaviour of national central bankers (including their choice of monetary instruments and how to use them) focuses on how they are driven by the private self-interests of central bankers acting as rational maximizers seeking their own prestige and self-preservation (Toma and Toma 1986). Public choice theory clearly fails to explain the timing of the move to EMU and central bank independence in that central bankers were compelled – in some cases reluctantly – to act by politicians. However, the theory can provide useful explanations (in terms of control maximization) of the strong influence of EC/Euro-Zone central bankers in the discussions and negotiations leading to the agreements on EMU, the role of the EMI in the preparations for the start of EMU, as well as the operation of the ECB in the Euro-Zone.

Campanella (2000) and Elgie (2001) convincingly draw on versions of rational choice theory in order to explore the inter-institutional dynamics of European monetary policy-making in terms of a principal–agent relationship (see Calvert, McCubbins and Weingast 1989 and Pollack 1997): the ECOFIN/Eurogroup (member state governments) as the principal and the ECB as the agent. Campanella (*ibid*.) applies a version of game theory – a variation on the strategic interaction approach (Fratianni and Hagen 1990) – to explain the conflict between the ECB and ECOFIN in the 1998–99 period and the likelihood of continued conflict: 'The strategic interaction approach would predict the emergence of a battle for political dominance, where the fiscal authorities are likely to want the bank to subscribe to their own preferences, while the bank resists these pressures [asserts its independence] and sticks to its own prerogatives' (Campanella *ibid*.: 111). However, Campanella argues that the triangular relationship of principal–agent and a third actor, namely the market constituency, to which the agent (the ECB) is accountable, establishes what she labels – drawing on Axelrod (1984) – an 'iterated strategic interaction'. A standard game-theoretic approach – a one-time game of chicken – does not apply.

> [The actors] belong to the same EMU environment, and are expected to play this game over and over again. This signals that they are bound sooner or later to learn to calculate, before any move is made, the likely consequences of the other group's move on its own payoff. … [ECOFIN/the Eurogroup] must recognize the ECB's motives in resisting political pressures. … This iterated game also explains why the ECB does not always engage in bitter confrontation with [ECOFIN/the Eurogroup]. Indeed, when direct governmental pressures are removed, the bank will eventually review its resistance, settling for an accommodation with political authorities (Campanella 2000: 112).

The details of this triangular inter-institutional relationship are further explored in Chapter 6 of this volume.

Elgie (2001) applies principal–agent theory to understand better the nature of the democratic deficit created by the ECB's control over European monetary policy. First, the theory can be applied to demonstrate that the agent (the ECB) is 'shirking' from the delegation of power as set up by the principal (the member states collectively) in the TEU – principally by insufficiently taking into consideration its secondary goals of supporting the economic policies of the Euro-Zone member state governments – and thus acting in an undemocratic manner. Second, the principal–agent theory can also be applied to explain the underlying logic of criticism of the ECB along the lines that the preferences of the principal have changed since the Maastricht Summit – notably in terms of French government demands for an 'economic government' – thus resulting in a divergence with the preferences of the ECB. Elgie also applies the agent–principal theory to demonstrate ways to diminish the deficit – what he labels as standard and non-standard solutions – in the event that it is deemed to be unacceptable. This application is further explored in the final chapter of this volume.

Rational choice theories can also be applied to explain and attempt to resolve the free-rider problem. In the context of EMU, the risk is strong that individual member states will, for domestic political reasons, not obey the rules of the Stability and Growth Pact and run excessive public spending deficits and/or permit excessive inflation. Although there are penalties – fines can be imposed on countries that fail to respect the deficit criterion – many observers believe that these would not be imposed for political reasons. The February 2002 decision of the Eurogroup not to sanction officially Germany and Portugal for running deficits approaching the 3 per cent figure – as recommended by the European Commission and the ECB – provides a good example. The other Euro-Zone member states would thus pay the price of higher ECB interest rates. This has implications for the ECB which plays the delicate role of policeman, delivering its very public warning to recalcitrant member states, as well as judge, delivering its verdict through its interest rate weapon.

Finally, a rational choice approach – focusing upon cost and benefit incentive structures – can be applied to the decision-making process of the ECB itself. According to this approach, the individual members of the ECB's Governing Council have potentially divided loyalties. NCB governors sitting on the Governing Council are, according to the mandate of the ECB, expected to consider the interests of the entire Euro-Zone when they make policy proposals. However, the governors, while officially independent from political influence at the national level, are prone to represent the economic interests of their own member state. Thus ECB monetary policy-making should – according to this approach – be seen as a reflection of a balance among the differing perspectives of the NCB governors competing to shape policy in a way most suited to the needs of their national economies and even political circumstances.

Conclusion

Several of the theoretical perspectives drawn from comparative politics emphasize the important role of central bankers in the move to EMU and the determination of its rules and institutional design: in historical institutionalist, cognitivist, structural and rational choice terms. However, it is important to note that, although the central bankers clearly played an important role, politicians played *the* crucial role in the move to EMU. Politicians initiated the project and overcame the caution of the central bankers as demonstrated most clearly in the bankers' view that the need for previous economic convergence meant that there should be no fixed dates for stages two and three of the project (Delors 1989: 28). Had the central bankers had their way, EMU may never have come about. Moreover, the bankers failed to convince EC governments of the need for an independent EMI in Stage Two – due principally to German refusal. Nonetheless, despite the clear limits to the influence of central bankers in designing the transition, the EMU project corresponded very much to their preferences: with the convergence criteria, including strictly interpreted rules on deficits, the abolition of government bail-outs, the absence of a counterbalancing EU-level macroeconomic policy ('economic government') and, above all, central bank independence.

In order to appreciate the contribution of different theoretical approaches from international relations and comparative politics to understanding the creation and operation of EMU and the ECB, this chapter has embraced the eclecticism adopted by Sandholtz (1993) in his study of the move to EMU. We argue that only a combination of different theoretical and analytical approaches provides a thorough explanation of the creation of the ECB, but also that the tools of comparative politics are more useful to our study of the operation of the ECB than those of international relations. The creation and operational principles of the ECB must be understood in structural and ideational terms – the development of global and European capitalism and the proliferation of 'sound money' ideas in particular – while the motives of the most powerful member states and central bankers – themselves structured by EC institutions, the operation of the EMS and increasing international economic interdependence – should also be taken into consideration. Chapter 2 examines the history of European monetary authority in terms of the development of an 'epistemic community', while 'cognitive' factors inspire our study of national perspectives on the ECB and central bank independence (Chapter 3). The role of the ECB in the 'international regime' of EMU is explored in Chapters 4 (organization and powers) and 5 (legitimacy and accountability issues), while theories of comparative politics, notably rational choice, inspire much of our analysis of the ECB in operation (Chapter 6).

2

The Long and Winding Road to the ECB: European Monetary Authority in the Prehistory of EMU

Table 2.1 Chronological development of European monetary authority

Date	*Event*
1964	First regular meetings of the Committee of Governors of the Central Banks of EEC member states.
1970	(October) The Werner Report recommends the creation of an ECB and an EC organization of national central banks.
1973	Creation of the European Monetary Cooperation Fund (EMCF / FECOM).
1979	Creation of European Monetary System (EMS) which involves the possible creation of a European Monetary Fund (EMF).
1987	(September) Basle-Nyborg Agreements reinforce inter-NCB coordination and increase EMS support mechanisms.
1988	(26 February) Genscher, the West German Minister of Foreign Affairs, submits a memorandum on the creation of the ESCB including an independent ECB.
1989	(April) Submission of the Report of the Delors Committee recommending the institutional design for EMU including the ESCB and an independent ECB.
1990	(July) Start of Stage One of the EMU project, Committee of central bank governors given additional responsibilities.
1990	At the October Rome (I) European Council, the Heads of State or Government agree to the principle of independent European central banks.
1991	At the December Maastricht European Council, the Heads of State or Government agree to a timetable and conditions for the move to EMU, the creation and powers of the EMI and of the ECB.
1993	(August) The EC ministers of finance agree to widen the fluctuation margins of the ERM to ±15% resulting in a dramatic shift in the co-ordination activities of the Committee of Governors / EMI.
1993	(October) At the extraordinary Brussels European Council, the Heads of State or Government agree to place the EMI (and future ECB) in Frankfurt.
1994	(1 January) Start of Stage Two of EMU. Replacement of the Committee of Governors by the EMI.

Table 2.1 Chronological development of European monetary authority

Date	*Event*
1995	(December) The European Council meeting in Madrid adopts the 'changeover scenario' to the single currency drafted by the EMI.
1998	(March) EMI publishes its *Convergence Report*, recommending that all those member states wanting to proceed with EMU were in a position to do so, with the exception of Greece.
1998	(2 May) On the basis of March 1998 EMI Convergence report and Commission recommendations, agreement by the European Council on the member states to participate in Stage Three of EMU.
1998	(25 May) Compromise in the European Council on the members of ECB Executive Board.
1998	(1 June) Creation of the European Central Bank. Start of term of Executive Board (end of EMI).
1998	(December) Agreement at Vienna European Council to allow ECB President to attend G7 meetings and grant the ECB observer status at the IMF board.
1999	(1 January) Start of Stage Three of EMU. ECB starts to manage the euro.

Introduction

The ECB has had a relatively short history (discussed in Chapter 6) but its antecedents, the Committee of Governors of the Central Banks of the EEC and the European Monetary Institute (EMI) played an important role in the management and development of European monetary policy from the early days of European monetary cooperation to the move to EMU. The history of European monetary authority is, of course, tightly intertwined with the history of monetary integration. Nonetheless, this chapter will not enter into the details regarding the progress of the discussions and negotiations on monetary integration. Readers should refer to the numerous studies of the move to EMU written by political scientists and historians (including, most notably, Dyson 1994; Ludlow 1982; Tsoukalis 1977) and economists and central bankers (including ECB Executive Board member Padoa-Schioppa 1994, 2000; Grahl 1997; Gros and Thygesen 1992, 1998; Kenen 1995; Steinherr 1994; Ungerer 1997). This chapter focuses on the role of EC/EU central bankers in the development of European monetary cooperation and integration. It also examines the debates since the late 1960s regarding the responsibilities of the central bankers in the context of monetary cooperation and more specifically, the responsibilities and powers of a

European monetary authority in the transition period leading to EMU and the design of the ESCB.

The early years of central bank cooperation

EEC central bank governors – notably in the Delors Committee but also in the EMI of the second stage of the EMU project – formed part of an 'epistemic community' which provided the intellectual and institutional backing to the underlying principles of EMU (sound money and finance and central bank independence) (Dyson 1994; Verdun 1999, 2000a).[10] This 'epistemic community' was long in the making. The Managing Board of the European Payments Union (EPU) (established in 1950 and ended in 1958) included central bank governors and national finance ministry officials, who also met regularly at IMF and Organization of European Economic Cooperation/Organization of Economic Cooperation and Development (OEEC/OECD) meetings. The EPU was the most efficient vehicle for West European economic policy co-ordination until the mid-1980s due principally to the temporary payments situation existing in the postwar period. The 1957 Treaty of Rome included provisions for the creation of the Monetary Committee, which comprised one representative from the ministry of finance and one from the central bank of each member state in addition to two representatives from the Commission. This group was to provide a forum for exchange of information and for preparing the meetings of the Council of Ministers of Economics and Finance (ECOFIN). Subsequently, it played a crucial role in the management of European monetary mechanisms (the Snake and the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS)) in particular with regard to co-ordinating system realignments. EEC central bankers also met regularly in international fora, notably the Bank for International Settlements (BIS) (consisting of central bank governors from the Group of Ten).

In 1964, Ecofin mandated the EEC central bankers to meet separately in the Committee of Governors of the Central Banks of the EEC following monthly BIS meetings in Basle. A Commission representative attended Committee meetings as an observer. The Committee's mandate was limited principally to the exchange of information and the resolution of technical issues of mutual concern. The Committee of Governors was one of a series of economic policy committees to develop economic policy co-ordination among the EC Six, to help ensure the smooth operation of the

Common Market. However, it lacked an operational role until the 1970s. In March 1975, the Committee decided – during a period of dollar weakness and volatility – to limit, on an experimental basis, the daily movements in the dollar rates of all EC currencies (not just the Snake currencies). However, this agreement was widely ignored and was not subsequently invoked. In March 1977, the Ecofin Council encouraged the Committee of Governors and the Monetary Committee to extend their consultations on exchange-rate matters. From the summer of 1977, these consultations were aided by the European Commission which submitted at regular intervals analytical papers on recent trends and prospects in exchange markets. The central bank governors also played an important role in both their Committee and the Monetary Committee transforming the often ambiguous Bremen European Council conclusions on the EMS into a workable system.

The idea of a European central bank pre-dates the discussions of the early 1970s in the Werner Committee. In October 1949, the Planning Group of the European Cooperation Administration of the European Recovery Programme presented a timetable for a European monetary union and European central bank, modelled on the American Federal Reserve, as a means to encourage European integration and trade liberalization. The Americans dropped the idea of monetary union when it became clear that several European governments, notably the British, found the resulting loss of sovereignty unacceptable. EMU was not an explicit goal in the Treaty of Rome of 1957 and only limited monetary co-ordination was called for through the EEC Monetary Committee. This Committee and its senior national finance and central bank officials actively called for closer co-ordination of monetary policies, notably to avoid unilateral revaluations. This encouraged the Commission to propose its 1962 *Action Programme for the Second Stage* which involved the creation of a Committee of Central Bank Governors which would manage a system of fixed exchange rates and a European reserve currency, en route to monetary union. French reluctance blocked the implementation of the Programme. However, its publication did stimulate discussions between national ministers of finance – also concerned about the effect of currency instability on the CAP – which led to the agreement on the need for consultations within the Monetary Committee prior to any currency revaluation; an agreement subsequently ignored. Moreover, the ministers of finance created the Committee of Central Bank Governors. The Barre Plan of 1969 was less ambitious than the *Action Programme* and focused on improving monetary cooperation, including the creation of a Community mechanism of monetary cooperation which would be managed by the Committee of Governors. The discussions surrounding the Barre Plan led to a July 1969 Ecofin agreement on prior consultation on all economic policy measures that would have effect on other member states, including monetary policy decisions. However, the unilateral float and revaluation of the deutsche mark in August 1969 demonstrated yet again the weakness of such agreements. The growing instability in the Bretton Woods System and its perceived damaging impact on the operation of the Common Agricultural Policy (CAP) encouraged further discussions.

The Werner Committee and the European Monetary Cooperation Fund

The EC Heads of State or Government meeting in the Hague in December 1969 affirmed the desire to move forward to EMU. Unlike the Delors Committee of 1988–89 which consisted principally of central bank governors, the Werner Committee – set up in March 1970 to examine the practical steps to EMU – comprised only one central banker, the chairman of the Committee of Governors (in addition to the chairmen of the Monetary Committee and other EC economic policy committees, a representative of the Commission, and the chair Pierre Werner, the Luxembourg Prime Minister). The October 1970 Werner Report recommended the creation of an ECB and an EC organisation of national central banks, based on the US Federal Reserve System, which would conduct the principal elements of internal monetary policy and exchange-rate policy in relation to third countries. However, the Report makes only a relatively brief reference to the necessary institutional framework and was vague as to its establishment and its relationship to political authorities. The Werner Committee's proposals on the move to EMU failed because of the fundamental divergence between the 'economists' (led by the Germans) and 'monetarists' (led by the French). The former saw institutional construction and the establishment of a 'single' currency as following after a necessary economic convergence. The latter saw a 'single' currency and monetary institutions as an initial step required to help achieve economic policy convergence (Tsoukalis 1977). Most members of the French neo-Gaullist government also saw the loss of sovereignty as unacceptable and French President Pompidou, who had first called for EMU, was forced to retreat to a more negative position. At the same time, many Germans saw the transfer of monetary power from the Bundesbank and the eventual loss of the mark – both important symbols of postwar German economic prosperity – as equally unacceptable. The immediate French concern in the EMU discussions was to improve European support mechanisms to support weaker currencies (notably the French franc) and maintain stability in inter-European parities.

The creation of the European Monetary Cooperation Fund (EMCF/FECOM, the Fund's French acronym) in April 1973 was the major institutional legacy of the EMU discussions. The Fund – legally based temporarily in Luxembourg – was responsible for monitoring the 'Community's exchange rate system', even though only five of the nine EC member states participated in the Snake. Each EC member state governor on the Fund's governing board had one vote. It was expected to provide the central bank governors their first substantive collective task since the European Payments Union (EPU) of the late 1940s: the management of a small percentage of European reserves pooled to help maintain stability in the balance of payments of countries participating in the Snake monetary mechanism established in April 1971. The Fund assumed responsibility for the existing currency support mechanisms (very-short-term and short-term facilities) – which had been developed through agreements by the central bank governors during the EMU negotiations – although the BIS was appointed the executing agent. It should be stressed that there was little substance to these agreements and the creation of the EMCF was of little actual significance to the operation of European monetary policy co-ordination: the Fund's board met formally for a few minutes each month after the Committee of Governors meeting where all the important issues were discussed. The Fund employed no one. Moreover, the separate central banks continued to hold and manage, on behalf of the EMCF, the pooled reserves and receive interest on them, which effectively limited the role of the EMCF to that of a bookkeeper. This limited role was due in part to the Fund's formal subordination to ECOFIN. The EC ministers of finance had rejected the Werner Committee's proposal that the Committee of Governors control the Fund. Several bank governors – notably the president of the independent Bundesbank – found this political yolk unacceptable and insisted that the substantive work on monetary policy co-ordination remain in their Committee.[11] This issue of autonomy would reappear in subsequent discussions on the reinforcement of the Fund.

Reinforced monetary co-ordination

A second product of the EMU discussions of the early 1970s were new provisions for reinforced short-term economic policy co-ordination, including monetary co-ordination (22 March 1971 ECOFIN Decisions). The Committee of Governors was asked to establish general – non-binding – guidelines for the trend of bank liquidity, the terms for supply of credit and the level of interest rates. However, no policy co-ordination resulted beyond the day-to-day concertation in the foreign exchange market. The Committee of Governors established a Committee of Alternates and expert groups, with small staffs, to monitor exchange market developments and trends in national money supplies and their determinants. The Committee also established (with the Monetary Committee) a Working Group on harmonization of Monetary Policy Instruments to follow up on the March 1971 decision. However, this group failed to contribute significantly to improved co-ordination: it only published a series of detailed surveys prepared by the individual central banks on national monetary policy instruments and their use. Although there was a gradual and significant increase in the exchange of information about domestic aspects of monetary policy, the money supply projections continued to be prepared separately on a national basis. The IMF remained the principal source of objective information for assessing the general monetary situation in the EC member states. Discussion in the various EC monetary committees proceeded predominantly on information volunteered by national policy-makers (often only orally for current issues) and no major initiatives were produced to improve the coordination (Gros and Thygesen 1992: 22).

Policy co-ordination – or more often *attempts* at policy co-ordination – was intensified in the context of the tighter fluctuation margins of the ERM of the EMS, which increased the significance of central bank governor discussions. This was in part due to the creation of a new credit mechanism, the extension of the repayment period of credit supplied under the short-term monetary support mechanism and the enlargement of medium-term financial assistance for this repayment. Moreover, the governors were given additional powers: by unanimous vote, they could decide on the use of 'debtor rallonges' to extend additional credit beyond the automatic extension of repayment allowed to debtor countries. During the 1980s, these facilities were gradually extended. However, it is important to stress that these support mechanisms were never very significant to the operation of the EMS because they formed only a small percentage of the reserves used by NCBs in their interventions. A central issue in the negotiations leading to the creation of the EMS had been establishment of some objective indicator or threshold (the 'divergence indicator' calculated in terms of ECUs) to trigger automatically policy co-ordination discussions. Had the indicator actually been used – it was not – this would have increased the role of the central bank governors even more. Overall, co-ordination remained limited because the EMS was principally a 'limited, defensive mechanism to improve monetary stability' (Gros and Thygesen 1992; 52). Moreover, even though the EMS involved increasing the common pool of European reserves as well as a system of compensation for holders of ECU, it did not involve transferring control over these reserves and this system – managed by the BIS – to the EMCF, which remained limited to its bookkeeping function.

In their April 1978 initiative on the EMS, French President Giscard d'Estaing and German Chancellor Schmidt called for the EMCF to be transformed into a European Monetary Fund (EMF) within two years of the start of the EMS: to manage pooled exchange reserves in accordance with a joint exchange-rate policy and offer balance of payments assistance. However, in the ensuing negotiations the Germans and French failed to agree upon what the EMF should do and plans for it were quietly shelved in December 1980. In 1982, the Commission produced a note listing ten possible tasks for the EMF, ranging from the relatively insignificant assumption of the accounting functions of the EMCF to responsibility over realignments in the EMS and for formulation of a joint monetary policy. The French had wanted the EMF to manage exchange reserves and promote the use of the fledgling European currency unit, the ECU, as a reserve currency and a repayment instrument. Crucially, the Germans (the Bundesbank) had feared that with more power to manage the ECU, the creation of the EMF would have inflationary consequences, especially given that it would be under the formal control of ECOFIN (Emminger 1986). Also, as with the Werner Plan, the EMF was overtaken by events: the international economic downturn of the late 1970s and early 1980s and the continued divergence in inflation performance among EC countries. The EMF saga suggests unmitigated failure. However, it also provided a useful lesson for EC governments, encouraging them to embrace a different approach to institutional matters in the late 1980s: the strengthening of a European monetary authority could only be achieved in the context of a larger project of monetary integration which satisfied German concerns on inflation and the authority's independence.

Furthermore, the opposition of the Bundesbank to the EMF demonstrated that future institutional reform ideas should first be vetted by the central bankers in their Committee rather than presented as a virtual *fait accompli* by political leaders.

The increased subtleties of co-ordination in the context of the EMS and difficult realignment negotiations increased the reliance of governments on the Committee of Governors and the Monetary Commitee. Gradual capital liberalization in the 1980s would impose even greater demands on monetary co-ordination. Moreover, the governors played a central role in EMS reform, sought above all by the French: the details of the September 1987 Basle-Nyborg agreements were prepared and first approved by the Committee of Governors in Basle (and subsequently by ECOFIN in Nyborg). The reforms involved measures to strengthen the operating mechanisms of the EMS including interest rate co-ordination among participating finance ministries and NCBs and the promotion of the more effective use of the credit support mechanisms.[12] However, these reforms did not reinforce institutional structures *per se*. Most central bankers were interested in discussing further monetary union. However, they were generally pragmatic about it. They preferred to develop the full potential of the Basle-Nyborg agreements within a system of voluntary co-ordination (Gros and Thygesen 1992). The Committee of Governors sought to 'strengthen the procedure for joint monitoring of economic and monetary developments and policies with the aim of arriving at common assessments of both the prevailing conjuncture and appropriate policy responses.' (Committee of Governors 'Press Communiqué' 18 September 1987), which remained a core objective right up to the start of Stage Three of EMU in 1999. The governors sought a better balance between exchange-rate movements within the fluctuation margins, changes in interest-rate differentials and interventions.

The French drive for EMS reform and the Genscher initiative

Mitterrand's March 1983 decision to keep the franc in the ERM made possible future developments in monetary integration. In 1985, Jacques Delors, as Commission president, (supported by the French) sought unsuccessfully to include mention of a European monetary authority in the Single European Act (SEA) (1986), although the goal of eventual EMU was incorporated into the Act's preamble and the EMS and the ECU (described as the 'European currency') were brought into the scope of the treaties. Of potential significance for the future development of European monetary authority, the SEA applied the unanimity rule of Article 236a to any institutional development in the field of economic and monetary policy – which meant that it could be vetoed by the British government. The new French neo-Gaullist-led government of Jacques Chirac (1986–88) began actively pushing for a reinforced EMCF to promote the use of the ECU which was seen as a way to challenge the supremacy of the German mark (Balleix-Banerjee 1999; Howarth 2001). This was part of renewed French efforts to achieve greater symmetry within the EMS: to increase strong currency central bank support for weak currencies (notably increased and obligatory Bundesbank support for the franc, through increased interventions and co-ordinated interest rate changes). On a few occasions in 1987, in newspaper interviews and speeches in France, the neo-Gaullist finance minister, Edouard Balladur speculated on the possible eventual creation of a new European monetary authority, anticipating the most important issues discussed in the Delors Committee and during the intergovernmental negotiations on EMU in 1990 and 1991.[13] The questions that he posed – in place of specific proposals for the establishment of a new European monetary authority – suggest that he, or at least his advisers, had actively considered the transformation of the EMCF, but that this was not a high priority for the moment.

Balladur reintroduced major institutional reform to the debate on the EMS in his memorandum of 8 January 1988. The French finance minister commented on the need for 'the rapid pursuit of the monetary construction' as a logical follow up to the Single Market programme and speculated on the creation of a 'common central institution'. Domestically, he and Chirac presented a far more gradualist vision and insisted that the creation of a reinforced European monetary institution was a long term issue, not of immediate importance, and refused to give details of their vision (Balleix-Banerjee, 1993, 1997 and 1999). However, the creation of some form of European monetary institution became an issue of debate – albeit a minor one – during the 1988 French presidential election campaign. Acting independently of the French government, the 'fathers' of the EMS, former President Giscard d'Estaing former West German Chancellor Schmidt joined forces again to lead the campaign for the establishment of an ECB. In late 1986 they set up the Committee for the Monetary Union in Europe which included former politicians, central and private bankers and academics as members (Dyson 1994).

In 1987, they also encouraged the establishment of the Association for Monetary Union in Europe (AMUE) which included several European large industrial companies as members. The Association published statements and the results of surveys demonstrating the largely favourable attitudes of company bosses to EMU. On 24 February 1988, Giscard and Schmidt presented a statute for an independent central bank (*Le Monde*, 25.2.88). Likewise, leading members of the Bank of France called for a hard European currency and European central bank to manage it.[14]

On 26 February 1988, to the surprise of most observers, the German Minister of Foreign Affairs Hans-Dietrich Genscher submitted a memorandum with the title 'A European Currency Area and a European Central Bank' which presented both as an 'economically necessary completion of the European Internal Market' (Genscher, 1988). Genscher had seized the opportunity to forward his federalist agenda and presented what was in fact a conciliatory position between the old 'economist' and 'monetarist' positions in order to forward discussions on EMU (Genscher 1995, 1998). On the one hand he argued that a 'common' currency and a federal European system of central banks was crucial to help build economic convergence necessary to make monetary union work. In his effort to make his project appealing to the French and Italians, Genscher emphasized that the ECB should be set up in order to promote the use of the ECU as a general means of payments in Europe and reduce European dependence on the dollar. His project was criticized both by the German Ministry of Finance and, more publicly, by the Bundesbank. However, Genscher's insistence on the autonomy of the ECB and NCBs from political instruction and the sole goal of price stability reflected one of the core German demands during the ensuing discussion: that the ESCB would have to follow a German institutional design or EMU would not proceed. The ESCB must not be obliged to finance public sector deficits. Likewise, the ESCB would mirror the federal organization of the German system of central banks with an appropriate balance between central and federative elements in its decision-making. Drawing on the German Stability Act of 1967 and the Amato memorandum of 23 February 1988, governments would also be expected legally to commit themselves to price stability. These formed the core elements of the institutional design for EMU subsequently agreed upon. Finally, Genscher called for a small group to be created at the June 1988 Hanover European Council to draw up a more precise project for EMU in order to forward the project rapidly.

The Delors Committee and the ECB

At the Hanover Summit, it was agreed to create a committee consisting mainly of central bank governors, chaired by the Commission president Jacques Delors, to examine the practical steps leading to EMU. The decision by Chancellor Kohl, President Mitterrand and Delors to leave the matter initially to the central bankers (in addition to three independent persons, Delors and the European Commissioner Frans Andriessen) acting in a personal capacity, reflected the recognition that German (Bundesbank) demands on central bank independence were a *sine qua non* of the project. National treasury officials from several countries balked at German demands on autonomy and focused a great deal more on the economic side of EMU and the matter of the dialogue between economic and monetary policies – as demonstrated by the recommendations of the High Level (Guigou) Group which, during the 1989 French Council presidency, was in charge of preparations for the Intergovernmental Conference (IGC) on EMU. Moreover, the difficulties created by the exclusion of the Committee of Governors in the initial preparation of the EMS and the relative success of the discussions leading to the Basle-Nyborg agreements served as useful reminders that central bankers should be placed at the centre of discussions. The Delors Committee was charged with the responsibility of examining both the economic and monetary aspects of unification, the transition and above all the requirements for achieving EMU. Although the Committee outlined provisions for the ESCB, it was not mandated to propose a draft statute for a European central bank. This was to be left to the Committee of Governors after the publication of the Delors Report, although an unofficial group chaired by an academic Jean-Victor Louis and consisting of central bank officials (notably those with legal expertise) worked on the ESCB design. The central bank governors agreed unanimously on the Delors Report, released in April 1989, and the work of the Louis group was published shortly afterwards.[15] Both provided a blueprint for the draft statute of the ESCB and of the ECB which was subsequently adopted by the Committee of Governors in November 1990.[16] Only minor modifications were subsequently made to the institutional structure of EMU. However, several matters eluded agreement in the committees and could only be resolved in the following IGC.

The Delors Report embraced and clarified the conditions outlined by Genscher in his memorandum and by Bundesbank President, Karl-Otto Pöhl in his own paper presented to Committee members at the start of their work in September 1988.[17] The German inspiration is very clear: the 'epistemic community' of central bank governors and other experts all shared the Bundesbank's predilection for guarantees on price stability and autonomy from political authorities and several had been struggling for years to increase their autonomy (Verdun 1999; for the French example, see Prate 1987). The bank governors accepted, however, the need for accountability and called for reporting requirements in relation to the European Parliament and the European Council. What is perhaps surprising is that the alternative major model for an independent federal system of central banks – the American Federal Reserve – was not seriously considered by the governors as it had been by the Werner Committee. Moreover, the European Council and ECOFIN's acceptance of the Report without serious disagreement is perhaps also surprising especially given that several national finance ministries and governments had a long tradition of opposition to increased NCB autonomy. Most of the governors subsequently campaigned publicly for independent central banks, both prior to and after the agreement by the Heads of State or Government in principle to accept independence at the October 1990 Rome I European Council.

The major issues of disagreement among the central bank governors and member state governments concerned the timetable to move to EMU, the role of the ECU and that of European monetary authority during the transition period from Stage One (the full liberalisation of capital movements) to the start of Stage Three, the irrevocable fixing of parities and the transfer of monetary power to the ECB. Due to this disagreement, the Delors Report's description of the two transition stages is brief and vague. Notably, an important paragraph in the Report in chapter III, section 1 ('gradualism and indivisibility') was left out. Pöhl was very critical of the sharing of monetary power during the transition period given the confusing signals that this could send to the financial markets. Monetary power had to be indivisible. Other Committee members agreed but felt that this did not prevent some functions from being transferred to the ESCB. The Report recommended only minor reinforcement of the powers of the Committee of Governors and its secretariat to improve the co-ordination of independent national monetary policies. In Stage Two, the ESCB would be set up and begin the transition from this co-ordination to its control over the formulation and implementation of the common monetary policy in Stage Three. While the central bank governors established the date of 1 July 1990 for the start of Stage One (the date by which capital liberalization in the EMS member states was to be completed), the starting date of the second stage, when they thought the ESCB would begin operating, eluded agreement. Moreover, the Delors Report was very vague on the institutional developments and nature of co-ordination of Stage Two, in part because the central bank governors argued that 'this [transition] would depend on the effectiveness of the policy co-ordination achieved during the first stage, on the provisions of the Treaty, and on the decisions to be taken by the new institutions' (para. 57).

Verdun (1999: 185) sums up the importance of the Delors Committee in the move to EMU as fourfold (see also Dyson 1994). First, the Committee accepted the German model of central banking for the ESCB (independent central banks and price stability) whereas politicians may not have done so. Second, the central bankers and other monetary experts had the technical expertise to suggest a credible blueprint for the EMU project. Third, all the member states were 'represented' by their NCB governors which eased the acceptance of most of the member states. Finally, the Delors Committee can be seen as having drafted the 'right kind' of EMU: one that contained the 'necessary ingredients' for success yet went beyond the 'lowest common denominator approach. In this sense, the Committee fulfilled some of the core characteristics of an 'epistemic community'.

It should also be noted that in addition to this debate on the role of European monetary authority in Stage Two, there were alternative approaches to the move to EMU – forwarded principally by the British government but also several leading political parties and economists in all the member states – than that recommended by the Delors Committee. The adopted approach was 'institutional' in the sense that it accepted that some form of new monetary institution was required to manage the transition to Stage Three and that a full blown ECB would eventually be created. The two major market-led approaches – explicitly rejected by the Delors Committee – involved considerably less institutional implications. The competing currency approach (Gros and Thygesen 1992: 329–32) rejected altogether the need for institutional developments: market forces would determine the success of the various existing national European currencies and the best would win and become the single European currency and, presumably, that currency's central bank would become the European Central Bank (with subsequent institutional modifications). All legal restrictions on the use of currencies, exchange-rate fixing and the co-ordination of national policies would cease to be necessary. The parallel currency approach – an EC currency circulating in parallel with the member state currencies

(Gros and Thygesen 1992: 332–8) – also relied principally upon market mechanisms. However, this approach involved an institution to manage the new currency in order to promote its use by the private sector.

The draft submitted by finance ministers to the Maastricht European Council in December 1991 was nearly the same as the one prepared by the Committee of Central Bank Governors. However, there were two major differences in the tasks of the ESCB. First, the governors sought to give the ECB full power over exchange rate policy whereas the finance ministers decided to divide responsibility between the Council of Ministers and the ECB. Second, the finance ministers agreed to give the ECB a lot less power over prudential supervision of the banking system. The Governors had recommended that the ECB 'would participate as necessary in the formulation, coordination and execution of policies relating to prudential supervision and the stability of the financial system' and be 'entitled to offer advice and to be consulted' on the interpretation and implementation of EC legislation concerning prudential supervision. The finance ministers decided that the ECB should merely 'contribute to the smooth conduct' of policies designed and pursued by others. There were also several minor differences in the two drafts. One example had potential implications for the ECB's pursuit of price stability. The Committee of Governors' draft read that the 'ESCB shall support the general economic policies *of* the Community' (italics added) whereas the finance ministers final draft read 'the general economic policies *in* the Community'. According to Kenen (1995: 30) the word 'of' was apparently 'seen to invite the ESCB to disregard the policies of the individual EC countries and seemed also to invite the Community to adopt a wide range of common policies'.

The Committee of Governors in Stage One of EMU

Following the recommendation of the Delors Report (April 1989), the June 1989 Madrid European Council agreed to start Stage One of EMU on 1 July 1990. Based on the recommendations of the Delors Report (paras. 50–2) ECOFIN granted the Committee of Governors additional responsibilities from the start of Stage One (Council Decisions dated 12 March 1990 to replace the Council Decision of 1964). A responsibility assigned to the Committee of Governors was to start preparations for Stage Three of EMU by identifying the major issues and establishing a work programme by the end of 1993. Stage One was also supposed to be about tighter *voluntary* co-ordination of monetary policies made necessary by the greater degree of exchange-rate fixity combined with financial market integration. The Committee of Governors was given new means to achieve this co-ordination. First, the new Council Decisions implied that the Committee of Governors could develop a more visible public profile, with the publication of an annual report and appearances of the Committee Chairman before the Economic and Monetary Committee of the European Parliament. Increased visibility was important in the context of the gradual construction of the future European monetary authority's credibility and legitimacy through demonstration of its accountability. The first report of the Committee (covering the first 18 months of Stage One to the end of the 1991) was published in April 1992. Moreover, the Decisions allowed the Committee of Governors' Chairman to decide to make public the deliberations of the Committee at any point in time.

Second, the Committee was encouraged to make critical reflections on the economic and monetary policies of individual member states and the EMS participants as whole. These critical reflections could appear in the Committee's reports to the European Council and Parliament or in the deliberations made public by the Committee Chairman. In theory, the Committee of Governors already possessed the power to make critical comments, although this power was severely curtailed by the control exercised by national ministries of finance over most of the NCBs. Moreover, the Committee had avoided criticism in the past because of considerations of collegiality and concerns about upsetting financial markets. It continued to do so, with a few notable exceptions. Most significantly, on 12 December 1990, the Committee of Governors agreed to ask publicly the German government to reduce its budget deficit, noting that it weighed too heavily on monetary policy and created tensions within the EMS (*Agence Europe*, 13.12.90, 5390).

Third, the ministers of finance hoped that the Committee would strengthen its analytical capacity (and its sub-committee structure) in order to develop an *ex ante* approach to, rather than an *ex post* analysis of, monetary co-ordination. The central bankers from the smaller member states were particularly keen to push ahead: they had few illusions about their remaining monetary autonomy. However, there were several obstacles to *ex ante* co-ordination, in addition to different monetary policy instruments and the reluctance of some of the larger member state central banks to change their ways. In several systems – including the UK and France – monetary authority was divided and ministries of finance (and governments) were unwilling to delegate some of their powers to an unspecified process of central bank co-ordination. Moreover, in some systems – notably, the German federal system – the organization of the central bank's decision-making structure made difficult the delegation of any power through its president (or other representatives) to a European monetary authority.

The failure of the Committee of Governors to establish co-ordinated intermediate monetary targets for 1991 was the first demonstration of the weakness of Stage One procedures to build voluntary co-ordination. The establishment of these targets for 1991 was arguably too ambitious. However, the governors also failed to achieve a less ambitious goal: an agreement of a quantitative assessment of the monetary objectives of the participating countries. This failure was due to three problems (Gros and Thygesen 1992; 347): first, the difficulty of agreeing to joint assumptions about external shocks (due to temporary uncertainty about oil prices and the dollar); second, the differences in monetary or credit aggregates used by the participants; and third, the disagreements as to the role that such aggregates could play in fostering co-ordination. In order to overcome the second problem, in 1991, the Committee of Governors set up an Economic Unit to work on building statistical compatibility and harmonizing concepts of the aggregates used by the different member states. However, progress in Stage One was slow.

The Committee of Governors failed to improve co-ordination sufficiently to challenge speculation against most EMS currencies in 1992 and 1993. The efforts undertaken in Stage One did not compensate for the underlying change in the EMS which undermined stability: notably rising German inflation; lower French (and other country) inflation; the corresponding weakening of the position of the German mark as the ERM anchor currency; the record high interest rates in France and other EU countries; economic recession and rising unemployment in most participating countries. The most effective co-ordination during this period was bilateral, notably 'the sweetheart deal' between the French and German ministries of finance and central banks, first arranged to keep the franc in the ERM in September 1992, and then repeatedly referred to as a weapon to stem the periodic bouts of speculation over the next ten and a half months. This deal amounted to the public engagement of the Bundesbank to provide unlimited support to the franc to defend it against devaluation. However, given the Bundesbank's refusal to provide this unlimited support in late July 1993 – given the potential inflationary effects – the franc was forced to devalue. In order to the save the ERM and ease speculation, participating ministers of finance (with central bank governors in attendance) reached a deal at the 1–2 August Brussels Extraordinary ECOFIN to widen the mechanism's margins of fluctuation from ±2.25 to ±15 per cent. The widening of the ERM margins nullified the practice of monetary cooperation built up over the preceding 14 years of EMS operation and dramatically diminished the role of the Committee of Governors. It became superfluous to monitor the operation of the EMS and manage its credit facilities because interventions in the foreign exchange markets were minimal. Following the experience of July 1993, the French sought to strengthen their convergence programme with the Germans: starting in August, the two countries' programmes were planned in 'tight concertation' and presented to the press simultaneously (Howarth 2001). However, this did not involve reinforced co-ordination on the part of central bank governors.

The European Monetary Institute in Stage Two of EMU

The date for the start of Stage Two, 1 January 1994, was agreed at the October 1990 Rome (I) European Council (and confirmed subsequently by the October 1993 Brussels extraordinary European Council). However, the actual powers of European monetary authority remained a subject of considerable debate throughout much of the IGC and subsequently. The opposing sides corresponded to the traditional 'monetarist' versus 'economist' divide. The French had – as demonstrated in their January 1991 Draft Treaty – a maximalist interpretation of the role of the EMI to promote actively the ECU. The Germans, however, sought a minimal EMI – indeed, with virtually no powers beyond those already granted to the existing Committee of Governors. The Delors Committee had clearly leaned towards the German vision: '[Stage Two] must be seen as a period of transition to the final stage and would thus constitute a training process leading to collective decision-making, while the ultimate responsibility for policy decisions would remain at this stage with national authorities' (para. 55). As in Stage One, monetary authority was seen as indivisible. Nonetheless, all the national governments recognised the complexity of managing the EMS – with the ultimate responsibility for monetary policy remaining in national hands – while preparing for EMU and the transfer of power to the ECB in Stage Three. At the ECOFIN Apeldoorn meeting on 23 September 1991, EC ministers of finance agreed to French demands on the automaticity of Stage Two but they only allowed the creation of an EMI with minimal powers: the German vision had prevailed. Meeting in

Basle on 29 October, the governors left open certain aspects of the statutes of the EMI – including the structure of the direction; the voting procedures within the Institute; the constitution of its capital and its location – on which agreement eluded them. The final provisions of the Maastricht Treaty ensured the creation of an institute with a legal personality, to be directed and managed by a Council, consisting of a President and NCB governors (article 109f.1). Control over monetary policy would be transferred to the European level only with the creation of the single currency at the start of Stage Three. The Treaty on European Union included the protocols on the Statute of the ESCB and of the ECB (see Appendix 1) and the Protocol on the Statute of the EMI.

The EMI Executive Board consisted of 13 members (16 following the 1995 enlargement) including the president and all EU central bank governors. All the EU member states participated in Stage Two of EMU, including Britain, Denmark and Sweden. Thus, perhaps oddly, the central bank governors from the three countries which did not intend to join the first wave of countries moving to Stage Three, nonetheless participated in all the discussions and preparations for the move to EMU. The Institute was assigned the responsibility to strengthen cooperation and co-ordination between the member state central banks with the aim of ensuring price stability, to assume the responsibilities previously assigned to the EMCF and the Committee of Governors, and to facilitate the use of the ECU and oversee its development (including the smooth functioning of the ECU clearing system) (article 109, TEU and article 2, EMI Statute). By the end of 1996, the EMI was to specify the 'regulatory, organizational and logistical framework necessary for the ESCB to perform its tasks' (article 4, EMI Statute). Specifically, the EMI was to:

- prepare the instruments and the procedures necessary for carrying out a single monetary policy in the third stage;
- promote the harmonization, where necessary, of the rules and practices governing the collection, compilation and distribution of statistics in the areas within its field of competence;
- prepare the rules for operations to be undertaken by the national central banks in the framework of the ESCB;
- develop the framework for conducting foreign exchange operations as well as for holding and managing the official foreign exchange reserves of the member states participating in the Euro-Zone;
- promote the efficiency of cross-border payments; and

- supervise the technical preparation of ECU bank notes (article 4, EMI Statute);

The EMI Council was granted minimal powers to formulate – by a two-thirds majority of its members[18] – and submit opinions and recommendations to the Council on the orientation of monetary policy and the functioning of the EMS as well as the monetary and exchange rate policies in individual member states (article 109f; protocol article 5). Article 6 of the Protocol allowed the EMI to hold and manage foreign exchange reserves as an agent for and at the request of national central banks. However, the pooling of reserves remained voluntary and as no NCB asked the EMI to manage its reserves prior to the start of Stage Three, the Institute effectively assumed the bookkeeping responsibilities of the EMCF. At the 1991 Maastricht European Council, the Heads of State or Government finally reached a compromise on one of the most difficult issues during IGC: the timetable to move to Stage Three, either in 1997 or automatically (for qualifying member states) in 1999.

The move to Stage Two and the creation of the EMI proceeded on schedule. At the December 1993 Brussels European Council, Alexandre Lamfalussy, the Belgian former head of the BIS, was selected as the first president of the EMI. He was seen as a safe pair of hands: the decision was uncontroversial, acceptable to all the member state governments, including the Germans.[19] One potential obstacle – regarding location – was overcome at the October 1993 extraordinary European Council, where the European partners agreed to place the EMI and thus the future ECB in Frankfurt. The French had favoured Lyon. However, Chancellor Kohl insisted upon Frankfurt on the grounds that a German location was needed in order to assuage the large number of Germans hostile to the loss of the mark and the transfer of monetary power to the European level and to address, symbolically, the fear that the ECU (as it was then called) would be much weaker than mark and that the ECB would have difficulty maintaining low inflation.[20] The selection of Frankfurt likewise had another symbolic purpose: to signal to the financial markets that the ECB would be as diligent as the Bundesbank in the maintenance of price stability.

In terms of real policy co-ordination, it turned out that Stage Two amounted to an extended Stage One. The French saw the co-ordination difficulties and EMS instability in 1992 and 1993 as an important reason to expand and clarify the co-ordination role of the EMI (Jaillet 1994). The Maystadt Plan, presented by the Belgian minister of finance to his European colleagues unsuccessfully pursued this objective. The co-ordination difficulties and the stability created by widening the fluctuation margins convinced the Germans that reinforced co-ordination in Stage Two was unnecessary. The EMI also chose largely to ignore the option of re-narrowing the EMS margins – which would have increased its co-ordination role – and focused most of its time and attention to its preparation tasks.

The EMI was much better equipped than the Committee of Governors to reinforce monetary policy co-ordination. First, the EMI Council was granted a strong degree of autonomy (EMI Protocol, article 8) – a foretaste of the ECB Governing Council's independence: members could not seek or take any instructions from EU institutions or bodies or member state governments. This autonomy was reinforced by the early move to NCB independence in several of the member states early in Stage Two. This autonomy increased the chance of criticism of the economic policies pursued by member state governments. Second, the EMI became a relatively large institution with a highly competent professional staff of over 200 by 1996, which could undertake independently some analytical functions, whereas the Committee of Governors had relied entirely on the NCBs. The Council and the Alternates Group were chaired respectively by the President and the Director-General of the EMI, who both devoted all their activity to the EMI, hence assuring the effective use of staff analyses. Third, the EMI's power to submit opinions and recommendations became more significant given the increasing independence of NCBs and the institute's greater professional analysis.

Some observers and participants (for example, Gros and Thygesen 1998) criticized the EMI for being insufficiently active in promoting co-ordination and collective evaluation of monetary developments, such as the significant movements in EU and other major currencies in 1995 and the strengthening of the Irish punt and British pound from 1997. However, the co-ordination role had become less relevant for reasons noted above – the wider fluctuation margins – because there were no crises in the EMS during Stage Two and most of the EU member states succeeded in maintaining price stability. Arguably a collective and public evaluation would have been more useful in the two years prior to the start of Stage Three. Policies pursued in this period would have a greater effect on inflation in the first years of EMU, and national and EMI inflation forecasts were of particular interest given that inflation targets would likely become an important factor shaping policy. Moreover, there remained the possibility of turbulence in the run-up to the selection of participating member states in the spring of 1998 and the move to Stage Three. Gros and Thygesen (1992 and 1998) argue that the EMI could have played a more active coordinating role without undermining the 'ultimate responsibility' of national authorities' (1998: 426). In their opinion, the EMI should have prepared three elements as part of a 'useful learning process' to smooth the transition to EMU (as recommended in the Delors Report): 'a consensus on the specific formulation of the ultimate objective(s); a common analytical framework for intermediate objectives and for the design of monetary policy; and a sufficient degree of experience with common operations.' In particular, the expert authors bemoan the lack of experimentation in genuine joint decision making. In their individual papers appended to the Delors Report, Committee members made some suggestions as to the non-institutional steps in the transition period which could help build common policy-making. However, these were ignored during the IGC. Gros and Thygesen (1992) examine several possibilities for building common decision making with regard to adjustment of short term interest differentials, intervention policy vis-à-vis third currencies, the development of a Community-wide reserve requirement, realignments, and on the issue of a parallel currency (the ECU).

EMI documents focused instead on analysing the progress of the member states in meeting the Maastricht convergence criteria. With the criteria and the 1999 deadline in place, the EMI Board's monthly debates and regular reports on monetary policy and economic performance and convergence (summarised in the EMI's annual reports) assumed greater importance than those of the former Committee of Governors and helped nudge member states toward compliance.[21] Throughout Stage Two, the EMI gently chided the member states which were making inadequate progress. It also frequently criticised member states for 'one off' deficit cutting measures that did not ensure sustainable low deficits. In its 25 March 1998 convergence report, the EMI drew attention to the large debts and inadequately low deficits of several member states, recalled the medium-term aim of budget surplus established in the Stability and Growth Pact, and encouraged accelerated economic reform and 'decisive and sustained corrective policies of a structural nature' (EMI 1998). Although the final decision on which member states adequately met the convergence criteria and thus could join EMU remained the responsibility of the European Council and was announced by the Heads of State or Government on 2 May 1998, the EMI's March 1998 report was considered the more objective and authoritative statement on the suitability of member state participation.[22] The report stated that Greece was not prepared to participate in

Stage Three. By supporting Italy's participation in Stage Three – opposed previously by the German and Dutch governments – the EMI made its inclusion in the eleven first members more politically manageable.

The Institute also played a more active role in the preparations for EMU. The EMI successfully completed all the essential tasks outlined in the EMI Protocol article 4 (mentioned above) and published numerous documents approved at its 45 meetings between 1994 and the end of May 1998. The Institute:

- closely followed the development of the use of the private ECU/euro with annual reports.
- prepared the chronological sequence of events for the changeover to the euro (November 1995) (adopted by the December 1995 Madrid European Council). The EMI outlined differences between national changeover scenarios and the potential need for harmonized actions in a March 1997 document and submitted its own scenario.
- outlined the operation framework of the single monetary policy in a January 1997 document (which the TEU required by the end of 1996), the single monetary policy strategy of the ESCB (February 1997) and produced general documentation on ESCB monetary policy instruments and procedures and documents on several more specific points.
- set up the future monetary and exchange rate relationships between the Euro-Zone and other EU countries (the ERM-II).
- published its money and banking statistics compilation guide (April 1998): guidance provided to all EU NCBs for the compilation of money and banking statistics for submission to the ECB.
- clarified the rules for NCB operations: The EMI achieved several specific goals, outlined in the Statute of the ESCB and of the ECB.

    1. It elaborated harmonized accounting rules and standards to make it possible to construct a consolidated balance sheet of the ESCB;
    2. it put in place the necessary information and communications systems support for the operation and policy functions to be undertaken within the ESCB; and
    3. it identified the possible ways in which the ESCB would contribute to the policies conducted by the competent supervisory authorities to foster the stability of credit institutions and the financial system.

- helped prepare necessary national and EU monetary and financial legislation, including the statute of the NCBs. It followed up on NCB reform in its annual reports.
- established foreign exchange rules (July 1997 common market standards for money market and foreign exchange transactions).
- developed the TARGET cross-border payment system (introduced in May 1995) and produced regular reports from August 1996 on the system's progress.
- organized a competition for the design of the new banknotes and selected a winner (approved by the December 1996 Dublin European Council).

As one of its final tasks, the EMI examined the irrevocable conversion rates for the euro. At a 2 May 1998 meeting, it agreed with the member state finance ministers and Commission representatives to use the existing ERM bilateral central rates of the participating currencies to determine the irrevocable rates.

The major final controversy in the lead up to EMU concerned the selection of the first ECB President. In May 1996, the NCB governors – with the approval of the Heads of State or Government – selected Wim Duisenberg, the experienced governor of the Bank of Netherlands, as the final president of the EMI. He was generally expected to become the first president of the ECB. However, the TEU granted the European Council the power to select the ECB president. At the December 1997 Luxembourg European Council, the political leaders failed to agree upon Duisenberg because the French President, Jacques Chirac, insisted upon the appointment of the Governor of the Bank of France, Jean-Claude Trichet. The French saw the presidency is an important symbol of monetary power: both the public and international face of the ECB. Placing Trichet in this position was thus of considerable importance to the French. It was also seen as an appropriate compromise given the decisions to establish the ECB in Frankfurt and to replace the ECU with the euro – both loaded with symbolic significance. Moreover, the French disclosed publicly that a secret agreement on Trichet's appointment had been reached with the Germans in October 1993 when Frankfurt was selected over Lyon. Owing to the important role of the future ECB president, the power motive went beyond the purely symbolic. The assumption was – regardless the autonomy of the Bank of France in relation to the French government – that Trichet's appointment would enhance French influence within the ECB during its crucial formative years and at the international level.

A lengthy and very public battle ensued. French stubbornness on this issue consumed most of the 25 May 1998 extraordinary Brussels European Council, where a compromise was reached. Duisenberg would stay on. However, to meet Chirac half way, the Dutchman agreed – supposedly 'of [his] own free will ... and not under pressure from anyone' – to step down after mid-2003 to make way for Trichet.[23] In the meantime, the French would be adequately represented in the Executive Board, with the appointment of Christian Noyer, the former head of the French Treasury, as ECB Vice-President.[24] The compromise was made even more palatable for the French by the strategic appointment of another recent head of the Treasury, Jean Lemierre, as the first president of the Economic and Financial Committee, the rebaptized Monetary Committee. The incident increased the perception that the ECB's independence would be difficult to safeguard from the influence of member states. Moreover, the compromise was almost certainly illegal when viewed against TEU provisions because Article 112(2)(b) EC (ex 109a(2)(b)) requires that the term of the President's office last eight years (Craig 1999).

On 1 June, in accordance with Article 123 EC (ex 109L), the EMI was replaced by the ECB and the Executive Board began its term. With most of the preparatory work successfully completed prior to June 1998, the ECB devoted the remaining seven months of the year to the final testing of systems and procedures and establishing the rules of procedure of the General Council. There remained a few issues to resolve. One concerned the Euro-Zone's monetary policy strategy which was adopted by the ECB's Governing Council on 13 October (see Chapter 4). A second outstanding issue concerned the external representation of the euro. At the December European Council in Vienna, it was formally agreed to allow the ECB President to attend G7 meetings for discussions relating to EMU (for example, multilateral surveillance and exchange rate issues) and at the time of the agreement on the relevant sections of the meetings' published statements. The ECB was also previously granted observer status on the IMF Executive board.

On 1 January 1999, EMU was officially launched. Control over European monetary policy, including interest rates and monetary mass, was transferred to the ECB. The parities of the participating currencies were fixed irrevocably by the Council. All new national public debt was to be issued in euros and the TARGET payment system was put into operation. It remained to the ESCB central bankers the task of bringing into circulation the euro banknotes and coins from the start of 2002. One of the most innovative developments in central banking history and, indeed, the history of world governance, had begun. With over half a century of close, and progressively tighter, cooperation behind them, the Euro-Zone central banks were well placed in their unique position to operate the world's most important multi-national system of central banks.

3
National Attitudes on the ECB and Central Bank Independence

> Money is more than a part of the economy. Money reflects the state, politics, and culture. The euro (however) will be a denationalized and de-politicized currency.
>
> Hans Tietmeyer – Former Bundesbank President and ECB Governing Board Member.[25]

Introduction

Despite the focus of our previous chapter upon the role of European central bankers, the history of monetary cooperation and integration was dominated by the actions and interests of France and Germany, the axis of European integration. We argue that it is necessary to explore the interests and preferences of these two countries and their monetary policy-making traditions in order to understand both the design of the EMU project and the ECB in particular, as well as the current politics of the Euro-Zone in which the ECB must engage. Not to downplay the importance of other Euro-Zone members (the Dutch or Belgians, for example), the institutional structure, roles and powers of the ECB reflect the explicit preferences of these two leading EU member states, notably Germany. The on-going debate about structure, roles and powers is, furthermore, energized principally by French politicians and policy-makers. The emphasis placed upon central bank independence owes principally to the German monetary policy-making tradition. Most other Euro-Zone member states – notably the French – have traditions which rejected independence. This leaves an ideational legacy that views the operation of EMU, and in particular the inadequate political counterweight to the ECB 'Leviathan', with much concern on both political and economic grounds. We therefore explore French attempts to construct some form of 'economic government' (EG) at the European level which could fill this role of political counterweight, and the diversity of ways in which EG has been presented by French politicians to different audiences. In particular, we examine French attempts to expand the role of the Eurogroup and develop European macroeconomic policy co-ordination. Contrary to the wishes of former Bundesbank and ECB member Hans Tietmeyer, the ECB operates in a political environment strongly shaped by member states.

The following analysis provides an overview of the historical, political and economic factors that have shaped – and continue to shape – the debates and policy developments in Germany and France with regard to central bank independence, the ECB and, more generally, EMU. Our ambition is to develop a more comprehensive understanding of the ECB and its operations. A short section is also devoted to the United Kingdom by way of comparison. The aim here is to explain how widespread traditional hostility to central bank independence in this country contributed to the persistent political hostility to EMU, yet also why, in the spring of 1997, one of the new Labour Government's first measures was to grant considerable autonomy to the governing board (the Monetary Policy Committee) of the Bank of England.

German monetary interests and attitudes: independence and price stability

German monetary interests were most influential in shaping the operation of the EMS, EMU and the institutional structure, roles and powers of the ECB. As a result, the current policy-making process and politics of the ECB bear a deep-seated teutonic flavour. Specifically, to understand Germany's monetary interests in EMU and the ECB is to zero in on a number of critical ECB issues examined in this book: the independence and the transparency of the ECB; the credibility of the ECB's monetary policies; the controversies over exchange rate management; and the interaction of the ECB and Eurogroup. In many ways, these issues mirror the politics and policies of the German national central bank, the Bundesbank, over its long and distinguished history (Loedel 1999a). The ECB was modelled on the Bundesbank, with its high degree of independence, its primary focus on price stability, its federalist structure (the Länder central banks), and its focus, in part, on monetary growth as a key target of policy-making. Moreover, without

Germany's political support for EMU, in particular the support provided by former Chancellor Helmut Kohl, EMU would not have happened. In fact, the ultimately political decision to sacrifice the treasured German deutsche mark for the euro is perhaps one of the most important in postwar German history – and perhaps postwar European history. Finally, with the ECB located in Frankfurt (the location of the Bundesbank) and the German-inspired Stability and Growth Pact guiding macroeconomic policy across Europe, the Germans have institutionalized the Bundesbank's legacy and monetary norm across Europe.

The following section examines the larger historical context of German monetary interests, the politics and policies surrounding the German approach to European Monetary Union, and the current operation of EMU and the ECB. We also examine the German views toward the concept of European monetary authority.

The historical context of German monetary interests

As part of the German national subconscious, monetary policy retains a prominent and consequential role in the political economy of Germany. In fact, the writing of German history can be punctuated by monetary affairs. The social and political consequences, to say nothing of the financial and economic ruin, of the hyper-inflationary period in 1923, for example, led to the undermining of the Weimar government's credibility and legitimacy, exacerbating the attacks of extremist movements on the left and right (Feldman 1993). Following the Second World War, the historic currency reform of 20 June 1948 launched the German *Wirtschaftswunder* that helped lay the foundations for the world-wide admired economic and political ascent of the Federal Republic of Germany (FRG) and its internal social stability and economic dynamism. German Economic and Monetary Union (GEMU) of July 1990 also marked a new era in German politics, as did the replacement of the DM by the euro during the first half of 2002.

These highly visible periods in German political and economic history illustrate the political nature of monetary policy and its importance as a fundamental socio-economic and political foundation or pillar of the Federal Republic of Germany. In fact, as these examples show, the stability and, in extreme cases, the very existence of the democratic order itself may depend on politically sensitive monetary decisions (Emminger 1986; von Arnim 1988). For example, von Arnim sets forth a theory of democracy that posits the primary importance of central bank independence to the stability and democratic order of the

German political system. In other words, the Bundesbank had become the guarantor of German democracy by acting as a guide, protecting the German government from irresponsible policy that could destabilize the democratic order. Arguably, then, monetary stability and social stability are one and the same. It is the confidence of the large German middle class (to say nothing of the upper class) in the money in their pocket, earned after years of hard work, that provides the building blocks of German democracy. German monetary interests and the policy that flows from it should, therefore, be examined for the political and social character it represents rather than in strictly economic or financial terms.

While always difficult to measure precisely or operationalize, the German economic culture is said to demand fiscal rectitude and a deflationary macroeconomic policy targeting price stability (Hanrieder 1989). Two leading commentators on the international political economy state the German case more bluntly: 'The German tribal memory heightens political awareness of the long-run penalties attached to inflation and, therefore, substantially assists inflation resisting policies' (Strange and Calleo 1984: 111). This economic culture gave German monetary policy a special quality, unique to the particular historical experience of the Germans. Some may label this deeply ingrained attachment to currency frugality a peculiar Germanic monetary angst or paranoia, but these features are staples of Germany's approach to monetary policy and EMU, and they reflect the broader social and political context in Germany and have developed into a distinct monetary ideology (see Noelle-Neumann 1968). This ideology presents a fairly simple yet stark view and message to the masses of the dangers of currency instability. This view is captured by Gordon Craig who states that 'the failure of the first German experiment with republican government was fore-ordained when the one commodity (money) that more than any other seemed to give people a means of rational assessment of their situation lost its power to do so any longer' (Craig 1982: 121). Unmistakably, social and economic conditions past, present and future play a powerful role in German society and the course of monetary policy.

This monetary ideology based on the fear of inflation and its socio-political consequence manifested itself in the institutional structures of the German political economy, in particular through the creation of the powerful Bundesbank. Most analyses of the German political economy cite the foundations of the Bundesbank in the postwar German constitution (*Grundgesetz*) which give German monetary policy its special administrative and legal quality. Therefore, to understand German monetary interests is to examine the quasi-independent Bundesbank that commands a towering and lofty position within the political economy of Germany. For many Germans from all socio-economic strata, the Bundesbank guaranteed the soundness, stability, and foundations not only of the currency, the treasured DM, but also of the democratic and stable political order. Without a sound and stable DM, society could easily be buffeted by un-democratic forces bent on subverting the established political-economic order of which the Germans – rightfully so – are proud. The Germans learned their bitter lesson about defacing and devaluing a nation's currency and entrusted to the Bundesbank the task of defending the 'stability of the currency' (see, for example, Lehment 1981; Kennedy 1991; Marsh 1992).

The strength of public support for an independent central bank guaranteeing the value of their beloved D-mark added to the resources of the Bundesbank in times of conflict. An attentive German public opinion and political, financial and economic elite on monetary affairs helped guard the independence of the Bundesbank. However, if the central bank was badly out of step with current economic conditions and misunderstood the cycles of history, the clashes with finance ministers and chancellors were less easily hidden from public debate, and no amount of independence could save the bank from strongly defending its position with the public. The Bundesbank thus went to great lengths in maintaining a consistent and vocal public relations campaign. It is in this role that the Bundesbank mastered the art of public communication and speaking with one voice. More importantly, that voice focused on one overriding goal for German monetary policy and that goal is price stability. The Bundesbank continually returned to this familiar German monetary leitmotif – a leitmotif surrounded by an aura of familiarity and respect to the public. The goals, objectives and policies of German monetary policy, especially as espoused by Bundesbank officials, remained remarkably consistent over the decades. Significantly, the German voice acts as the conscious of the ECB as the message of price stability resonates strongly through the halls of the ECB.

Germany and EMU: interests and objectives

Given the powerful historical backdrop of German monetary preferences, one wonders why the German government did not dismiss the idea of EMU out of hand (given the implications of the prospective treaty). Despite some of the efficiency gains from a single currency, Germany would not expect to benefit a great deal from the reduction in transaction costs (primarily on the export side rather than on imports) because a sizeable proportion of German trade within Europe was already denominated in DM. Nor would Germany immediately benefit from the anti-inflationary credibility of the future European Central Bank. Indeed, the reverse could happen. Even if the ECB's independence from political control was more formally guaranteed than the Bundebank's, it was arguable that the ECB would find it hard to inherit the Bundesbank's reputation and credibility. Moreover, the Bundesbank was not altogether convinced that other European central banks could deliver the same level of price stability. Finally, French pressure for a European-level political counterweight to the ECB (see the following section for more detail) raised additional red flags about the future independence of the ECB. In sum, the persuasiveness of economic or monetary motivations should not be stressed in understanding the German approach to EMU.

Instead, a political explanation is required to understand why the Germans were willing to offer the DM as the sacrificial lamb in return for EMU. Internally, the political will of Germany's leading politicians led to a great deal of overt and tacit pressure placed on the Bundesbank not to derail the negotiations on EMU. The key government players, Chancellor Helmut Kohl and his Foreign Minister, Hans-Dietrich Genscher, had a singular interest in EMU which reflected long-standing foreign policy goals and ideas – built on the Treaty of Rome and the Franco-German axis. Most importantly, European integration, while generally supported by the German public, was always an elite driven process of German foreign policy-makers. Moreover, the political importance of European integration for the foreign policy establishment expanded as Germany slowly reasserted its dominant political and economic position in Europe during the late 1980s. It was believed that German reassertion of power and influence could best be expressed with the comforting and binding constraints of the EC and an overall strengthened European identity. Finally, with the seeming month-by-month collapse and disintegration of Eastern Europe through 1989 and with the looming prospect of German reunification into 1990, the political (or foreign policy) salience of EMU moved to the foreground for German and European politicians. As the historic 'German problem' – the long held political, economic, and military-strategic concerns of Germany's geo-political position in the heart of Europe – came to the forefront of debate, irrevocably binding Germany to the EC, with monetary union as the crucial means for doing so, became the negotiating mantra of German politicians and their European partners.

The Bundesbank was not blind to the pressures coming from politicians. The Bundesbank's distinctive position on EMU and the Maastricht Treaty negotiations is best summarized in its *Monthly Report for September 1990,* 'Statement on the Establishment of an Economic and Monetary Union in Europe'. The bank's views should not have been surprising to anyone and reflected long-standing principles associated with earlier European discussions on EMU, beginning with the Werner Report in 1970. The bank's cautious approach toward EMU centred on its belief in the coronation theory (*Krönungstheorie*) – the view that EMU must result only as the final stage of a prolonged period of convergence of key economic variables (notably inflation, but also budget deficits and public debt) and institutional safeguards (political independence of a European central bank). Apparently, the Bundesbank believed that convergence in line with the Bundesbank model would so slow down the process of EMU such that monetary union might not ever arrive. The bank also argued that 'substantial transitional problems as a result of the intra-German unification process', and the uncertainties in Eastern Europe justified postponement of any further steps on EMU 'until such time as the economic situation in Germany as a whole and in the European Community can be regarded as sufficiently consolidated'. The Bundesbank accurately and justifiably feared being pressed to support EMU because other countries had supported Chancellor Kohl's rapid movement on unification.

Given the political realities and the Bundesbank's concerns, the decision to sacrifice the DM was indeed a profoundly political move. There was some concern over the ambiguity of the protocols on exchange rate management as well as concern over the strength of other countries' commitment to the convergence criteria in the Maastricht Treaty. The timetables for implementing EMU were also seen as problematic by many Germans. But the Germans essentially got what they wanted – especially in monetary terms (Dyson 2001). First and most importantly, they got a powerfully independent ECB with a primary objective defined as price stability. Second, the strict (some would argue draconian) convergence criteria essentially demonstrated agreement among the negotiators that inflation was, in the words of former Bundesbank President Karl Otto Pöhl, 'democracy's enemy number one'. As such, success in ensuring price stability would be taken by many Germans as adequate testimony to the (European) central bank's accountability. Third, the federal structure of the ESCB would still allow the Bundesbank to have a direct voice in European monetary politics. Moreover, each state committed itself to securing independence for national central banks – a radical departure for countries like France and the United Kingdom. As if the Germans had not gotten enough, in the years following the Treaty of Maastricht, the Germans demanded and received two additional points of monetary interest: the location of the ECB in Frankfurt and the Stability and Growth Pact. More importantly, the political power of the French-led effort to create a more substantial role for the new Eurogroup was significantly watered down. In essence, the Eurogroup would have no formal role in ECB deliberations and would not have any say over monetary policy.

Given the outcome of Maastricht and as the launch of the euro in 1999 approached, the Germans should have felt somewhat reassured that their monetary norm of price stability, central bank independence and fiscal rectitude had been enshrined in EMU and the ECB. But have EMU and the ECB's actions lived up to German expectations? The answer, in short, is largely no.

Germany, the ECB and the euro

Modelled after the Bundesbank and German monetary norms, EMU and the ECB seemed poised to serve the monetary interests of Germans. In addition, in macroeconomic terms, the euro has had very tangible benefits for Germans over the last few years. The cheap euro has boosted exports and employment in the all-important export-intensive sectors of the economy, all with minimal inflationary risks (outside of energy). In fact, German politicians have been accused of their own game of euro 'benign neglect' in order to stimulate economic growth and job creation. Furthermore, in the dynamic telecommunications, financial, and high tech industries, German companies have been on the forefront of developing new strategies – especially Euro-Zone mergers and acquisitions – to confront the newly competitive Euro-Zone market. In part, Germany's somewhat protected economy and society have opened up to the new euro reality and done so with great promise.

But Germans are still concerned about the future of monetary stability and whether national (read German) and European monetary interests will remain largely harmonious in the years to come. The future remained unsettled; the anchor function of the DM had been lost; more importantly, the European monetary ship of state was floating in entirely new seas and guided by a crew not dominated by the Germans. To say that some Germans were unsettled by the situation was indeed an understatement.

While political and (most) economic elites were supportive, the German public was sceptical of the EMU plan from the start. Already resistant to the idea of relinquishing the DM for the euro, German citizens found added fuel for their EMU scepticism in the government's gold revaluation plan of 1998. As the launch dates for the ECB and EMU approached, the Kohl Government was skating on thin ice in its strong support for the euro – support that could not be found in the public. In a survey conducted by the Allensbach Institute, 47.4 per cent of the German public noted outright opposition to EMU (Loedel 1999b). Only 26.4 per cent signalled support for the euro project, with just as many Germans unclear in their position. More significantly, over 60 per cent of the public had real doubts and fears about EMU; at a ratio of almost 3:1, the German public felt that there were more disadvantages than advantages to the idea of EMU. Perhaps most important, fully 45.9 per cent of the public felt that EMU would have a negative impact on inflation. Also interesting, support for EMU was weakest among eastern Germans, not surprising given that they had only experienced a handful of years of monetary stability in the form of the DM.

Over the next three years, from 1 January 1999 to 1 January 2002, the public remained quite sceptical about EMU and the euro. German public opinion was not convinced that the euro would be as strong and stable as the deutsche mark. And many believed that the ECB would not be quite as vigilant as the Bundesbank in preserving the stability of the money. Given the weak track record of the euro and the repeated communication problems of the ECB during this period (see Chapter 6 for more detail), Germans were still questioning the decision to sacrifice the DM even as they handed over their DMs for euros. Specifically, the German public has been outspoken in its criticism of the euro's declining external value, as well as the operation of the ECB and Duisenberg's repeated misstatements. 'The Bundesbank would never have made the same mistakes' – was a typical German response to our surveys of German public opinion. Even the Social Democratic (SDP) government of Gerhard Schröder has been on the blunt receiving end of public scepticism. Schröder's initial support for the euro depreciation was rebuffed by public criticism so strong and vehement that he had to back down under fire. Indeed, monetary questions remain highly sensitive and overtly political in the German system.

For its part, the Bundesbank watches the unfolding euro drama with a mixture of suppressed delight and public concern. Even with the relinquishing of its power over monetary policy, the Bundesbank has continued to exert a strong influence in the ECB's monetary policy. For example, after only five months in operation, the Bundesbank took on a very public role in championing the euro as it headed toward parity with the dollar. Former Bundesbank President Hans Tietmeyer and current Bundesbank President (and ECB) member Ernst Welteke both signalled strong concern about the currency sliding toward the one dollar level. This was in sharp contrast to some other members of the ECB (and the German government) who were only giving half-hearted support to the euro. 'Clearly the decline in the euro's external value has been overstated', remarked Tietmeyer.[26] Moreover, when Italy was granted some concessions on its budget deficits for 1999, Bundesbank members lashed out at the deal suggesting that EU ministers had 'stabbed monetary policymakers in the back'. Other Bundesbank members described the decision as 'disastrous'.[27]

At the root of the Bundesbank's discomfort is the fact that it put its neck out on the line and, in 1997 and 1998, used its enormous credibility with the German public to reassure the public of the soundness of the EMU project. It consistently suggested the euro would be as strong as the DM. The fear now is that the ECB has neither earned the perception in the financial markets of the Bundesbank's credibility nor has the European bank the inherited authority of the Bundesbank. While most German central bankers note that it took the Bundesbank some time to earn its credibility and that price stability remained steady over the period 1999–2002, there is a good measure of discomfort with the ECB's performance on the communication and credibility front.

The public remains vigilant. All sections of German society are intense 'ECB watchers'. German journalists complain that the press conferences of the ECB come later in the afternoon – different than the Bundesbank – and too late to make the evening news or press editions. German economists have criticized the monthly reports as lacking in enough detail and information. Professor Jürgen Donges, chair of the economic committee known as the 'five wise men' which advises the German government on economic issues has argued that Germans were bitterly disappointed with the EMU project and that they had been promised that the euro would be equal to the DM (*Financial Times*, 6 May 2001). More fundamental structural reform was needed – in labour markets, social security and tax systems, and in countries like

France and Italy – but also Germany. Interest groups also have raised their concerns: labour unions that the ECB has been too tough especially with growth slowing through 2001 and 2002 and savings associations that the ECB has been too soft on inflation. While it is impossible to satisfy all interests, the ECB has struggled to portray a united front to this highly informed and engaged German public.

Even with the successful changeover to the euro on 1 January 2002 and the ECB's seemingly authoritative control over European monetary policy, most Germans still remain fearful of the potential rise of a political counterweight to the ECB. Such concern is drawn from the continued French insistence on some form of an EU-level *gouvernement économique* as well as the potential for continued political concentration of EU authority. Such concerns were formed early in the ECB's history. The dramatic confrontations in early 1999 between the new SPD Government – in particular the finance minister Oskar Lafontaine – and the ECB indicated to many Germans the dangers that the ECB faced in its new task of defending the euro's stability. Despite the popular support for Schröder (and his election victory in September of 1998), the public did not elect him to take on the ECB. Lafontaine's repeated public demands for lower interest rates and target zones for the euro's exchange rate upset many Germans – even Social Democrat supporters. Lafontaine's resignation in March of 1999 – just three months after the euro's launch – is indicative of the sensitivity with which Germans viewed the pressure on the ECB as inappropriate. The replacement of Lafontaine with Hans Eichel – a more moderate less ideological former state premier of Hesse with close contacts with the Bundesbank and the current Bundesbank President Ernst Welteke – helped smooth over some of the earlier tension. But pressure to restructure the Bundesbank to conform with the increasing needs for a more centralized EU process of regulating the integrating financial services industry and banks has put the Bundesbank (and especially the Land central banks) on the defensive.

The particular German view toward European monetary authority outside the hands of the ECB is, as noted, driven by the particular German view and history. Yet the Bundesbank never retained absolute independence from political influence from the chancellor or the finance minister. German chancellors – from Adenauer to Schröder – have repeatedly expressed views on monetary policy at odds with those of the Bundesbank. And while the Bundesbank often actively resisted these overtures, it could still be held accountable for its actions by the German parliament (*Bundestag*). The legislation creating the Bundesbank

– while constitutionally inspired – could be amended by a simple majority vote in the parliament. The government could also delay Bundesbank monetary decisions by two weeks, if deemed necessary by the chancellor. And external financial arrangements and exchange rate management remained firmly in the hands of the government. In short, the Bundesbank was never quite so independent from the government as many believed.

As a result, the real failure to develop an effective political counterweight to the ECB should say something about the high level of political independence that the ECB retains – greater than the Bundesbank (see the following chapters for more detail). German fears about French-led efforts to create some form of EU-level macroeconomic authority with power over the ECB should be understood from this perspective. Even the Bundesbank recognized its own political limitations. The Bundesbank at times retreated on policy differences in the face of political pressure from the government so as to insure its long-term independence (Goodman 1992). For now, the ECB has not had to retreat on any monetary policy decisions in the strict definition of its interest rate policy. With no immediate plans for a more formal or more powerful role for the Eurogroup, Germans should not be concerned about the ECB succumbing to political directives.

In the future, will the residual public discontent with the euro spillover into official government discontent with the project? And will this carry over into the European policy-making arena? There are a number of factors which suggest not: the relative stability of prices; the stabilization of the euro since 2001; recognition that EMU has always been an elite driven process; the weakness of any form of political counterweight to the ECB; the fact that the ECB may be slowly learning from its public missteps; Germany's own failure in 2002 to respect the rules of the Stability Pact and support for a more flexible application of this Pact. More importantly, with the highly successful changeover of the euro in the first months of 2002, Germans have come to accept the euro as a part of their economy and as a part of German history.

French attitudes on European monetary authority: a story of persistent reluctance

The French reluctantly accepted the German-imposed design for the ESCB and independent central banks. Despite the well-entrenched French aversion to central bank independence, President Mitterrand prioritized the achievement of monetary power objectives in the context of pooled control over monetary policy at the European level. The willingness to accept compromise only came after over a decade of failed attempts to reform European monetary mechanisms to create a more symmetric system in which strong currency central banks (notably the Bundesbank) would share the burden of inter-parity stability by intervening to support weak currencies. The French also consistently supported the expanded use of the ECU, in part as a means to challenge the predominance of the deutsche mark in the EMS. The first national proposals to strengthen European monetary authority thus came from the French who saw this authority's principal task being the promotion of the ECU and eventually its emission as a hard currency. These proposals did not, however, advocate EMU. President Mitterrand imposed the EMU project upon a largely sceptical government, political class and financial administrative elite.

French aversion to central bank independence was rooted in four different factors: the French republican tradition; the belief that control over economic and monetary policy should not be separated; the perception – rooted in the history of French political economy – that low inflationary economic policies can be maintained by democratically elected officials, guided by enlightened bureaucrats and advisers; and power considerations within the French administration. This opposition shaped French positions on the details of the EMU project, the intergovernmental negotiations and their outcome. An appreciation of this opposition is thus necessary to understand the nature of French motives for supporting EMU and the process leading to monetary integration.

The republican tradition in France upholds the control of democratically elected officials over all elements of policy-making. This was reinforced by the strong tradition of '*volontarisme*'. In the case of monetary policy, this must be qualified. The Bank of France enjoyed a semi-autonomous status from the middle of the nineteenth century (Bouvier 1988; Prate 1987). The minister of finance had more or less influence over the decisions of the Bank depending on the matter at hand (a consensus normally existed) and the personalities involved. The height of the Bank's expression of autonomy was during the interwar period of monetary instability when certain Bank governors forced modifications in government economic policy in order to ensure greater stability. On the Left, the Popular Front sought to curtail the growing power of the Bank through a major reform of 1936. Following the Second World War, the autonomy of the pre-war period was widely associated with the protection of elite interests, the general backward state of the French economy, the Laval deflation of the mid-1930s and the defeat of 1940. De Gaulle further reinforced State control through the nationalization of 1945. However, the precise nature of this control and the legal status of the Bank were not defined. The strong economic growth of the '*Trente Glorieuses*' has been widely seen as the result of an economic, financial and monetary policy designed in co-ordinated fashion by the Treasury, the Planning Commission and democratically elected governments. Given the strong republican consensus of the postwar period and that most Bank of France governors were former Treasury officials (and members of the elite Financial Inspectorate), the expression of Bank autonomy – in defiance of the government – was only periodic and rarely public (Bouvier 1988, Koch 1983, Patat and Lutfalla 1986, Prate 1987). As during previous periods, this expression of autonomy depended upon the personalities involved and the degree to which governments diverged from the goal of monetary stability. Governor Olivier Wormser succeeded in clarifying Bank powers in the context of the January 1973 reform which explicitly granted the Bank greater scope to modify its monetary mechanisms. However, the reform in no way diminished State control over monetary policy. The republican bias in favour of a democratic check on the central bank was reinforced by technocratic arguments which stressed the historic dependence of the Bank of France on the Ministry of Finance as the principal source of monetary and economic information. Treasury officials generally believed that the Bank was unable, technically speaking, to take decisions in matters of credit and money (Koch 1983, Mamou 1987).

Most leading French politicians and financial bureaucrats correspondingly believed that economic and monetary policy should not be completely separated for economic reasons: that the latter should be seen as a tool of the former. While the importance of price stability was perceived by a growing proportion of the political class in the 1970s and 1980s, very few believed that it should be considered a goal to be pursued separately from other economic goals. The relations between French governments and the Bank since the middle of the nineteenth century effectively demonstrated this duality. Beneath the different German and French attitudes on central bank independence, there lay two different conceptions of the role of money. According to the German conception, monetary stability was considered to be a categorical imperative of economic and democratic order linked to the maintenance of the rule of law (inflation is a non-voted tax). According to this tradition, citizens have as much right to a stable currency, as they have a right to the security of their person and their property. In consequence, macroeconomic policy should involve as little manipulation as possible of credit. Such attitudes, as noted in the previous section, are also rooted in the experience of hyperinflation in the interwar period (Marsh 1992). French monetary history was considerably different from that of Germany. Although inflation had repeatedly been a problem both prior to and since the Second World War, the Laval deflation of the mid-1930s was generally perceived to be the most economically disastrous monetary development in the twentieth century (Patat and Lutfalla 1986). The Delors Report – written by central bankers and monetary economists – reflects the German conception. The strongly negative reaction of most leading French politicians and the Treasury to the report reflected the degree to which this conception was alien to the French (Balleix-Banerjee 1997).

The preference of French governments to link the management of economic and monetary policy does not necessarily indicate a limited commitment to low inflationary policies. It has been claimed that French governments have not been preoccupied with inflation as an economic problem but rather have adopted low inflationary policies in order to achieve a competitive advantage in relation to Germany (most notoriously by Connolly (1995)). There has been an historic preoccupation with the competitive position in relation to the major trade partners, in particular the Germans. The drive to cut inflation – under President Giscard d'Estaing in the late 1970s and early 1980s and then the Socialists from 1982 – was linked closely to competition-oriented goals: inflation led to devaluation which only temporarily improved the competitive position of French industry and discouraged necessary structural change. Competitive advantage was sought via the maintenance of a lower level of inflation than France's European partners (notably Germany): thus the policy of '*désinflation competitive*' (Fitoussi 1993). This policy – linked to the avoidance of franc devaluations through the maintenance of relatively high interest rates given the asymmetric operation of the ERM – also forced French companies to become more cost efficient.

It is important to note that different actors have placed different emphasis on the two goals. Most leading French policy-makers sought both. French governments clearly had to balance monetary with other goals. Competitive ambitions – more acceptable to a French political class traditionally sensitive to the commercial balance – were often appealed to as the justification for the high interest rates needed to maintain low inflation. However, most leading Treasury officials focused principally upon monetary goals, while those in the Bank of France have been singularly preoccupied with the maintenance of low inflation.

French reluctance to accept independent central banks during the discussions and negotiations on EMU and insistence upon '*gouvernement économique*' was also rooted in the belief that 'sound money' economic policies do not rely on independent central banks (Aglietta 1988).[28] French monetary history was presented in order to challenge the numerous Anglo-American econometric and statistical studies which have shown a strong correlation between central bank independence and lower inflation rates. According to these studies, politicians are likely to adopt monetary policies which do not lead to optimal results on inflation because they are motivated by more than just monetary goals (Goodhart 1988 and 1993). Some in France did support these claims, notably leading Bank of France officials who from the period of increased inflation in the late 1960s repeatedly attempted to convince party leaders of the logic behind increased autonomy (Prate 1987). Correspondingly, the Bank presented the argument that independence would increase confidence in the franc, diminish speculation and allow the lowering of interest rates. Such economic arguments had greater political appeal apparently and convinced Jacques Chirac and other RPR leaders of the logic behind independence prior to the 1986 elections when they supported the Pasqua private member's bill (1985) which granted a large degree of autonomy to the Bank of France. Once in power, however, Chirac's position changed. In the face of the determined opposition of his Minister of Finance, Edouard Balladur, and the Treasury, Chirac's own position on the matter was insufficiently strong to lead to a change in policy (Balleix-Banerjee 1997 and Prate 1987).

Posen (1993) argues that political support for low inflation is responsible for both low inflation and central bank independence. He attributes this political support to the influence of a narrow financial or banking interest group. In the French case, this group can be defined as the financial administrative elite consisting of top Treasury officials (members of the elite *grands corps*, the Finance Inspectorate and other corps, and principally those involved in monetary policy-making); Treasury officials in the support staffs of the president, the prime minister and the minister of finance; and top Bank of France officials, notably the governor who has almost always been a member of the Finance Inspectorate and a former Treasury official. In the Treasury, it was also generally believed that the argument linking central bank independence and inflation did not take into consideration the rationalized French model of monetary and economic policy-making in which a trained financial administrative elite had considerable influence over the formation of policy. Relative French success in controlling inflation during the postwar period – from 1958 to 1968 and from 1978 to the present (with the brief exception of 1981–83) – was achieved with minimal central bank influence over government policy-making. The inflationary tendencies in the French economy were linked to the excessive dependence of French public and private sector companies upon State-allocated credit, not inadequate Bank of France autonomy (Loriaux 1991; Aglietta 1988).[29] Moreover, from 1991, the French succeeded in lowering inflation well below levels in Germany. Given these achievements, French governments and the Treasury were reluctant to surrender control on the grounds that they were prone to excess. The admiration of the German economic model – and its low inflationary economic growth – did not extend to the institutional structure of German monetary policy-making.

The EMU project modified the economic policy-making power structure of the French State rooted largely in the financial administrative elite (Dyson *et al.* 1994). For the Treasury, central bank independence was one in a series of blows to its power, diminished by privatizations, the liberalization of financial markets and EC rules on competition which limited large state aids, previously managed by the Treasury. Ironically, it also could be seen as the result of the victory of the Treasury in its struggles over a 20-year period with neo-Gaullist and Socialist governments to maintain low inflationary policies. EMU was only made possible by the willingness of both governments of the Left and the Right to embrace 'sound money' economic policies.

The loss of this Treasury power due to the 'independence' of the Bank of France was mitigated somewhat by the close links between the Bank's governor, the French financial administrative elite and leading French politicians. Although opposed to the statutory independence of the Bank of France during the discussions and negotiations on EMU in 1990–91, Treasury officials and the Socialist Minister of Finance, Pierre Bérégovoy focused their opposition on the issue of ECB independence. With power over interest rate policy transferred to the European level, it was necessary to extend Treasury control over this policy through the influence of the French Minister of Finance in the context of ECOFIN, and thus to ensure extensive Council control in relation to the ECB.

There were also other reasons for opposition to central bank independence, although these appear to be secondary. Notable among these was the concern expressed by several politicians and officials – including Bérégovoy – that independence would not lead to a true sharing of policy-making power at the European level (Balleix-Banerjee 1997; Bauchard 1994). Rather it was his belief that independence would further reinforce the dominance of the Bundesbank in the determination of European monetary policy – principally because most of the participating member states were in effect German monetary satellites, or were insufficiently large to challenge German monetary influence. The concern to diminish Bundesbank and maximize French influence in the context of EMU explains in large part the intransigent French insistence upon Italian participation in Stage Three and upon the choice of Bank of France Governor Jean-Claude Trichet as the first president of the ECB. This insistence was not diminished by Trichet's repeated and public displays of autonomy in relation to the demands presented by President Chirac and the Juppé and Jospin governments (Aeschimann and Riché 1996). The hard-won compromise to replace Wim Duisenburg by Trichet after four years was made palatable for the French by the appointment of Christian Noyer – like Trichet, a former head of the French Treasury – as ECB Vice-President.

Given these views, it is not surprising that none of the political parties supported the concept of central bank independence until 1991 (Balleix-Benerjee 1993, 1995, 1997 and 1999). The RPR was opposed for nationalistic reasons (dropping all further discussion of the Balladur memorandum in the campaigns leading to the Presidential and National Assembly elections of 1988) and sought the maintenance of Council control over monetary policy. The Socialist party placed stress on social goals and the appropriate policy mix, although was forced into acquiescence by the Socialist government. Moreover – and surprisingly – Giscard d'Estaing's centre right party confederation, the UDF, supported only a more cautious, evolutionary approach – although one of its more pro-European components came out strongly in favour of central bank independence. Despite this general party opposition or reluctance, French public opinion was generally – albeit vaguely – in favour of the EMU project and the transfer of monetary power to the European level and thus, implicitly, national and European central bank independence.[30]

The French preference to maintain political/Treasury control over monetary policy helps to elucidate the logic behind the development of French negotiating positions on the details of the EMU project – notably the French draft treaty of January 1991 – and likewise the overall negotiation process. During the period following the first meetings of the Delors Committee, Bérégovoy and Treasury officials introduced the idea of '*gouvernement économique*'. In the French draft treaty of January 1991 they insisted:

> Everywhere in the world, central banks in charge of monetary policy are in dialogue with the governments in charge of the rest of economic policy. Ignore the parallelism between economic and monetary matters … and this could lead to failure.[31]

Moreover, they proposed that the European Council, on the basis of ECOFIN Council reports, define the broad orientations for EMU and the economic policy of the Community. Within these orientations, ECOFIN would co-ordinate the policies of member states and make recommendations to individual governments and the ECB would manage European monetary policy. Bérégovoy and Treasury officials also argued in favour of giving the ministers of economics and finance control over exchange rate policy.[32] Bérégovoy claimed that the French draft treaty did not seek to challenge the independence of the ECB and the pursuit of the goal of price stability – which the Germans would have refused to accept. However, the draft treaty sought to limit the European bank's margin of manoeuvre as much as possible.[33]

The French draft treaty had to respect the basic conclusions of the Rome I European Council which granted independence to the ESCB. Its article 2-3.2 therefore states that the ESCB will neither solicit nor receive the instructions of the Council, the Commission, the European Parliament or the member states. However, this list omits mention of the European Council which elsewhere in the draft treaty (article 4–1) is given the power to define the major orientations of EMU. In addition to appearing self-contradictory, the French project thus seemed to be in direct contradiction with the conclusion of the Rome I Summit which stated that the ESCB would be independent of *all* instruction. The draft treaty also very much reflects Treasury attitudes regarding the goal of price stability and French monetary policy tradition. It maintains a double language in favour of the primacy of monetary stability (article 2-3.1) while giving the European Council and ECOFIN the means to challenge this primacy.

The Germans opposed any such control beyond ensuring that the member states respect the specific convergence criteria they sought to place in the EMU treaty. Several unsuccessful attempts were made to reconcile the French and German approaches to the link between Community institutions and the ECB.[34]

The opposition of Bérégovoy and Treasury officials to central bank independence also explains, in large part, their consideration of the parallel currency approach to EMU and the British proposal of the hard ECU – effectively as a way to delay the move to EMU.[35] Moreover, the French draft treaty provides for a potentially indefinite period of transition to EMU: article 5–9 requires the Heads of Government and State to meet prior to the end of 1996 to determine by *unanimity* the length of a subsequent transition period prior to the final decision on the move to Stage Three. In other words, Bérégovoy and the Treasury sought effectively the same monetary power objective demanded by previous governments: a reinforced European monetary authority to promote the use of the ECU as a means to weaken the mark and promote a more symmetric EMS.

On parliamentary control, Bérégovoy proposed a combined sitting of European and national parliamentary members to confirm the monetary policies pursued by the ECB.[36] However, he did not elaborate in any detail on this control and nothing was included in the draft treaty on the matter. There is reason to doubt Bérégovoy's democratic motives, especially given the tradition of a minimal parliamentary role in domestic monetary policy-making and French reluctance to extend European Parliamentary powers in other areas. Rather it is more likely that he sought allies for his efforts to establish a political control over the ECB.[37] On the Commission's participation in the economic affairs of the Union, the French draft treaty proposal went further than any previous French document in advocating 'an active role' of proposal and recommendation. Again, given French reluctance to increase Commission control in any other policy-making areas, this reflected Bérégovoy's attempt to balance the powers of the ECB.

There is an apparent contradiction between the demands of Bérégovoy and the Treasury on setting monetary policy within an economic policy framework established by elected politicians, on the one hand, and their relatively easy acceptance of the Treaty based economic convergence criteria, on the other, given that the imposition of these criteria would severely constrain the economic policy-making powers of national officials. In other words, Bérégovoy and the Treasury appear to have been more concerned with the elements of formal control than the details of permissible economic policy.

The logic of this apparent contradiction can be explained principally in terms of the degree of the loss of the government's control over policy-making. In principle, the independence of central banks ended most government control over monetary policy, which the French believed should not be disassociated from economic policy, whereas the convergence criteria only provided limits not to be exceeded by national policy-makers. Moreover, in 1990 and 1991, the French thought that the criteria could easily be respected. Only from 1992 did it become clear that considerably more rigorous economic policies were necessary in order to meet the criteria. During the negotiations, French concern with the criteria reflected more a desire to ensure Spanish and Italian participation in the EMU project in order to balance German monetary power.

It can be argued that Treasury opposition was as much rooted in a desire to avoid losing control over monetary policy as it was in any perception of the link between economic and monetary policy, French institutional tradition or democratic sensitivities. It should, however, be noted that Bérégovoy's position reflected the intensity of opposition to central bank independence in political circles which was only fully expressed during the 1992 referendum campaign. Bérégovoy conceded defeat on the matter, after a prolonged and much publicized outcry, only when the President forced his acquiescence. Treasury was not in a position to damage the project once arranged.[38] Moreover, the political and economic situation of the post-Maastricht period demonstrated that the EMS was not sufficient to ensure monetary stability or low inflationary policies in the context of liberalized capital flows and growing demands to devalue the franc outside the ERM, in order to lessen the economic difficulties created by high German interest rates.

Given the control that he exercised over European policy and his decision to force the acquiescence of Bérégovoy and the Treasury, the President's own position on central bank independence was of considerable importance in determining the development of French policy. There has been some difficulty in understanding the precise development of Mitterrand's stance on central bank independence and the EMU project. In terms of public announcements, it appears that he did not support independence until the end of 1990 when he endorsed the conclusions of the Rome I European Council, which accepted the independence of the ESCB. If his position did change at this point, this suggests the importance of two considerations: first, that German reunification encouraged his willingness to accept German demands on the matter in order to push ahead with EMU (Grant 1994) and second, that after a couple of years of discussions, it was very clear that the Germans would not alter their position on the matter. In any case, Mitterrand continued to allow Bérégovoy and Treasury officials to push for more political control throughout the IGC of 1991.

An alternative perspective on Mitterrand's position on independence comes from the Bank of France governor at the time, Jacques de Larosière, who met with the President in May 1988 and presented the necessary conditions (notably those imposed by the Bundesbank) for the successful conclusion of the EMU negotiations. De Larosière claims that Mitterrand understood and accepted these conditions from the start of the negotiations.[39] However, given the President's decision-making style – his preference to meet his advisers separately and to demonstrate a strong empathy for their position – there is reason to doubt this.[40] It is possible that he understood the nature of German demands and was willing to compromise at the end of the negotiations, but that in the meantime he would allow the Treasury to demand as much political control as possible.

Mitterrand's own position on central bank independence, as on many policy questions, is far from certain. According to both perspectives, the President's willingness to allow Bérégovoy and the Treasury to make their demands was likely rooted in his own personal support for the maintenance of a political control.[41] It is also likely that he used the matter of independence as a bargaining chip in the negotiations in order to secure German agreement on an automatic move to stages two and three. Furthermore, he likely sought to prevent a Treasury revolt on the matter and that he was very sensitive to 'republican' opinion on central bank independence. This sensitivity was most clearly demonstrated in the President's misleading statements during the campaign prior to the September 1992 French referendum on the Maastricht Treaty. On one significant occasion, during a major televised debate on the Treaty, Mitterrand claimed that elected officials would establish the economic policy framework for the formation of monetary policy: an interpretation of the Treaty inconsistent with its actual provisions.[42] Nonetheless, according to both perspectives, Mitterrand was not prepared to allow demands on the maintenance of a political control – from French or other member state officials – to derail the negotiations (Bauchard 1994).

Mitterrand's insistence upon satisfying the German demand for independent central banks in exchange for a fixed date for the start of EMU – despite the impact on the republican model and the structure of power within the French State – perhaps demonstrates the importance that he placed on European power motives. French governments sought to end the independent expression of German – that is, the Bundesbank's – monetary power. They sought to maximize control over domestic monetary and economic policy-making by sharing monetary power at the

European level, as a more acceptable alternative to Bundesbank dominance. Previously, French governments had demanded that German monetary policy incorporate the interests of other EMS member states, notably French interests. Specifically, this meant lowering German interest rates. In the context of the asymmetric operation of the EMS, French governments sought maximum German financial support for the defence of the franc–mark parity and extended monetary assistance to prevent excessive currency fluctuations within the ERM margins. German refusal to create a truly symmetrical EMS – in which strong and weak currency countries were equally responsible for the maintenance of inter-parity stability – led Mitterrand to the conclusion that German power could only be reduced in the context of EMU. The French were also concerned about the international implications of German monetary power. Sharing this power in the context of EMU was deemed the only way to avoid the creation of a tri-polar world of monetary power around Germany, Japan and the United States. Power motives also shaped the perception of other leading politicians of the EMU project. The psychological impact of German reunification, and its perceived strategic impact, further increased the importance of power arguments and thus helped to convince many former sceptics in the Socialist government of the merits of the project, including Prime Minister Michel Rocard and diminish the opposition of some government members, including Bérégovoy himself (Bauchard 1994).[43]

French opposition to central bank independence also explains the negotiation strategy of Commission President, Jacques Delors and Chancellor Kohl. The March 1988 proposal of the German Minister for Foreign Affairs, Genscher, on the creation of a European System of Central Banks (ESCB) stated clearly that central banks would have to be made independent.[44] Delors and Kohl's decision to convene central bankers in the Delors Committee for the initial examination of the project was clever strategy both to overcome Bundesbank reluctance on EMU but also to side-step the inevitable opposition of certain member state governments and treasuries – notably the French – to central bank independence (Dyson 1994). The aim was to accustom governments to independence via the decisions reached by their own central bankers, acting in a personal capacity. The deliberations of the Committee imposed a central banker's bias on the project and shaped future discussions (Ungerer 1993; Østrup 1995). The Delors Report recommended both the independence of national central banks and the ECB, in addition to precise measures on the manner in which this development was to be ensured.

In the negotiations on the ECB, the French succeeded in establishing a certain role for the Council of Ministers – notably with regard to external monetary policy – but had to accept German demands that this role be contained within a tight framework which respected price stability.

French policy on EU Economic Government: the ECB's political interlocutor in European level economic policy co-ordination

The issue of '*gouvernement économique*' ('economic government' (EG)) has been raised by the French more than other Euro-Zone member states: a preoccupation that reflects concerns linked to the traditionally widespread reluctance in France to accept central bank independence. Since the Maastricht Summit, the issue of EG has resurfaced in French political discourse and in French demands at the European level. The Jospin-led Plural Left Government prioritized the reinforcement of economic policy co-ordination among the 11 (12 since the start of 2001) Euro-Zone member states, notably in the context of a new body, the Euro XI (Eurogroup). The term 'economic government' can signify several different things. In general terms, EG is an institutional set up at the European level that is designed to establish some form of macroeconomic policy, be it only economic policy co-ordination, that has direct impact upon the member states. This is a form of collective governance (Wallace 2000; 541*ff.*) 'among core actors from several institutions and bodies in a multi-faceted network which is constituted by mutual participation patterns' that can be called horizontal fusion (Wessels and Linsenmann 2001).

There is then disagreement about what EG should amount to, both in France and in all the Euro-Zone member states and various proponents of the idea are frequently not very clear about their preferred version. Pierre Bérégovoy, worried about central bankers dominating the discussions over the shape of the future EMU project, raised the need for a political counter power to the ECB in order to achieve an appropriate policy mix at the EU level. At the time of the December 1996 Dublin European Council, the then Prime Minister Alain Juppé claimed that he had secured general agreement to create a 'Euro-Council' – consisting of Euro-Zone ministers of finance – which would form the core of 'economic government', a reinforced economic policy co-ordination among the Euro-Zone government and an improved dialogue with the ECB. The French Socialists made 'economic government' a central element of their policy on EMU during the campaign prior to the June 1997 National Assembly elections. They had been radicalized in opposition, during the recession of the early- to mid-1990s which was blamed widely on the high interest rates required to keep the franc in the ERM and the cut backs required to meet the deficit convergence criterion. The Socialists' joint election manifesto with their Plural Left coalition partners pulled them further to the left. They forwarded European 'economic government' as a means to promote growth and employment, goals which were ostensibly given equal weight to the 'growth and stability' goals in the Amsterdam Treaty due to Jospin's insistence on parallel resolutions. Rhetorically, the building of EG was linked to the establishment of a 'euro-social': an EU-level economic and monetary policy mix that would counterbalance the 'sound money' policies pursued by the ECB. Socialist Finance Minister Dominique Strauss Kahn succeeded in achieving a more formal agreement on the creation of what he labelled the 'Euro-Council' (*conseil de l'euro*) in December 1997 which the Jospin Government widely presented as a manifestation of 'economic government'. This body was subsequently relabelled the Euro-X due to German opposition that the label Council incorrectly suggested that this new body had legal status. This body became the Euro-XI following the determination of the number of member states participating in EMU and was subsequently officially relabelled the Eurogroup during the French Council presidency during the second half of 2000. Leading French officials also claimed that the creation of the new Economics and Financial Committee, the rebaptized Monetary Committee, helped to reinforce the control of the Euro-XI over the economic framework in which monetary policy was made, and thus was a step closer towards the creation of 'economic government'.[45]

What different French politicians mean exactly when they espouse EG has often been unclear. Nonetheless, different governments – indeed different policy-makers – place different emphasis on different kinds of co-ordination and the appropriate role to be fulfilled by the Eurogroup. There are at least five understandings of 'economic government' that can be discerned from French policy statements, each having a potentially different impact on the role of the ECB in the co-ordination process.

1. EG as co-ordination of macroeconomic policies to achieve greater stability – to support fiscal policy co-ordination (which is supposed to involve binding rules and even fines). In this sense EG contributes to the construction of the 'stabilization state' (Dyson 2000). This reinforces the primary objective of the ECB and

promotes a positive co-ordination role between ECOFIN and the ECB – which was also charged with promoting convergence. EG as stabilization has involved the 'hard' co-ordination of the convergence criteria rules (with rules for the imposition of fines established in the Stability Pact) and the mutual surveillance of national macroeconomic policies begun in Stage One of EMU in 1990, which was reinforced by the Maastricht Treaty and the Stability Pact requiring member states to prepare and submit medium term stabilization reports (Broad Economic Policy Guidelines).

2. EG as co-ordination of macroeconomic policy to achieve a good policy mix aims to promote a more activist co-ordinated policy of member state governments to increase economic growth and create employment. This is about qualifying/counterbalancing the drive for monetary stability by achieving an 'appropriate' policy mix. This form of EG can involve a positive co-ordination between the Council and the ECB – which also has for goals the promotion of employment and investment in the Euro-Zone – as long as the Council places clear limits on its pursuit of improved economic growth and this does not become inflationary.
3. The third version of EG that can be discerned in French government policy speeches is more interventionist involving EU job creation strategies and programmes. This could involve varying degrees of intervention in the context of the EU's employment and social chapters or in terms of EU sponsored investment.
4. EG has also been perceived and advocated in a fourth way – notably as a means to improve the credibility of ECB monetary policy. In large part this links in with the first version (EG as stabilization). But this is also crucially about communication – the co-ordination of government voice regarding ECB monetary policy and desirable economic policy. As shown in Chapter 6, there is a problem of many voices making different pronouncements on ECB policy-making (notably German Chancellor Schröder on the positive aspects of a weaker euro in September 2000 and several public criticisms of ECB management, etc.) which in turn can be blamed for contributing to the weakening of the euro. This version of EG involves the creation of a clear political interlocutor of the ECB, which focuses on maintaining good relations with the ECB. This would also – as noted in Chapter 3 – contribute to the improved co-ordination of the international representation of the Euro-Zone. The Eurogroup would play this role.

5. This is linked to a fifth version of EG (which is compatible with all the previous versions with the exception of the third) which involves embedding the independent ECB in a political framework: to reinforce its democratic legitimacy and public accountability. This version provides a partial response to those who express concern for the problematic existence of a single currency without a single state (see Chapter 4).

Initially, in the discussions and negotiations on EMU in the late 1980s and early 1990s, French use of the term 'economic government' was linked closely with the need for an effective policy mix (the second version mentioned above). Such a policy mix would be impossible to achieve with one monetary policy and several varying economic policies, potentially going in different directions and not responding in a co-ordinated manner to asymmetric shocks in the Euro-Zone. Rules on fiscal policy were not enough to ensure effective co-ordination (as the Irish case of early 2001 demonstrates). Other governments (notably the German and the British) feared that the French Socialist government of the day had too Keynesian a vision of appropriate policy mix and intervention that would undermine the stabilization goals of the ECB. The Plural Left Government's rhetoric (notably that of certain government ministers including Prime Minister Jospin himself and the powerful Social Affairs Minister Martine Aubry) emphasized a much more interventionist EG linked closely to an activist EU employment policy. However, the Jospin Government's preferences in this area were not met: the Employment Chapter of the Amsterdam Treaty, the Luxembourg and Cardiff Jobs Summits of November 1997 and March 1998, and the Cologne and Lisbon Summits of June 1999 and March 2000 established a non-binding 'soft' or 'open' form of co-ordination that fell far short of the kind of intervention sought by the French.[46] Nonetheless, EU employment policy served its legitimizing purpose at the domestic political level and French Socialist ministers consistently stressed – if not exaggerated – the significance of developments in this area.[47]

Interventionist Jospin Government rhetoric effectively damned the term 'economic government' in the eyes of several other EU governments, which largely explains why the term was largely absent from French government rhetoric during the French Council Presidency of the second half of 2000 (although the state-sponsored studies on EG produced in the lead up to and during the Council Presidency used the term quite freely). Nonetheless, the discourse of Jospin, the Socialist

Minister of Finance Laurent Fabius and President Chirac regarding the role of the Euro-XI and economic policy co-ordination continued to focus on all versions/logics of EG with the exception of the more interventionist third.

In order to strengthen its hand in discussions with its EU partners, in 1998 the Jospin Government created a group of the French Planning Commission to examine possible scenarios of improved economic policy co-ordination in the Euro-Zone. The group was led by Robert Boyer, a leading academic critic of the lack of economic policy co-ordination at the European level (see Boyer 1999), and the group's May 1998 Report demonstrated both the problems of increased co-ordination and the potential paths for co-ordination. Furthermore, Jospin called upon the Council for Economic Analysis linked to the Prime Minister's office to examine economic government and to produce a report at the start of the French Council Presidency, to provide the intellectual backing for the project. The report by Pierre Jacquet argues that economic growth over the upcoming decade would be considerably lower without tightened co-ordination and the European partners would not be able to meet their goal of 'full employment' by 2010 (set by the March 2000 Lisbon European Council).[48]

In his June 2000 speech before the German Bundestag, President Chirac called for improved economic policy co-ordination and a stronger Euro-XI as a key component of his vision of a 'pioneer group' needed to make EMU work. The French Council Presidency thus had two specific goals: improve the visibility of the Euro-XI and improve economic policy co-ordination. Progress in both goals was limited during the French presidency but potentially significant. Regarding the first goal, the Jospin Government had unsuccessfully sought to give the Euro-XI a legal personality of its own. Thus all Euro-XI agreements had still to be ratified by ECOFIN. The Germans insisted that the commonly used label 'Euro-Council' be dropped. Also, ECOFIN remained very much the most important body for co-ordination (including discussion of the stabilization plans which were also prepared by the four ESCB members not participating in the Euro-Zone). Nonetheless, the French scored a minor victory in convincing the Euro-Zone governments to relabel the Euro-XI the Eurogroup. The French also succeeded in bringing an agreement to produce a clearer, published agenda for Eurogroup meetings, to have longer meetings, to discuss more current matters at them and to improve their communication output (notably through the organization of a press conference immediately after the Eurogroup meeting, prior to the ECOFIN the following day). This was very significant because it gave the Eurogroup the opportunity to make policy announcements prior to their confirmation by all EU finance ministers in ECOFIN, effectively turning ECOFIN into a subsidiary body. With regard to Eurogroup–ECB relations, Laurent Fabius, unsuccessfully, sought the organization of more frequent bilateral meetings between the presidents of the two bodies. The aim here was to improve the co-ordination of member state positions on ECB policy-making and channel this through the Eurogroup to the ECB president. Fabius also blamed the weakness of the euro on the lack of strong political leadership in the Euro-Zone, the absence of an EU equivalent to the American Secretary of the Treasury.[49] He raised the idea of a Mr. Euro – previously introduced by the French – to be held by an individual over a period of several years and responsible, in conjunction with the Council presidency, for the international representation of the Euro-Zone (an economic policy equivalent to the Mr. CFSP, the EU's foreign policy representative). The campaign for a Mr. Euro by the end of 2001 was intensified by the Belgian Eurogroup President – although to little avail.

With regard to the second goal of the French Council Presidency, some progress was achieved when the Euro-Zone finance ministers reached an unbinding agreement to improve the co-ordination of economic policies and statements on the major economic issues of the day and of member state analyses of economic developments in the Euro-Zone. The official French aim was to improve the co-ordination of these analyses with the policy 'map' being developed by the ECB in order to give clearer signals to financial analysts. However, the Eurogroup's communication problem arguably worsened during the French Council Presidency – notably the different views on the decline of the euro and attacks on Duisenberg's competence as ECB president – contributing to the general state of disorder fanned by inappropriate policy statements emanating from the ECB (see Chapter 6). This version of 'economic government' as confidence booster still has many growing pains to endure. Another perceived co-ordination problem of the Eurogroup concerned its failure to be more active in intervening and reaching agreements with the United States and Japan to boost the euro – using the new Article 109 provisions on exchange rate interventions agreed the Amsterdam Summit.

Despite the efforts of French and other governments there have not been great strides towards tightened co-ordination. The Eurogroup is clearly more visible than the Euro-XI and is discussing a wider range of problems, which contributes to the development of the fourth and fifth versions of 'economic government' and the legitimization of the ECB. However, some – principally Anglo-American – observers argue that there is a very real risk that the Eurogroup is not performing its core task successfully enough, that is ensuring stability: the first version of economic government. Peer pressure in the Eurogroup has failed to prevent delays to major structural reforms in several countries, including France. This in turn places the ECB in the spotlight – along with the Commission – as the main watchdog of price stability in the Euro-Zone. However, this stabilization goal of 'economic government' was clearly not prioritized by the Jospin Government – despite the constant assurances of Socialist finance ministers to their Euro-Zone counterparts and the international financial markets – and President Chirac's own election campaign rhetoric of the first half of 2002 suggested that the achievement of the stabilization goals of the French medium-term programme could be delayed three years (2004 to 2007) to allow for tax cuts and increased government spending.

The United Kingdom, central bank independence and the EMU project

The Attlee Government nationalized the Bank of England in March 1946 as one of its first acts. Opposition to central bank independence soon became wide-spread across the ideological spectrum and well-entrenched. As in France, government control over monetary policy was seen as necessary for economic reasons – a manifestation of the Keynesian consensus – and political reasons – democratic control, with focus in Britain upon the doctrine of parliamentary sovereignty (Busch 1994; Cairncross 1988). Monetary policy, it was frequently argued, was not to be left to 'unelected bankers' but rather democratically elected governments should maintain their control. The Bank of England between 1946 and 1997 has been ranked as one of the most dependent on government (Busch 1994; Elgie and Thompson 1998). Busch (1994) explains the comparatively well-entrenched opposition to independence also in terms of the high degree of centralization and concentration of power in territorial, institutional and political terms (the regularity of single-party majority governments).

It is thus understandable why, even though the British record on inflation was very poor,[50] central bank independence was rarely presented as a solution to the problem by either Labour or Conservative governments. Indeed, Britain was affected far more than France by high inflation in the 1970s. The shift in governing economic policies towards 'sound money' was initially imposed by outside sources: principally, the International Monetary Fund, of which Britain had been by far the largest borrower of balance of payments facilities, which imposed tighter conditionality, and pressure from the US Treasury department. 'Sound money' arrived in force as part of the revival of monetarism and neo-liberalism under the Conservatives that went much further than any other West European country. Nonetheless, the Thatcher and Major Governments of the 1980s and 1990s – which embraced monetarism, of which central bank independence is a central tenet, and New Public Management reforms, creating quasi-autonomous organizations to manage a wide variety of policy areas – refused to accept granting central bank independence, despite growing support for independence in the City. At least two chancellors of the exchequer proposed independence. Nigel Lawson did so in November 1988 (revealed only in his resignation speech in the House of Commons on 31 October 1989) but was refused by Margaret Thatcher, who subsequently argued that this would have been 'seen as an abdication by the Chancellor when he is at his most vulnerable' (Thatcher 1993: 706). Following his departure from the Chancellor's office in September 1992, Norman Lamont claimed that he had tried unsuccessfully for two years to convince Prime Minister John Major of the benefits of an independent Bank of England. When the Delors Committee proposed independent central banks – a move clearly supported by Bank of England Governor Leigh-Pemberton – there was very little public political backing in the United Kingdom.

The opposition of Thatcher and Major to EMU was only partly based on the requirement of central bank independence (see Blair 2002). The transfer of monetary policy-making power to the European level was the much more important cause for concern. During the 1993 debate on EMU and the ratification of the Maastricht Treaty, the issue of independence was raised more as a reason for opposing European monetary integration and very few Members of Parliament (MPs) supported independence. There remained some confusion about the impact of the British opt-out of Stage Three of the EMU project upon central bank independence which was required as part of the second stage, in which the British were supposed to be participating. However, in January 1993, Prime Minister Major reaffirmed the continued opposition of his government to independence (the *Financial Times*, 23 July 1993). A 1993 private member's bill on Bank of England independence was rejected by the government majority and a substantial number of opposition MPs (Marcussen 2000: 255–6).

Most left-wing opponents criticized European monetary integration, central bank independence and 'sound money' principles on the grounds that they conformed with the dominant monetarism of the day, while independence involved unacceptable forms of accountability and gave 'narrow minded' central bankers excessive power. Much of the opposition to central bank independence was linked with the broader xenophobic opposition to EMU, including fear of German domination and the problematic trustworthiness of the Mediterranean member states in money matters, in addition to more general – widespread – opposition to further European integration. The opposition MPs who supported the private member's bill did so for three reasons (Marcussen 2000: 254–5): to enable the Bank of England to participate fully in the ESCB and thus enhance British influence in the EU; to redefine the manner in which the concept of 'political accountability' had traditionally been defined in Britain; and, on economic grounds, to improve inflation performance and the operation of the single market.

Given the widespread hostility in the Labour Party to central bank independence, most observers were very surprised when – only a few days after the May 1997 election – the new Labour Government's Chancellor of the Exchequer, Gordon Brown, announced the decision to grant 'operational independence' to the Bank of England and the creation of the Monetary Policy Committee (MPC) as the Bank's decision-making body. This was justified in terms of providing monetary stability, presented as a pre-condition for improved economic performance. As noted in Chapter 1, Marcussen (2000) explains the move to independence in Britain (as well as the other EU countries not participating in the EMU, Denmark and Sweden) in terms of the ideational coercion of EU policy elites. Entrenching causal ideas about the positive relationship between central bank independence and low inflation in the Maastricht Treaty made it increasingly 'illegitimate' to deviate from this norm. The British Labour Government was also able to place the move to independence in the context of its broader constitutional reform package: independence was presented in terms of modernizing an 'old-fashioned' system. The justifications for reform thus tended to differ from the pro-independence arguments presented in 1993 (Marcussen 2000: 258–63). Crucially, independence was not justified with reference to European monetary integration: it was necessary in itself, not as a stepping-stone to British participation in EMU.

The reluctance of British governments to participate in European exchange rate mechanisms (the Snake of the 1970s and the ERM of the

EMS) and the highly negative experience – in both economic and political terms – of participation (forced removal from the Snake in 1973 and the ERM in September 1992) can be seen as both relating to opposition to central bank independence as well as reinforcing this opposition. The reluctance stemmed in large part from the unwillingness of British governments to restrict their margin of manoeuvre in monetary and macroeconomic policy-making. The monetarism of the 1980s also prohibited exchange rate targeting (although Nigel Lawson secretly/unofficially shadowed the deutsche mark and sought to keep the pound within the fluctuation margins of the ERM for most of the 1980s, he subsequently justified doing so in order to reinforce the pursuit of low inflation in Britain). British non-participation also weakened the role of British central bank governors, who did not participate in the co-ordination exercises of their European counterparts. Non-participation also decreased the likelihood that British governments would accept the reinforcement of central banking power and participate in EMU.

Does the move to Bank of England 'operational independence' suggest that the Prime Minister is determined to push ahead with his plan to hold a national referendum on British participation in EMU? This – in the final months of 2002 – remains far from certain. The decision not to announce a referendum following the June 2001 national election surprised many observers and the continued opposition of a solid majority of British voters to EMU and strong divisions in the Labour cabinet – with Euro-sceptics in the ascendant – may delay a referendum for several years to come. However, it is not the purpose of this brief presentation of British attitudes on central banking and monetary policy to analyse the debate on EMU in broader terms. The crucial question here is whether or not Bank of England 'operational independence' – and we can add the widely proclaimed success of the Bank's MPC in managing monetary policy – has helped to change the views of Euro-sceptic British politicians and public opinion and accept the transfer of monetary power to the ECB? The answer to this question is almost certainly no. Opposition to EMU is rooted in much more than attitudes on central bank independence. Moreover, we should also add that there is a crucial difference between Bank of England operational independence and ECB independence: in Britain, governments set the inflation target that the Monetary Policy Committee must attain by manipulating the short term level of interest rates. If the MPC does not attain the target, the government is entitled to replace its members. In this sense the MPC is more like the governing body of the Bank of New Zealand or, in some respects, the executive board of a 'quango'. That the British government continues to determine the desirable rate of inflation – at least in official legal terms, however restricted it is in terms of how it uses this power – can be said to conform to the British tradition of parliamentary sovereignty (Busch 1994). The Governing Council of the ECB, on the contrary, sets its own inflation target. The 2 per cent figure that it has decided upon has been challenged by many British observers as being excessively restrictive (the current Bank of England target is 2.5 per cent) and likely to hinder economic growth in the Euro-Zone in up-coming years (and unlikely to be met thus weakening the bank's credibility). However, it is impossible for governments to change this figure (and problematic for them to argue in favour of doing so, given the potential impact upon ECB credibility). Given the important difference in the political control over the two institutions it is not surprising that many British politicians, journalists and even members of the Bank of England's MPC have been critical of the ECB's institutional structure. One MPC member, Willem Buiter (1999), has criticized the ECB for being undemocratic, unaccountable and lacking in transparency.

Moreover, well-informed British opposition to EMU has long focused on the difficulty of adopting a single Euro-Zone monetary policy that best meets the economic needs of a dozen different member states. The first three years of the operation of EMU – with strong divergence in economic growth and national inflation rates and the widespread criticism of the ECB's refusal to cut interest rates as rapidly as the Bank of England – have largely reinforced this concern (see Chapter 6). Many politicians and commentators argue that the ECB's pursuit of the narrow inflation target is inappropriate given the diversity of the Euro-Zone national economies. The Blair Government has embraced five economic conditions that need to be satisfied before it will hold a referendum on EMU participation. Most observers agree that the difficulty of determining whether or not Britain has met these conditions makes the future decision on a referendum principally a political one. However, some (see for example, *The Guardian,* 28 January 2002) have also argued that ECB reform should be incorporated into this list of conditions. It is argued that without reform that allows greater flexibility in ECB monetary policy-making, Britain and other member states will not be able to 'live comfortably with euro interest rates on a permanent basis', one of the five conditions. Many British and foreign observers thus hold up the post-1997 Bank of England as the model for ECB reform.

It was also unsurprising when on 23 January 2002, Pascal Lamy, the Socialist French commissioner for trade and Jean Pisani-Ferry, Prime Minister Jospin's economic adviser, published (in a 'personal capacity') a pamphlet echoing British concerns about the structure and monetary policy-making of the ECB (*L'Europe que nous voulons*, 2002).[51] In their pamphlet, Lamy and Pisani-Ferry argued for what could be described as a sixth form of 'economic government': that the ECB should imitate the practice of the Bank of England in following a less constraining monetary policy set by government (2–3 per cent as opposed to the ECB's 1–2 per cent) and being less secretive. They also noted that ECB's structure had been determined by the need to reassure the German public that it would be as tough on inflation as the Bundesbank. The changed economic conditions – especially in Germany – required a different approach to monetary policy. Only reform along British lines would enable a more flexible monetary policy that could better respond to the economic downturn in most of the Euro-Zone. However, for the moment, it appeared unlikely that a German government – even Social-Democratic led government – was prepared to reconsider the original cornerstone upon which EMU was established – ECB autonomy and the singular pursuit of monetary stability.

Conclusion

In this chapter we have attempted to explain the complicated interrelationship between dominant national attitudes on central bank independence and attitudes regarding the structure, roles and powers of the ECB and the operation of the Euro-Zone in which the ECB must operate. The Germans dictated so much of the structure, roles and powers of the ECB, to replicate to a large degree the Bundesbank and the German monetary policy-making tradition at the European level in exchange for the loss of a national central bank and currency that had been the envy of much of the world and the model upheld by adherents to the 'sound money consensus'. President Mitterrand accepted the German design despite the strong reservations of his government and Treasury. However, French efforts since the Maastricht Summit have focused upon developing an EU-level 'economic government' to ensure an 'effective' dialogue between political leaders and the ECB, although to achieve what precise goal remains unclear. We have demonstrated that the use of the term 'economic government' in French government discourse has shifted over the years and varies depending upon the proponent. The dominant versions of EG appear to have shifted from those emphasizing a political counter-weight designed to qualify the 'sound money' bias of the EMU project and the ECB, to those emphasizing the Eurogroup–ECB partnership in the process of stabilization and the building of European monetary policy credibility. It is with this aim, that the German government and ECB Executive Board members have increased their support for a reinforcement of EU-level economic policy co-ordination.

Opposition to central bank independence in the United Kingdom was less easily overridden than in France, where the pursuit of monetary policy power and other objectives through the EMU project outweighed national policy-making tradition. The move to Bank of England 'operational independence' in 1997 and the widely proclaimed success of the MPC in managing British monetary policy are unlikely to contribute to a shift in elite and public attitudes in the United Kingdom on the transfer of monetary power to the ECB, especially given the distinct differences between the Bank of England and ECB models. However, in this context, the January 2002 pamphlet by Pascal Lamy and Jean Pisani-Ferry – setting the Bank of England as the example to follow and thus encouraging British entry into the fray – presents an interesting twist in the on-going Franco-German debate about the ECB and its relationship to political authority.

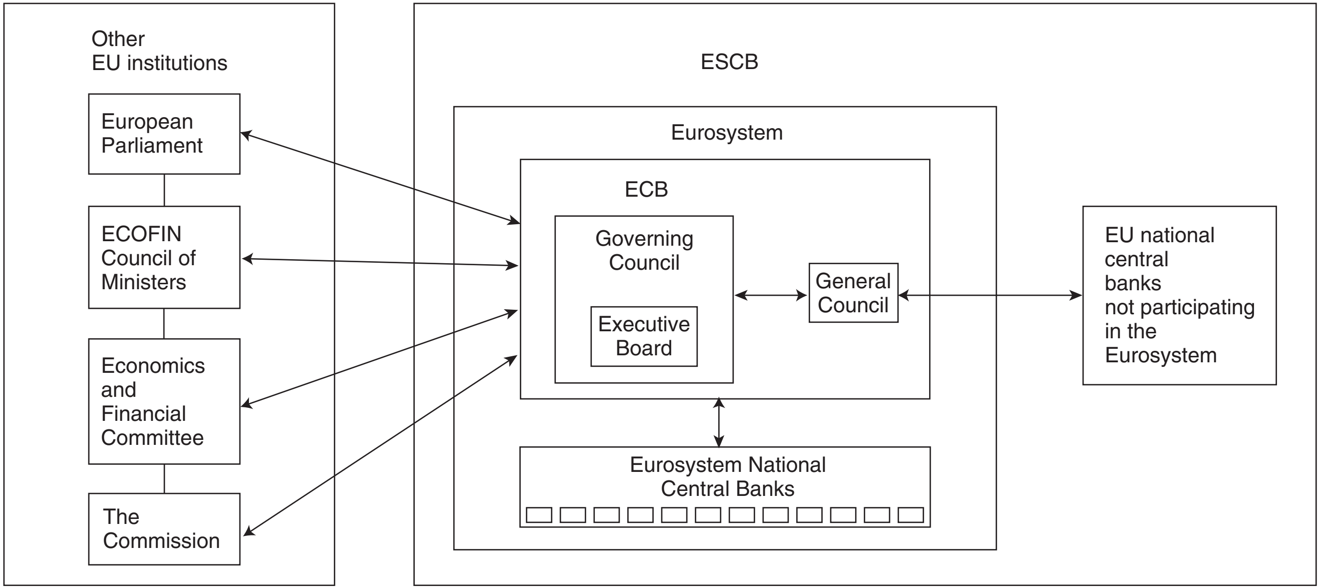
4

Managing Europe's Money: the Organization, Powers and Functions of the ECB

Introduction

The aim of this chapter is to provide a brief overview of the organization – including voting procedures – powers and functions of the ECB and the organization of the ESCB. We also take the opportunity to explore some of the main issues of concern and debate regarding the operation of the ECB and its relationship with other institutions, although we discuss the larger issues of the bank's independence and problematic legitimacy in the following chapter. Despite the ECB's statutory independence, our 'Leviathan' must operate as part of a constantly developing and controversial EMU 'regime' that has a substantial impact on the bank's activities. One issue of debate concerns the role of the ECB over prudential supervision. The ECB argues in favour of transferring control over prudential supervision to NCBs on the grounds that, as part of the Eurosystem, the NCBs are more likely to be effective supervisors of banks which operate in an EU-wide/international market. We also examine the developing and often unclear role of the ECB in the context of four levels of co-ordination. The first is within the Eurosystem and the respective roles of the ECB and NCBs in the management of Europe's money. The second level is in relation to other EU institutions, notably in the context of the 'soft' macroeconomic policy co-ordination managed by the Council of Ministers (the Eurogroup) and the co-ordination with the Council on external monetary policy. The third level is with other EU NCBs participating in the ERMII. Finally, there has been much disagreement regarding the co-ordination of the external representation of the Euro-Zone and the role of the ECB in international level cooperation.

Figure 4.1 The European System of Central Banks: ESCB structure



Composition (see Table 4.1)

The ECB consists of two main decision-making bodies: the Executive Board and the Governing Council. The Executive Board comprises the President, the Vice-President and four other monetary policy and banking experts.[52] They are appointed for non-renewable eight-year terms by the European Council on the recommendation of the Council of Ministers after it has consulted the European Parliament and the Governing Council of the ECB (the Council of the European Monetary Institute (EMI) for the first appointments in 1998) (Articles 11 and 50, ESCB Statute). The first Executive Board members (with the exception of the President) were given terms of different length so that future members can be given staggered terms in order to ensure the continuity of policy-making. According to the Treaty, the Executive Board is appointed on the grounds of recognized standing and professional experience in monetary or banking matters (Art. 109a, Art 112 EC). Officially, Board members, like European Commissioners and European Court of Justice judges (etc.) are not supposed to represent the participating Member States. However – as the designation of the first Board in May 1998 demonstrated – some governments have placed great emphasis on the inclusion of a member from their country and five of the six original members were citizens of the most populous participating member states with the largest economies (German, France, Italy and Spain).

The Governing Council comprises of all the members of the Executive Board and the 'Eurosystem' NCB governors – that is of those EU member states which participate in the Euro-Zone (12 following the accession of Greece on 1 January 2001). NCB governors are appointed by governments for minimum renewable terms of five years. Like the Executive Board, most decision making in the Governing Council takes place, officially, on the basis of simple majority voting. Each member possesses one vote, including the NCB governors regardless of the population and GNP of their member state. In the event of a tie, the President casts the deciding ballot. However, so far, decision-making has been based on consensus and no voting has taken place. Qualified majority voting is used on most matters concerning the ECB's capital. Votes in the Council are weighted according to the national central banks' subscribed capital in the ECB (the NCBs are the only shareholders in the ECB) and Executive Board members possess no votes (Art. 10.3). NCB subscriptions to ECB capital will depend on a formula, the weights of which reflect national shares in the population and gross national product (GNP) of the entire Euro-Zone (articles 28, 29, 32, 33 ESCB Statute). A third voting system – a qualified majority vote of two-thirds (of the votes cast, each member possessing one vote) – is used to adopt the use of new operational methods of monetary control. The President of the Council of Economic and Finance Ministers (ECOFIN) (the Minister of Finance of the member state holding the EU Council Presidency) and a member of the Commission attend the Governing Council and can submit motions to it (Art. 113(3) (ex 109b) EC). However, they have no voting rights. The Governing Council meets normally in Frankfurt roughly every second week on alternate Thursdays (normally twice a month and at least 10 times a year). However, the President or three members of the Governing Council can call a meeting at any time. It was agreed in 1999, that starting in the year 2000 two scheduled meetings each year would be held in a venue in another member state of the Euro-Zone. Several meetings of the General Council have also been organized as teleconferences. Press conferences are held after the first meeting of every month.

The ECB is at the summit of the European System of Central Banks (ESCB), created by the TEU, which consists of the NCBs of *all* 15 EU member states (including those not participating in the Euro-Zone). The governors of the non-participants – currently Britain, Denmark and Sweden – are not entitled to take part in decision-making on the single monetary policy. During the 1991 IGC, the British and Danish governments, anticipating that they would not initially participate in EMU, sought to include all EU NCB governors in the deliberations of the Governing Council even if those from countries not participating in the Eurosystem were not entitled to vote. However, most other governments insisted that non-participants be excluded. The compromise reached involved the creation of a third body, the General Council, to deal with matters concerning the entire ESCB, and thus consist of all ESCB (EU) central banks governors in addition to the President and Vice-President of the ECB.[53] Voting in the General Council also takes place according to simple majority with each member possessing one vote. The four other members of the Executive Board (in addition to the President and Vice-President) are entitled to attend meetings of the General Council, although they have no voting rights. General Councils are held once a quarter on the same days as Governing Council meetings.

The ECB administrative and operational staff is divided into nine directorate generals (DGs): administration and personnel; legal services; information systems; statistics; operations; economics; research; international and European relations; and payment systems. The DGs fall under the responsibility of one of the five members of the Executive Board other than the President. They are further subdivided into either directorates and then divisions or simply divisions. Several directorates stand on their own outside the framework of the directorate generals (for example, prudential supervision, banknotes, and controlling and organization). A total of 770 policy staff from the 15 Member States of the ESCB – including those not participating in EMU – work for the ECB. There are currently over 50,000 employees working in the 12 Eurosystem NCBs. This imbalance suggests the ECB's considerable operational reliance upon the NCBs, an issue discussed below in the context of ECB–NCB relations. The ECB also has working groups (on matters including forecasting and econometric modelling) consisting of experts from the NCBs and the ECB, and committees (notably on monetary policy and international relations) consisting of heads of departments from the NCBs and the ECB.

Powers and functions

Prior to exploring the powers of the ECB it is important to note that it is – like the rest of the NCBs participating in the Eurosystem – an independent institution. The issue of independence is discussed in the following chapter. Here it is helpful to quote article 107 of the TEU (108 EC):

> When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB, nor a national central bank, nor any members of their decision making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision making bodies of the ECB or of the national central banks in the performance of their tasks.

The basic power of the ECB is to define and implement the monetary policy of the Euro-Zone. According to the TEU and the Statute of the ESCB and of the ECB '[t]he primary objective of the Eurosystem [is] to maintain price stability. Without prejudice to [this] objective, the ESCB shall support the general economic policies in the Community and act in accordance with the principles of an open market economy with free competition, favouring an efficient allocation of resources' (Art. 105). The general economic policies of the Community include:

Table 4.1 Current members of the ECB Governing Council (as of 1 July 2001)

Executive Board members and responsibilities
Willem F. Duisenberg (The Netherlands),
President of the ECB: Directorates Communications, Secretariat and Language Services, Internal Audit.
Christian Noyer (France)/Lucas Papademos (Greece) (from 31 May 2002),
Vice-President of the ECB: DGs Administration, Legal Services, Directorate Planning and Controlling.
Eugenio Domingo Solans (Spain),
DGs Information Systems, Statistics, Directorate Banknotes.
Sirkka Hämäläinen (Finland),
DG Operations, Payment Systems, Risk Management.
Otmar Issing (Germany),
Chief ECB economist: DGs Research, Economics.
Tommaso Padoa-Schioppa (Italy),
DGs International and European Relations, Prudential Supervision. ECB Permanent Representation in Washington, DC.
National Central Bank Governors
Jaime Caruana (Spain)
Antonio Fazio (Italy)
Klaus Liebscher (Austria)
Lucas D. Papademos (Greece)/Nicholas C. Garganas (from May 2002)
Yves Mersch (Luxembourg)
Maurice O'Connell (Ireland)/John Hurley (from Feburary 2002)
Guy Quaden (Belgium)
Vitor Manuel Ribeiro Constâncio (Portugal)
Jean-Claude Trichet (France)
Nout Wellink (Netherlands)
Ernst Welteke (Germany)
Matti Vanhala (Finland)

'… balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion' (TEU, Article 2). These goals are cited at the start of the ESCB statute and in so far as price stability is not put at risk, the ESCB *must* take them into consideration when formulating monetary policy. The Executive Board of the ECB implements monetary policy in accordance with the guidelines and decisions laid down by the Governing Council and, in doing so, gives necessary instructions to the NCBs. The Executive Board also executes those powers which have been delegated to it by the Governing Council.

The Statute (principally Article 3) sets out the tasks of the ESCB. Some of these are explored in the previous chapter given the debates during the discussions and negotiations on the ESCB design in the 1988–91 period. Several of these tasks are also discussed in greater detail below.[54]

1. To define and implement the monetary policy of the Community.
2. To conduct foreign exchange operations consistent with the provisions of Article 109 of the TEU.
3. To hold and manage the official foreign reserves of the member states.
4. To promote the smooth operation of payment systems.
5. To contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

Although the ECB does not possess a general power to make regulations, it can do so to the extent necessary to implement specific tasks (Art. 110(1) (ex 108a(1)) EC), notably with regard to the operation of the ESCB (see Craig 1999). Some of the ECB's regulatory power also depends upon what the Council of Ministers grants to it (for example, regarding the establishment of the minimum and maximum reserves to be held by national credit institutions with the ECB). The ECB possesses the limited power to impose fines or periodic penalty payments for failure to comply with obligations contained in its regulations and decisions (Art. 110(3) (ex 108a(3)) EC); notably, with regard to the reserves which credit institutions should hold with the ECB and the prudential supervision of credit institutions.[55] However, it remains the power of the Council of Ministers to establish first the rules. While the possibility exists for the ECB to be taken to the European Court of Justice (ECJ) or Court of First Instance (CFI) on matters pertaining to its management of the ESCB (Craig 1999; Zilioli and Selmayr 2001), the ECB can itself have recourse to the courts (as stated in Article 230(3) (ex 173(3)) EC) in particular with regard to inter-institutional disputes – for example, if the Council fails to consult the ECB on matters where it is expected to do so.

The Governing Council specifically has several responsibilities. It formulates the monetary policy of the Eurosystem 'including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the [Eurosystem] and shall establish the necessary guidelines for their implementation' (Article 12.1 ESCB Statute). Thus the Governing Council has the exclusive right to authorize the issue of bank notes in Eurosystem countries, although the notes themselves may be issued by either the ECB or the NCBs. The Governing Council adopts the monetary policy strategy and makes the decisions necessary to ensure the maintenance of price stability. The three elements of monetary policy strategy, adopted on 13 October 1998, are a quantitative definition of price stability and the 'two pillars' used to achieved this objective: the announcement of a quantitative reference value for the growth rate of a broad monetary aggregate (namely, M3: the stock of notes and coins in circulation, the value of bank current accounts, and deposit or interest-bearing accounts), and a broadly based assessment of the forecast for price developments and risks to price stability in the Euro-Zone (ECB 1998 and 1999).[56] The Governing Council may decide by two-thirds of the votes cast to use other operational methods of monetary control as it sees fit but must respect the price stability and open economy requirements of the ESCB. The Governing Council adopts the internal rules of the ECB and exercises its advisory functions vis-à-vis other Community bodies. It has the power to form opinions on its own initiative on the economic policies adopted by the Community and member state governments on matters which fall within its jurisdiction, crucially with regard to the pursuit of 'sound money' economic policies. The Governing Council has also assumed control over the statute provision that allows 'recourse to the national central banks to carry out operations which form part of the tasks of the ESCB' (Article 12, ESCB Statute). The Governing Council performs these functions on the basis of the work undertaken in the ECB's working groups (NCB and ECB experts) and committees (NCB and ECB senior officials) which prepare reports (monthly, quarterly and annually) that are forwarded to the Executive Board and Governing Council for final approval.

The Executive Board implements the Eurosystem's monetary policy – giving necessary instructions to the NCBs – in accordance with the guidelines and decisions established by the Governing Council. This consists of initiating open market operations which play an important role in the Eurosystem's monetary policy for the purpose of steering interest rates, managing the liquidity situation in the market and signalling the system's monetary policy stance. The Executive Board decides the precise instrument to be used (there are five major instruments to conduct open market operations[57]) and the terms and conditions for the implementation of such operations: on the basis of standard tenders, quick tenders or bilateral procedures. The Executive Board may have certain powers delegated to it by the Governing Council (Article 12 ESCB Statute). The Board prepares the meetings of the Governing Council.

The General Council has assumed responsibility for the tasks previously performed by the European Monetary Institute (EMI) which must still be assumed by a body that includes *all* ESCB NCBs. These tasks include the preparations for setting the irrevocable exchange rates of the currencies joining the Euro-Zone in the future (as in the Greek case in the run-up to its accession in 2001). The General Council also contributes to several ECB functions including: the collection of statistical information; the setting of rules for standardizing the accounting and reporting of operations undertaken by the NCBs; and the establishment of the conditions of employment of ECB staff (some of which come from the three ESCB countries not participating in the Euro-Zone). According to the ESCB's operating procedures, the General Council is also supposed to contribute to the preparation of the ECB's quarterly and annual reports and weekly consolidated financial statements. However, in practice it would be inappropriate for the central bank governors of countries not participating in the Eurosystem (currently Britain, Denmark and Sweden) to make substantive comments on the ECB's reports and statements. The General Council has no role in making Eurosystem monetary policy. It is informed by the ECB President of Governing Council decisions and discusses them. However, the General Council does not have the right to be informed (or consulted) on matters pending before the Governing Council. Moreover – even though the General Council is supposed to continue the work of the EMI – the TEU and the ESCB Statute fail to give it the explicit power to advise the ECB or even nonparticipating EU NCBs on monetary matters.

The debate over prudential supervision

The issue of the role of the ECB in prudential (banking) supervision was discussed briefly in the previous chapter: during the 1991 IGC it was decided to strongly limit the ECB's potential role in this area. The TEU grants the Eurosystem the responsibilities to 'contribute to the smooth conduct of policies pursued by competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system' (Article 105.5), as already encouraged by the First and Second Banking Directives (1977, 1989) and the so-called BCCI Directive which lay the foundations for cooperation (exchange of information), but does not contain specific provisions or institutional arrangements to this end. The Treaty and Article 25 of the ESCB Statute also grant the ECB the right to offer advice and be consulted on the adoption of EC and national legislation relating to prudential supervision and financial stability and the right to perform specific tasks concerning policies relating to this supervision. Moreover, the TEU establishes a simplified procedure – demonstrating the hope of most member states for progress in this area – that makes it possible, without amending the Treaty, to entrust specific supervisory tasks to the ECB (Article 105.6). However, the precise role of the ECB in this area remains the subject of ongoing debate. It is not unusual that the ECB lacks control over banking supervision, in that the central banks in many advanced industrialised countries do not have this power or share it with ministries of finance (more often there are completely separate institutions responsible for supervision). However, the Euro-Zone is rather unique in that the areas of jurisdiction over monetary policy and over banking supervision – which remains nationally based – do not coincide. ECB Executive Board members argue in favour of improved cooperation between Eurosystem central banks (including the ECB) and national banking supervisors on the grounds that central banks are, because of their responsibilities – including money creation, payment services provision, savings management, etc. – necessarily concerned with the health of the banking system and central bank credit control is managed in 'a situation that is generated by problems of interest to the supervisor' (Padoa Schioppa 1999).[58]

The Basle Committee on Banking Supervision – which was the main forum in which multilateral cooperation among EU banking supervisors could be enhanced – assumed the task of promoting cooperation between the ECB, the NCBs and national supervisory authorities. To give the EU members of this Committee a more specifically Eurosystem profile, their gatherings were officially labelled the Banking Supervision Committee of the ESCB. ECB Executive Board members have sought to develop this cooperation further: to ensure that the system of national supervisors can operate as effectively as a single authority when required, in particular when dealing with local or national banking problems which may have wider effects. In a personal capacity, Executive Board member Padoa Schioppa (1999) argues that it is not necessary to take advantage of the possibility created in the treaties and give the ECB greater powers in this area. Rather he seeks the transformation of the largely voluntary cooperation among banking supervisors into 'a sort of euro area collective supervisor to emerge that can act as effectively as if there were a single supervisor' which will 'assist the Eurosystem in the performance of its basic tasks'. The simplified legal procedure established in Article 105.6 could be interpreted as a 'last resort clause', which might become necessary if the development of cooperation between the Eurosystem and national supervisory authorities fails to develop. Kenen (1995, 35) argues that if the ECB is not given responsibility for prudential supervision, then it 'must at least have access to the information gathered by [the prudential supervisors] and it must be consulted by them whenever they expect to act in ways that might affect the banking system or the financial system as a whole'.[59]

The ECB has sought to clarify its position on the role of central banks in prudential supervision, most recently in a March 2001 report. The ECB makes the point that the organization of the institutional framework of the Eurosystem weakens the arguments in favour of a separation of banking and supervisory functions, in large part due to the NCBs' loss of control over monetary policy to the ECB. Furthermore, the ECB claims that EMU and the financial integration that it encourages strengthen arguments in favour of a fusion of responsibilities under the control of NCBs. The growth of large banking conglomerates and the increased risk that bank failure could lead to systemic instability increases the need for NCB surveillance: NCBs are part of the wider Eurosystem with greater capacity to assess effectively the potential for systemic crisis. The emphasis placed on the role of NCBs as opposed to the ECB is due in large part to their role managing the Target payment system, which gives the NCBs much greater awareness than the ECB could ever have regarding the situation of the banks.

The handling of solvency crises is neither within the competence of the NCBs nor that of the ECB. Although it is expected that NCBs will be consulted as they have been in the past, the precise role of the ECB remains unsettled and the lack of crisis management capacity of the Eurosystem has been the subject of some criticisism including from the IMF.[60] Most importantly, the worry has existed that the ECB could become an overly generous lender of last resort which would divert it from pursuing price stability. However, ECB Executive Board members and others argue that that these concerns are overstated.[61]

Four levels of co-ordination

I. Within the Eurosystem: the ECB and the NCBs

The ECB's relatively small Executive Board and its weight on the Governing Council (6 out of 18 places, or a third) demonstrates an important feature of the Eurosystem. Compared to other federal banking systems – including the American Federal Reserve – the Eurosystem is relatively decentralized: national central bankers have more sway collectively than, say, representatives from the American state banks. This reflects the highly decentralized nature of the EU political system and the problematic legitimacy of EU in many member states. Arguably, European citizens are more likely to accept ECB monetary policy if they know that they are represented, however indirectly and unofficially, by NCB governors, and that policy is designed in the fora of working groups, committees and the Governing Council, where NCB experts and officials predominate.

The relative importance of the NCBs in the Eurosystem also reflects practical reality: they are well-established whereas the ECB is a fledgling and small institution. Eurosystem NCBs perform several operations vital to the operation of the Euro-Zone: notably, they conduct foreign exchange operations and ensure the smooth operation of payment systems (including Target). The NCBs hold and manage the official foreign reserves of the Member States (of which they can provide up to 40 billion euro to the ECB) and hold the capital of the ECB (just under 4 billion euro). However, NCBs must follow the regulations, guidelines and instructions of the ECB in these and several other areas: buying and selling securities and other claims; borrowing and lending securities; dealing in precious metals; conducting credit operations with banks and other financial institutions based on adequate collateral; acting as fiscal agents for public entities (although they may not grant them credit facilities or buy their debt instruments directly from them). The ECB can also engage in these activities. The precise role of the ECB in relation to the NCBs depends on the kinds of open market operations selected (with regard to aim, regularity and procedures). NCBs are able to perform tasks beyond those specified in the ESCB Statute, except if the Governing Council decides that these activities interfere with the work of the ESCB. The ECB alone attends Eurogroup meetings and ECOFIN Councils. However, all 12 Eurosystem NCBs (and all 15 ESCB NCBs) occasionally attend informal ECOFIN meetings with varying degrees of participation.

The important role of the NCBs in ECB decision-making (in the working groups, committees and the Governing Council) reflects the reliance of ECB upon the much greater analytical – including statistical – resources available in the NCBs. In this regard, the American Federal Reserve is much better endowed than its Euro-Zone equivalent and relies less on the state reserve banks. The importance of the NCBs in ECB decision-making encourages a combination of collaborative and competitive work (Goodfriend 1999; Mayes 1998 and 2000). In their attempt to have an impact on Governing Council decision-making, each NCB governor will use the resources of his own NCB to provide the necessary information and strengthen his position in the on-going debate with other NCBs and the ECB Executive Board on appropriate policy and the way that the Euro-Zone economy works.

Despite the often heated debate over appropriate policy, members of the Governing Council are expected to speak with one voice on the basis of the agreed upon forecasts, although there is no legal requirement to do so. The President is spokesperson in the official press conference following the bi-weekly meetings, while the other members of the Council have to explain Eurosystem policy in the member states in their own languages, which arguably creates the possibility of diverging expression and interpretation of ECB policy. However, there has yet to be a publicly expressed substantive difference of opinion between members of the Governing Council (as there has been in several member states between members of national monetary policy committees).[62]

Another potential source of divergence in the public expression of policy is the separate national forecasts published by the independent NCBs. Varying NCB forecasts could send different signals to market operators about the development of ECB policy. However, it is the role of ECB working groups and committees to iron out differences and ensure coherence in all the forecasts of the Euro-Zone prior to their publication. In a move that may spell the beginning of the end of separately published NCB forecasts – or at least their slide in significance – the ECB published its first Eurosystem forecast ('Staff economic projections for the euro area') in its *Monthly Bulletin* in December 2000 (with which the NCB forecasts are expected to be consistent).

A major issue of debate in ECB–NCB relations has concerned the appropriate degree of centralization in the different ways that the ECB uses the NCBs to implement its monetary policy and the harmonization of national practices. Prior to the 1990s, the operational procedures of Eurosystem NCBs differed considerably. However, much of this difference reflected the varying structures of national financial systems and of commercial banks asset holdings. With financial integration and growing convergence, the difference in operational structures has diminished. By the mid-1990s, several EU NCBs, including the four largest, were using similar methods (Kenen 1995: 63–4). Nonetheless, in the third year of Stage Three, variations in methods remain due principally to lingering differences in financial markets which result, for example, in various forms of collateral. The Eurosystem is the most decentralized banking system in the world. However, national differences do not prevent the operation of a single monetary policy.

II. Within the EU policy-making system

The provisions of the TEU have created a distinct institutional setting for monetary policy-making with the ECB at its core and a unique policy-making style which can be labelled 'supranational'. The Treaty gives some of the other institutions – notably the EU Council of Ministers, the European Council and the European Parliament – specific responsibilities with regard to monetary policy. However, the ECB interrelates informally with a large number of other actors with distinct roles at both the EU and national levels.

The ECB/ESCB does not have complete control over all aspects of European monetary policy. The Council of Ministers (the Council of Economics and Finance ministers, ECOFIN) is given limited powers over monetary policy and the management of the ESCB. These powers are de facto exercised by the Euro-X (renamed the Eurogroup in mid-2000) consisting of the finance ministers of only the member states participating in the Euro-Zone. Lacking a legal personality, the Eurogroup must have ECOFIN confirm all its decisions. The Council can adopt complementary legislation concerning the operation of the ESCB in a limited number of areas, by qualified majority voting on a recommendation from the ECB after consulting the Commission or by unanimity acting on a proposal from the Commission and after consulting the ECB (Art. 42 ESCB statute). In both situations the European Parliament must give its assent. These articles of the ESCB statute concern the following matters:

- the limits and conditions to be imposed on national authorities seeking to consult the ECB on draft laws in the banks field of competence (Art. 4);
- the people subject to reporting requirements to the ECB and the confidentiality regime (Art. 5.4);
- the 'basis for the minimum and maximum reserves to be held by national credit institutions with the ECB, and the maximum permissible ratios between these reserves, as well as the appropriate sanctions in the case of non-compliance' (Art. 19.2);
- the definition of the scope of other operational methods of monetary control if they impose obligations on third parties (Art. 20);

- the limits and conditions on any increase to the ECB's capital (Art. 28.1);
- further calls for foreign reserve assets beyond the limit set in the ESCB statute (Art. 30.4);
- the limits and conditions on the ECB's power to impose fines or periodic penalty payments on undertakings for failure to comply with obligations under its regulations and decisions.

The Council of Ministers is thus empowered to influence future developments of the operation of the ESCB. However, the Council is unable to modify the objectives or tasks of the ESCB or the provisions regarding its independence. The Council of Ministers is also responsible for setting the rate at which new currencies merge into the euro – as with the drachma – while the European Council makes the final decision on entry. Notably, the Council is responsible for the establishment of exchange rate agreements with third countries and has final say over most aspects of external monetary policy. However, when performing these tasks, the Council must consult the ECB, attempt to reach a consensus, and respect the goal of price stability. The organization of co-ordination, focusing upon the role of the ECB, in the area of external monetary policy is discussed in greater detail below.

The ECB also maintains direct relations with the European Parliament (EP), notably in terms of *ex post facto* reporting and questioning. (These relations are discussed in the context of the issue of the ECB's democratic legitimacy in the following chapter.) The EP must be consulted on appointments to the ECB Executive Board. It receives and debates the ECB's annual report and requests that the president and other Executive Board members appear before its committees (notably, the Committee on Economic, Monetary Affairs and Industrial Policy (C4) and the Subcommittee on Monetary Affairs (SC4)) (Art. 113 (ex 109b) EC) (see, for example, ECB 2000b). The TEU and Statute establish no specific appearance requirements. The EP succeeded in obtaining Duisenberg's agreement that he would appear before the Committee C4 four times a year. In its relations with the EP, the ECB pursues several goals. The wide-ranging review of the ECB by the EP's committees can ensure that the Bank's technical decisions are subject to scrutiny from beyond the ESCB. This review can increase awareness and widen support for the Bank's underlying policies and principles. Regular meetings with the EP's committees can also help to personalize the ECB and build public support for its actions. Overall, however, the EP has little say over the ECB's management of monetary policy. As

Dyson (2000: 69) notes, the model of ECB–EP relations 'is no match for the more Lockian-informed practice of US Federal Reserve-Congress relations'. The ECB is not responsible to the EP or other EU institutions: none have the power to dismiss ECB Executive Board members on the grounds of unsatisfactorily performance according to fulfilment of the Bank's own goals (as in New Zealand) (Taylor 2000).[63]

Co-ordination at the European level in the areas of fiscal and macroeconomic policy is leading to greater horizontal fusion and the creation of a form of 'economic government': (as defined in Chapter 3) an institutional set-up at the EU and national levels 'of collective governance among core actors from several institutions and bodies in a multifaceted network which is constituted by mutual participation patterns' (Wessels and Linsenmann 2001; see also Wicks (1999), Wyplosz (1999) and Boyer (1999)). Fiscal, economic and employment policies are all of great concern to the ECB as they have a direct impact on the capacity of the central bank to manage monetary policy to achieve the goal of price stability (the search for an appropriate 'policy-mix') and shape public perception of both the nature of this goal and the ECB itself (Aglietta and de Boissieu 1998). The nature of policy-making differs considerably from the 'supranational' policy-making in monetary matters where the ECB is dominant. The European bank's role in both the 'hard' – binding – co-ordination of fiscal policy (Art. 105 EC and the Stability and Growth Pact) and 'soft' – largely unbinding – co-ordination of macroeconomic and employment policies (Art. 99 and 128 EC) is more subtle and not yet fully fleshed out.[64] Nonetheless, the ECB is an important part of the institutional set-up in these areas of policy-making which directly influence the manner in which it carries out its monetary policy responsibilities. Collectively, these policy processes form part of a 'stabilization state' (Dyson 2000). Unlike the regulatory state, the instruments of stabilization will need to be used in a discretionary and sometimes discreet manner given the likelihood of problematic political implications in many of the Euro-Zone member states.

According to the TEU, the ECB is expected to be involved in a 'constructive dialogue' with the other institutions engaged in this co-ordination – crucially the Council. Opportunities for constructive dialogue are invariably increased by the right of one ECB Executive Board member (normally the President) to attend Council/Eurogroup meetings where matters pertaining to the tasks of the ESCB are discussed. Two members of the ECB Executive Board – along with representatives from national ministries of finance and central banks and the Commission – also attend meetings of the Economics and

Financial Committee, where the negotiations on the details of macroeconomic policy co-ordination take place. The presence of the President of ECOFIN/the Eurogroup and a member of the Commission at ECB Governing Council meetings – and their right to submit motions – also contributes to the constructive dialogue (Art. 113(3) (ex 109b) EC) (Everson 1999).

The precise role of the ECB in these policy areas varies. In the 'hard' co-ordination of fiscal policy, the ECB contributes to policy-making in the Eurogroup aided by the presence of its President (Eijffinger and de Haan 2000). The European Bank consults informally with the Commission alone and formally with national and Commission officials in the Economic and Financial Committee which are given the power (Art. 104 EC) to watch over national budgets. The Stability and Growth Pact (agreed at the December 1996 Dublin European Council) gives the Commission – not the ECB – the power to express opinions to ECOFIN to adopt recommendations, requirements and ultimately impose sanctions if the obligatory annual national fiscal and structural plans are deemed insufficient (Artis and Wrinkler 1997). However, the ECB will also have its word to say on national plans, notably in the Eurogroup and through the Economic and Financial Committee (which must also be consulted) and informally. What the ECB thinks about national plans will invariably have as much influence on Council pronouncements as the Commission's opinion – if not more. The manipulation of interest rates – or the threat of doing so – can be seen as the ECB's most effective sanction of inadequate member state policies. Likewise, the ECB President can appear before the European Parliament to defend the continued imposition of Stability and Growth Pact rules and (one day) even recommend the use of fines, however politically problematic this might be.

The interest rate weapon is likewise a source of influence in the context of the 'soft' (largely unbinding) co-ordination on economic and employment policies. In addition to its links with the Eurogroup (ECOFIN) and the Economic and Financial Committee, the ECB has input in the macroeconomic dialogue (the Cologne process) initiated by the Germans during their 1999 EC Presidency as a means of improving the interaction between monetary, budgetary and fiscal policy and wage developments in order to achieve stronger growth and higher employment – although this dialogue accepts that price stability and appropriate wage developments are crucial to good and sustainable economic performance over the medium and longer term. The Broad Economic Policy Guidelines (BEPGs) – established in the Maastricht

Treaty under article 103 (article 99 of the consolidated treaty) – were clarified to integrate the different 'soft' co-ordination processes at the EU level including the stability and convergence programmes of the Stability and Growth Pact, the National Action Plans for Employment and the Joint Employment Reports. Because of the lack of binding EU rules in this area, however, national central banks will continue to play a vital role in the co-ordination process as the interlocutors with the other elements of the ESCB and national finance ministries (see below).

Despite the gradual development of 'economic government', the lack of binding EU rules in these areas means that co-ordination on macroeconomic and employment policies will remain 'soft' for the foreseeable future despite pressures for continued convergence. In the context of 'soft' macroeconomic policy co-ordination, the links between Eurosystem NCBs and national governments remain vital in terms of establishing the precise policy-mix that is best for each country, in the context of the maintenance of sound money policies, and for the Euro-Zone more generally. However, the ECB will increasingly take centre stage in the co-ordination of NCB efforts.

To date discussions in the Eurosystem have been rather general in nature and, as noted above, the ECB only published its own Euro-Zone-wide forecasts and simulations for the first time in its December 2000 *Monthly Bulletin* (ECB 2000c). The refinement of Euro-Zone-wide analysis should improve co-ordination by helping the Commission and national governments set the guidelines for fiscal, employment and structural policies. It should also improve ECB policy-making transparency which – linked with the accountability of ECB – is a major concern of both economists and political scientists.

Moreover, co-ordination is a two way process: it is meant to shape national government policy-making as well as the formulation of ECB monetary policy (via the NCBs). Much of the co-ordination is informal and indirect (as in most countries where the central bank is independent). The main players never physically sit around the table and agree on what to do. In terms of national policy-making, the focus is currently on actions rather than outcomes. However, the process of policy co-ordination has been improved with the implementation of the Broad Policy Guidelines and the Annual Review of Structural Policies which focus on longer term structural questions such as pensions. Member state governments have to set out their fiscal and structural plans on an annual basis. As noted above, the ECB takes a great deal of interest in the plans and expresses its views to the Council. In the light of the likely developments of national fiscal and structural policies, the

NCB governors and Executive Board members debate appropriate monetary policy. The NCBs will also express the ECB's opinion of the plans at the national level.

Confusing co-ordination on external monetary policy

The respective roles of the ECB and the Council of Ministers in the formulation of external monetary policy were the subject of considerable debate during the 1991 IGC and the contents of Article 109 TEU went through numerous draft versions. The central bankers and several member state governments – notably the German government – were concerned with the inflationary effects of exchange rate agreements which might require ECB intervention on the foreign exchange markets in a manner damaging to the pursuit of price stability (precisely the Bundesbank's fear with regard to its obligations in the context of the EMS). Because of this concern several pro-EMU economists, including Gros and Thygesen (1992), opposed the creation of a residual EMS. Other member state governments insisted that governments, through the Council of Ministers, keep their control over exchange rate policy. The careful, rather complex, wording on this matter in Article 109 TEU should be quoted at length.

> 1. … the Council may, acting unanimously on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, after consulting the European Parliament, in accordance with the procedure in paragraph 3 [below] …, conclude formal agreements on an exchange rate system for the ECU in relation to non-Community currencies. The Council may, acting by a qualified majority … and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, adopt, adjust or abandon the central rates of the ECU within the exchange rate system.
> 2. In the absence of an exchange rate system in relation to one or more non-Community currencies as referred to in paragraph 1 [above], the Council may, acting by a qualified majority either on a recommendation from the Commission and after consulting the ECB, or on a recommendation from the ECB, formulate general orientations for exchange rate policy in relation to these currencies. These general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability.

> 3. … where agreements concerning monetary or foreign exchange regime matters need to be negotiated by the Community …, the Council … shall decide the arrangements for the negotiation and for the conclusion of such agreements. These arrangements shall ensure that the Community expresses a single position. The Commission shall be fully associated in the negotiation. … Agreements concluded in accordance with the paragraph shall be binding on the institutions of the Community, on the ECB and on Member-States.
> 4. Subject to paragraph 1 [above], the Council shall, on a proposal from the Commission and after consulting the ECB, acting by a qualified majority decide on the position of the Community at the international level as regards issues of particular importance to economic and monetary union and, acting unanimously, decide its representation … .

The interpretation of Article 109 remains a matter of debate.[65] Paragraph 1 is relatively clear, although there is no indication as to what the attempt to reach consensus would really amount to. Paragraph 2 fails to note which body has the power to judge whether exchange rate agreements are inflationary – or how it would do so. The answer cannot be found in the third paragraph's stipulation on the Council's decision-making power which is cited in the first but not the second paragraph. The lack of clarity raised concerns regarding the ECB's ability to maintain price stability, heightened since the exchange rate crises of 1992–93 and the obligation placed on the Bundesbank to provide massive assistance to support weaker currencies in the ERM.

However, the threat to price stability is not particularly great for reasons that are both institutional and practical. On the institutional side, the Council can only enter into a formal agreement on a proposal from the Commission or the ECB, preventing unilateral action. Moreover, any 'general orientation' guidelines for exchange rate policy that the Council establishes on its own or with country partners (such as those found in the Plaza and Louvre Accords of 1985 and 1987) would not be binding on the ECB. Although not clearly established in Article 109, it has also widely been accepted that the ECB could be the only judge to determine the compatibility of these guidelines with the goal of price stability (Kenen 1995).

On the practical side, Euro-Zone member states are far less interested in exchange rate agreements with major currencies such as the US dollar and the yen than previously because of the much diminished exposure of the Euro-Zone economy to foreign currency fluctuations than that faced by individual EMS countries prior to the start of Stage Three. Moreover, most members of the ECB Governing Council, emphasizing the ECB's primary goal of price stability, appear to share the Bundesbank's scepticism towards exchange rate agreements and even currency stabilization on the grounds that this could distract domestic monetary policy from the primary purpose of securing internal price stability.[66] The ECB thus ignored the demands of German Social Democrat government leaders (both Lafontaine and Schroeder) for more active policies in this area.

Some observers claimed that for much of 1999 and 2000 there were strong tensions within the ECB Governing Council between supporters of a flexible currency regime and supporters of a more managed exchange rate policy (Padoan and Henning 2000: 41). The dramatic decline of the euro versus the dollar since January 1999 – and the considerable attention paid to this by the European media – finally prompted coordinated interventions with the US Federal Reserve and the Japanese central bank in September and November 2000. (See Chapter 6 for detailed coverage on the interventions.) Officially, these interventions were justified on the grounds of the impact of the dollar's rise and 'economically unjustified' slide of the euro on the world economy and the potential contribution to Euro-Zone inflation. They were designed to break the widespread expectations in the markets that the ECB would not intervene and to discourage the reigning pessimism in the markets on the value of the euro. Support for occasional interventions, however, does not mean that the Governing Council has embraced an actively managed exchange rate policy let alone growing support for exchange rate target zones. ECB President Duisenberg (2000c) has repeatedly reaffirmed the ECB's opposition to the establishment of any exchange rate target and the dangers of ex ante exchange rate co-ordination to the ECB's mandate and independence. The overall policy mix in the Euro-Zone of tight fiscal policy required by the Maastricht convergence criteria and the Stability Pact, combined with a flexible monetary policy (the so-called Clinton–Greenspan combination) appears sustainable in the medium term.

A further reason for the limited preoccupation with the potential impact of external monetary policy on the Euro-Zone has been the small number of ERM II members. Interventions in the context of ERM II – consisting initially of Denmark and Greece alone and now just Denmark – cannot seriously threaten the pursuit of price stability in the Euro-Zone. However, the extension of the ERM II to central and eastern European accession countries will create more concern for the ECB.

It is perhaps surprising that the complicated machinery of the Euro-Zone's external monetary policy-making has not yet been clarified and the elements addressed in the TEU not yet fully operationalized. ECOFIN (Eurogroup) possesses the leading role in the formulation of external monetary policy, except for foreign exchange operations for which the ECB is responsible. However, there is a lack of clarity on several matters: the line between policy formulation and operations, the organization of internal consultation between the ECOFIN and the ECB on intervention and the role of the Commission. Padoan and Henning (2000) argue that it would be highly problematic if the ECB had to assume authority over external monetary policy in the event that the Eurogroup was incapable of taking action. They doubt that a central bank alone could sufficiently manage a number of international contingencies. They point out (2000: 36) that:

> Financial relations with countries such as Russia, international financial rescues, and even foreign exchange intervention have a heavy political content and are generally negotiated by political authorities. A central bank whose transparency and democratic accountability were under scrutiny, such as the ECB, would be well advised to secure political cover for external monetary operations (36).

III. Cooperation and co-ordination with other EU NCBs

A third level of cooperation/co-ordination concerns the relations between the ECB and those ESCB central banks not participating in the Eurosystem – the United Kingdom, Sweden and Denmark (since June 1998), Greece (from June 1998 to the end of 2000) and future new EU member states. The TEU imposes no reciprocal responsibilities on the ECB with regard to the management of the exchange rates between the euro and non-participating currencies. Article 109k requires EU member states not participating in EMU to assume only a vague exchange rate obligation (to treat their exchange rates as matters of common interest). The ECB's General Council is the only forum for the meeting of all the ESCB central bank governors. However, the TEU and the ESCB Statute fail to note that the General Council inherits the responsibilities of the EMI for fostering monetary and exchange rate policy co-ordination and monitoring the EMS. Indeed, given its lack of powers and right to information (discussed above), the General Council is an inadequate body to bring about this fostering.

Kenen (1995) argues that the organization of an adequate forum for promoting exchange rate co-ordination between the ECB/Eurosystem and the non-participants is important. Although the number and economic importance of the member states not participating in EMU is lower and less than Kenen had feared, the future accession of central and eastern European countries will likely increase the significance of this level of co-ordination. Kenen (1995; 190) recommends that

> the treaty should be amended to establish a new body comprising the president of the ECB and the governors of the central banks of the nonparticipating countries. It should not replace the General Council, which will have duties of its own, but should have responsibilities and powers similar to those of the EMI. It should have the right to be consulted in advance concerning important policy decisions by the Governing Council of the ECB and the right to give advice to individual central banks, including the ECB. Furthermore, it should be made responsible for managing exchange rate arrangements linking the ECU with the nonparticipants' national currencies.[67]

Kenen also anticipated the creation of a residual EMS with mutual obligations for the ECB and the participating countries. All four member state governments not participating in EMU signed up to the ERM II agreement in September 1998. However, they were not required bring their currencies into the mechanism. Greece and Denmark did so, which potentially mitigated the co-ordination problem. However, the ERM II has kept the ±15 per cent fluctuation margins of the post-1993 ERM and it minimal reciprocal agreements. Moreover, the United Kingdom and Sweden have opted for floating. As members of the ERM II they would have been obliged to continue respecting the conditions of the original EMS: a regular exchange of information with the ECB on developments in foreign exchange markets and prior agreement of other EU central banks to use currency issued by them for interventions or other transactions in excess of certain amounts. The more general aim of the ERM II agreement is to encourage all participants to orient their economic policies towards encouraging stability and convergence. However, this does not encourage cooperation, let alone co-ordination, in exchange rate management. In the obviously asymmetric ERMII, the burden of adjustment falls on the participating countries outside the Euro-Zone.

IV. The ECB, the external representation of the Euro-Zone and international level cooperation

What role should the ECB play in the external representation of the Euro-Zone in intergovernmental organizations and international level cooperation that touches upon its areas of competence? This issue links into the broader problem of the division of responsibilities among EU institutions over the major elements of economic policy and the respective roles of ECOFIN, the Commission and the ECB in external representation.[68] The current absence of a Euro-Zone equivalent of the US Treasury Secretary (despite efforts by the French and Belgian Eurogroup presidencies to create a 'Mr Euro') potentially strengthens the role of the ECB (however desirable). The issue of representation has been a subject of debate since the Delors Committee. However, serious discussion on the matter only began following the creation of the ECB in June 1998, awaiting a decision by both international organizations and ECOFIN (as stipulated in Article 109.4 TEU).

The official ECB position on external representation runs as follows (Duisenberg 2000). The ECB plays three different roles in the international community which are determined by the Eurosystem's tasks involved in international relations. First, the ECB is a major and autonomous counterpart of the Eurogroup whenever the Eurosystem's exclusive jurisdictions – monetary policy and related central banking tasks – are involved in international relations. Second, with regard to issues relating to the exchange rate of the euro, the ECB shares with the Eurogroup the responsibility for consultation with third parties. However, the ECB is solely responsible for external representation concerning foreign exchange operations. Third, within the limits of the Eurosystem's field of competence, the ECB can advise other Euro-Zone policy-makers on international issues. In specific circumstances the ECB may also act as 'catalyst for cooperation' with third countries. This may happen when the Eurosystem develops common views on issues which fall within the competence of other Euro-Zone authorities (mainly national governments), but in which the Eurosystem has a strong institutional interest, in accordance with its statute. This applies, for example, to issues related to the stability of global financial markets and the architecture of the international monetary system, which in turn affects the ability of the ECB to pursue its price stability goal in the Euro-Zone.

The ECB made its initial demands for right to external representation on the basis of Article 6 of the Statute of the ESCB. Article 6.1 provides that 'in the field of international co-operation involving the tasks entrusted to the ESCB, the ECB [namely, the Governing Council] shall decide how the ESCB shall be represented' by the ECB and/or by Euro-Zone NCBs.[69] Moreover, ECB officials have pointed to Article 109 TEU, paragraph 3 which stipulates that the coordination on external monetary policy must 'ensure that the Community expresses a single position'. ECB officials claim that in order to ensure consistency and coherence in the development of Euro-Zone positions, the ECB must be present whenever matters falling into its jurisdiction are discussed (Padoa-Schioppa 1999). ECOFIN/Eurogroup also has an interest in ECB participation in international fora. The potential success of (eventual) international exchange rate cooperation (under the aegis of the G-7) or concerted intervention (organized through the IMF) will rely very much on both ex ante and ex post internal Euro-Zone co-ordination that ensures that the ECB will be willing and able to implement the policy bargain (Kenen 1995; 118). Dobson (1991) argues that the difference between success and failure in the work of the G-7 depended crucially on the degree of agreement between the German government and the Bundesbank (see also Kennedy 1991, Henning 1994). The ECB will likely play a similar role in the context of international exchange rate management.

On 1 December 1998, ECOFIN proposed arrangements endorsed by the Vienna European Council a few days later. These dealt with ECB representation in bilateral and multilateral intergovernmental fora, including the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD) and the Group of Seven (G-7) Finance (meetings of finance ministers and central bank governors from the G-7 countries, distinct from the summit meetings of heads of state or government, and responsible for exchange rate policy cooperation). ECOFIN wanted three-member Community delegations to attend these international fora, including the ECB president and a Commission representative. The arrangements were described as pragmatic and temporary to be developed further. ECB representatives were also to be actively engaged in the preparation of Euro-Zone positions for these meetings within the Economic and Financial Committee (EFC) prior to being finalized in the Eurogroup. Given the diverse circumstances of bilateral economic relations with third countries, the EU finance ministers did not set arrangements for Euro-Zone representation. The presence of the ECB in these bilateral discussions would be left to the Council Presidency.

The organization of ECB representation in international fora required difficult negotiations with international partners. Difficulty arose in part from the fact that intergovernmental institutions such as the IMF or the OECD are – with minor exceptions such as Belgium and Luxembourg – organized on the basis of a strict correspondence between one currency and one country. The situation was potentially less problematic with regard to the G-7 Finance and the G-10 Governors which, set up under the aegis of the BIS, are informal, less institutionalized fora. Special arrangements therefore had to be designed in order to enable the ECB to contribute to the representation of the Eurosystem in these institutions. With regard to the IMF, this was less problematic given that there was no question that the ECB could gain membership and voting powers. The major concern was the over-representation of the Euro-Zone; thus Commission representatives were not allowed to attend IMF Executive Board meetings. In December 1998, the IMF Executive Board agreed to grant observer status to the ECB (IMF 1998) and the right to send a representative to Executive Board meetings (which did not require an amendment to the Fund's Article of Agreement).[70] The ECB representative attends and has the right to speak at meetings on the role of the euro in the international monetary system, multilateral surveillance of the Euro-Zone and individual countries within the zone, international capital market reports and world economic and market developments. The ECB observer represents the ECB at IMF Executive Board meetings on agenda items recognized by the ECB and the IMF to be of mutual interest for the performance of their respective mandates. The representative can also be invited to other Executive Board meetings – such as discussion on international financial architecture – although s/he does not have the *right* to attend. The official Euro-Zone representative on the IMF Executive Board remains the Council President (chair of the Eurogroup). The ECB's role is limited compared to that of the member state governments, although its presence may help to unify the views of the EU participants on particular matters.[71]

Likewise with the OECD, another intergovernmental institution, ECB membership was out of the question. However, the organization deals with issues – notably its surveillance of the Euro-Zone – relating to the tasks assigned to the Eurosystem. In February 1999, the OECD Secretary General confirmed that the ECB would be allowed to participate in the work of the relevant committees and working groups as a separate member of the EC delegation alongside the European Commission.[72] The ECB also obtained observer status in the meetings of the G-10 Ministers and Governors which are organized in connection with the IMF Interim Committee meetings. It should be stressed that observer status in these fora does not mean a passive role for the ECB: the ECB is the most independent central bank in the world and responsible for the monetary policy of an area with the second largest economy. ECB Executive Board members (and Eurosystem governors) have taken strong outspoken positions on major international monetary, financial and other economic issues.[73]

Despite its informal status, ECB representation in the G-7 (G-8 including Russia) proved more problematic. The EU's proposals were rejected by the non-European members of the G-7 on the grounds that the Euro-Zone would be over-represented in the organization, given the presence of Euro-Zone NCBs. Nonetheless, on an ad hoc basis the President of the ECB started participating in G-7 Finance meetings from October 1998 on issues related to monetary policy and multilateral surveillance, including exchange rate policy cooperation. Provisional arrangements for Euro-Zone representation were finally agreed upon at the June 1999 G-7 meeting in Frankfurt. The ECB president would replace Euro-Zone NCB governors during the first part of G-7 Finance meetings when monetary matters are discussed. The viability of these arrangements remains to be seen. The aim of many G-7 participants and Euro-Zone member states is to form a 'monetary G-3' (following the eventual accession of the UK to the Euro-Zone) which might eventually be paralleled by a finance trio. The eight smaller Euro-Zone member states currently excluded from the G-7 have a particular interest in strengthening the role of the ECB. In central banking fora, the participation of the ECB has been more straightforward: the ECB president participates in the meetings of the G-10 Governors organized in the context of the BIS and in the committees under the aegis of the governors, notably the Basle Committee on Banking Supervision and the Committee on the Global Finance System.

The ECB does not find the temporary ad hoc approach to its representation in international fora satisfactory. Duisenberg (2000b) argues for the gradual but fundamental adaptation of the traditional institutional framework of international relations on the grounds that the existing framework – based on the representation of national governments – 'was not tailored to the involvement of monetary unions, nor to the advent of the Eurosystem, and more generally the [Euro-Zone], as a new actor in international relations'. In other words, the observer status of the ECB in the IMF and OECD is acceptable, but only as a first step to improved representation. With regard to

Eurosystem representation in international fora where both ministers and bank governors are represented (G-7 Finance, G-20), Duisenberg focuses on the capability to speak with one voice (if and when appropriate). He argues that the specific arrangements already established 'may still call for some improvement'. In these fora, Duisenberg seeks a clearer Euro-Zone political counterpart for the ECB: instead of the four or twelve Euro-Zone member state finance ministers (in the G-7 and G-20 respectively), he would prefer a single Eurogroup representative with a higher profile. This would make it easier to achieve and maintain single policy positions in the context of multilateral discussions and negotiations, and thus simplify international level decision making as well as the ECB's role. The aim here is to overcome a more general problem with the internal coordination of external monetary policy: namely, the lack of rules to oblige member states to adhere to a common policy and speak with one voice.

At the bilateral level – notably in terms of intervention in foreign exchange markets and the organization of financial rescues – the respective roles of the Council President and ECB have yet to be determined. The ECB has proceeded in forging improved bilateral relations with other central banks. Notably, it has become involved in the EU enlargement process by providing assistance to the central banks of central and eastern European candidate countries to prepare them for participation in the ESCB following accession and their eventual participation in the Eurosystem. In Helsinki in November 1999 and Vienna in December 2000, the representatives of the ECB Executive Board, the then 11 Eurosystem NCBs and the central banks of the 12 countries applying for EU membership met together in seminars to review the central banking issues involved in the accession process, identify the main problem areas and enhance cooperation between the Eurosystem and applicant NCBs. Issues of common interest include primarily monetary and foreign exchange policy matters, financial market structures and the legal convergence of central bank statutes in applicant countries. Tommaso Padoa Schioppa, the Executive Board Member responsible for international and European relations has also visited other central banks – starting with Japan, Korea and China in early 1999 – and other central bankers have been received in Frankfurt, with the aim of improving bilateral ties on issues of mutual concern including operational facilities, cooperation in matters concerning prudential supervision and financial stability, the provision of technical assistance but also systemic issues, such as the strengthening of the international monetary and financial system. In addition to central banks, the ECB has begun to establish contacts with other relevant foreign institutions, such as banking supervisory authorities, local banking associations, stock exchanges and national public administrations. ECB Executive Board members have, in numerous private banking fora called upon improved cooperation between the ECB and the private sector with the aim of strengthening the international financial architecture (for example, Duisenberg 2000).

Duisenberg (2000b) explains the rationale behind the ECB cooperation activities at the international level. Much of this cooperation is consultation, which consists of a regular mutual exchange of information and views in both international fora and bilateral contacts. The principal aim here is to better incorporate possible spill-over effects from third country policy actions into the ECB's analysis of price developments in the Euro-Zone. In the IMF and OECD, cooperation also involves Euro-Zone surveillance: the regular monitoring and assessment of the economic policies of the Euro-Zone and its member states. International surveillance contributes to the transparency of both the ECB and Euro-Zone governments as both the IMF and the OECD make their assessments of Euro-Zone economic policies available to the public. Cooperation can then extend to the development of 'standards' and 'codes' developed by the international community which constitute a form of multilateral rule-making to be implemented on a voluntary basis, for example, 'The IMF Code of Good Practices on Transparency in Monetary and Financial Policies'. The ECB participates in international organizations also to watch closely over the development of cooperation – consultation, surveillance and co-ordination – among macroeconomic policy-making officials. Above all, ex ante co-ordination[74] of macroeconomic policies and exchange rates creates the greatest potential danger for the ECB's mandate and independence.

Conclusion

This chapter has provided a brief overview of the organisation, powers and functions of the ECB. We have also explored some of the main issues of concern or debate regarding the operation of the ECB and its relationship with other institutions at the four different levels of co-ordination: Eurosystem NCBs in the management of monetary policy; other EU institutions (notably the Eurogroup) in the co-ordination of EU macroeconomic and Euro-Zone external monetary policy; ESCB and specifically ERMII NCBs; and Euro-Zone governments, NCBs and the European Commission within international institutions and gatherings (IMF, OECD, G-7 and G-20). The role of the ECB and Eurosystem in the monetary and economic management and representation suffers from a lack of clarity in some areas (notably in external monetary policy) or, in the ECB's view, insufficiency in others (notably prudential supervision and representation in international relations), and is still being fleshed out. The question of the ECB's role in the four levels of co-ordination is complicated in that it frequently involves wider issues, crucially the bank's problematic legitimacy. The precise role of the ECB in the four levels of co-ordination will remain the subject of debate for some years to come.

5
The Independence of the ECB

> It's normal for the political side to give suggestions or opinions, but it would be abnormal if these suggestions were listened to.
>
> Wim Duisenberg, President, European Central Bank[75]

Introduction: the institutional dilemmas of an independent central bank

The monetary policy of the European Central Bank (ECB) was in many ways supposed to be different than the policies pursued by national central banks. As the *Financial Times* noted, 'It was not meant to be like this'.[76] From the ECB's first days in office in June 1998, the ECB's policies were extremely politicized, its independence questioned, and its credibility doubted. What is immediately and abundantly clear is that the institutional and policy dilemmas faced by the ECB are quite similar to the dilemmas faced by other national central banks over the last 50 years. Exchange rate fluctuations, to say nothing of internal political pressure from the Euro-Zone governments, act as a direct constraint on the ability of the ECB to pursue an independent monetary policy. The ongoing efforts of the ECB to prop up the sagging euro – which has lost over 20 per cent of its value since its inception in January 1999 – illustrate the dilemmas the bank faces. While the weak euro boosts exports from and employment within the Euro-Zone, the euro's value demonstrates in part the power of the markets over the ECB, contributes to the credibility problems of bank, complicates trade relationships with non-euro members and the US, and undermines public support and confidence in the euro. The first years have been difficult ones for the ECB.

With the ability of nations to restrain capital all but eliminated as a viable policy option, the choices facing the ECB are clear. The ECB can retain 'domestic' (meaning within the Euro-Zone) monetary autonomy and pursue targeted monetary objectives, but sacrifice a measure of exchange rate stability in the process. Or the ECB can pursue a monetary policy emphasizing exchange rate stability but at the expense of 'domestic' monetary policy autonomy. Although the choices for central bankers and politicians may not always be so simply arranged on an autonomy–exchange rate stability continuum (Cohen 1993), for analytical purposes such an approach can be useful to understanding the degree of ECB independence. This chapter examines the level of political, personal and financial independence of the ECB. Drawing upon previous analyses of other independent central banks, in particular the Bundesbank, we can set forth some basic propositions on the likelihood of an independent ECB monetary policy. Indeed, most studies have suggested that the ECB is in fact more independent than the Bundesbank (DeHaan 1997; Elgie 1998). Our analysis confirms this impression and suggests that we should expect the ECB to be quite independent in terms of its strict mandate on interest rates and price stability.

At the same time, the ECB will experience increased and ongoing difficulties as a result of external exchange rate politics that will complicate its Euro-Zone monetary objectives. Adding to these difficulties is the lingering debate over the democratic accountability of the ECB. Can an independent ECB be held accountable for its actions? Indeed this question is central to our analysis of the possible new 'leviathan' emerging on the European landscape. This chapter seeks to clarify some of the debates over the accountability and independence of the ECB and provide our conception of the relationship between these two concepts.

Debating central bank independence

In the negotiations leading to Maastricht, the key debate over the institutional structure and the policy-making powers of the future ECB was over the issue of the degree of central bank independence from political influence (Hasse 1990; De Haan 1997; Brentford 1998; Verdun 1998a; and Loedel 1999a). More directly, would nation states have any authority and influence in the policy decisions of the future ECB? While most analysts focused on the influence of states, other possible influences – business and banking associations, and labor unions, for example – would also need to be limited. The focus on central bank independence was strongly articulated by Germany and especially Bundesbank officials, given Germany's strong tradition of non-inflationary monetary policy and independent central bank (Loedel 1999b). Germany's views were also shared by a number of the leading architects of EMU, primarily within the Delors Committee (Verdun 1999).

The view from Germany and the Delors Committee was based on a series of arguments. Most empirical studies have shown that countries with independent central banks achieve substantially lower rates of inflation than countries in which the central bank is controlled directly by the government (Alesina and Summers 1992; Bernard 1998; Blinder 1998), although there is mixed evidence from some other countries – primarily in the developing world (Posen 1993). Others argue that independence is important due to technical factors – policy-making from an independent central bank can be more straightforward and responsive to short-term needs of the economy in order to avoid the inevitable delays or 'decision lags' that exist in the normal political process. While some can argue that central banks also suffer such 'time-lags' (for example, 6–9 months or even much longer) and their decisions have not always been accurate or timely in nature, proponents counter that an independent central bank will at a minimum remain consistent in its monetary policy orientation.

One can also see constitutional principles at work and envision an independent central bank as a separate branch of government that can check potentially damaging policies of other government branches (Issing 1999). For example, the German Bundesbank has long suggested that that the bank acted as a state within state, a coalition partner of the government. In other words, the Bundesbank could act as a check upon the actions of the federal government if the government's spending policies threatened price stability. The same logic could be applied to the ECB as it constantly reminds the Euro-Zone governments to reign in spending under the limits set forth in the Stability and Growth Pact. Furthermore, in view of the politicians' short term motivation and propensity to spend in support of lobbies, interest groups and other pressures, issuing money, that is, making the central bank provide credits when needed, should be limited or capped to some ceiling. Tight money can only be insured if the central bank acts as an independent economic and political counterweight to the spending proclivities of the government. In short, the lessons of history have provided substantial evidence that a nation's currency should be protected by an independent central bank due to the government's inability to properly manage a nation's monetary stock.

Central bank independence and its corresponding impact on policy credibility have also been cited by many analysts as an important reason for freeing the hand of a central bank. Independence has a strong impact on policy credibility and vice versa (Blackburn and Christensen 1989; Woolley 1992; Schaling 1995; Nolan and Schaling 1996; Mayes 1998). A central bank with a strong reputation for credible anti-inflationary policies may be able to resist political pressures to reform the legal structures and statutes of the bank that might threaten price stability. More importantly, perhaps, the issue of credibility centres on whether and how policy-makers can make credible commitments about their future conduct. Independence and the credibility that flows from it need to be understood in terms of actual behaviour and not just institutions. The structure of the economy and internal politics may present policy-makers with difficult tradeoffs between short-run policy benefits and long-run policy costs that may impact credibility. An institution such as a central bank can be considered credible if it is willing to let the government, the public and the economy incur the costs of their decisions.

For example, during the speculative crises within the EMS in 1992–93, many observers puzzled over the fact that the French franc came under more pressure than the DM, despite the franc's underlying strength in terms of the economic fundamentals (primarily inflation) of the French economy. The answer to this puzzle is rather simple. It centres on monetary credibility: the markets trusted the Bundesbank to bring the inflationary pressures in Germany under control; the markets did not believe the French government's ability – in the face of elections and growing unemployment – to withstand the pressure to reflate. The question today: Has the ECB established the same level of credibility as the Bundesbank? While this chapter touches on this subject in so far as it relates to independence, Chapter 6 tracks in more detail the credibility crisis of the European Central Bank.

Credibility of monetary policy will also depend not just upon monetary policy alone but rather upon the perceived coherence of the overall macroeconomic programme. This coherence, together with the intellectual and political consensus on the monetary theory being used and the objectives and conduct of monetary policy, subject to the conditions of the current political climate, significantly influences credibility (see, for example, Schaling 1995). Not surprisingly, the independent structure of institutions makes any promises about future behaviour more believable. The Bundesbank used this understanding of credibility in its decision to publish yearly quantitative targets of the money stock. Focusing on a medium term monetary target like M3, the Bundesbank believed it could make credible commitments to ensuring a pre-determined range of monetary growth. If the bank failed to meet such targets, which it did on occasion, the credibility of the bank can be harmed.[77] Despite some problems with the M3 indicator, the markets ultimately trusted the Bundesbank to control monetary growth.

As for the ECB, it employs the M3 indicator, after the insistence of the Germans, but also targets other macroeconomic indicators like inflation (following the lead of the British). The OECD has argued that the ECB's intermediate monetary target of M3, which was set at a reference value (or loose target) of 4.5 per cent (measured on an annual basis) for 1999, 2000 and 2001, may not be useful for setting policy.[78] This broad monetary measure most likely will be subject to great instability as the single currency markets develop. Moreover, the ECB must deal with vastly divergent economic indicators in growth and unemployment, for example, rates of higher growth and lower unemployment in Ireland as compared with lower growth and higher unemployment in Germany. Early decisions by the ECB to emphasize one target over another when setting interest rates has in part weakened the perception that the ECB has full mastery over the numbers. Whatever the disagreements over M3 or other measures, the freedom to decide which measures are employed and the freedom to stick to these measures despite political protest from governments, should be seen as important pillars of an independent central bank establishing credibility.

Democratic accountability

While these arguments carry with them considerable merit, they should not go unquestioned. Perhaps the strongest argument against central bank independence is based on legal or democratic theory (Arntenbrink 1999; Berman and McNamara 1999; Buiter 1999; Magnette 2000; Majone 1996, 1999; and Verdun 1998a). The theory would contend that an independent central bank cannot be held democratically accountable for its politically sensitive actions. In other words, the delegation of power to non-elected officials (the ECB Governing Council) can only be acceptable in a democratic society if the bank is accountable in some manner to democratically elected institutions. One might ask who should be held responsible for the effects on employment created by the ECB's monetary policy – the bank or the governments of the Euro-Zone? Central banks remain free from the task of legitimating their power (via elections), unlike other representative institutions. This is of central concern to the ECB and the institutions of the European Union as they grapple with questions of democratic deficits, pressures of regionalism, and issues of transparency. General consensus exists that the EU – and thereby the ECB – should be transparent and largely accountable to its citizens in the future.

ECB President Duisenberg's assertions – that the ECB's definition of price stability as an annual increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below 2 per cent acts as a yardstick against which the public can hold the ECB accountable[79] – suggest a differing (economist) view on accountability. This view sees accountability and independence as mutually dependent. But Duisenberg's confidence in the ECB's monetary indicators and objectives do not necessarily assuage sceptics who see the ECB as beyond the control and legitimacy of democratic processes and institutions. While we recognize that accountability and independence can be served by quantifying monetary objectives (see also Arntenbrink 1999) and are interrelated, we do not fully accept the notion that merely publishing monetary objectives meets the full standards of democratic accountability.

Specifically, as Verdun notes, 'the lack of formal parliamentary control over the (ECB's) decision-making process ... has led to considerable concerns about democratic accountability: the aspect of secrecy, technocracy and lack of transparency ...' within the European Union (Verdun 1998: 111). More bluntly, Buiter warns that the 'lack of openness, transparency and accountability ...' threaten to 'undermine the viability of the whole enterprise' (1999: 185). In principle, one can argue that the final decisions and the priorities, which are given to monetary policy, must lie with the European Parliament or some other nominally representative body – perhaps the Council of Finance Ministers. It follows that if necessary, monetary policy should be subordinated to fiscal policy or other objectives laid out by popularly elected officials. Only democratically elected officials of the government have the respective legitimacy and authority to proceed with the negotiations and reach an agreed upon solution. As powerfully stated by Berman and McNamara, allowing the ECB 'to rest unchallenged both damages democracy and begs important questions about who the winners and losers of economic policy should be' (Berman and McNamara 1999: 2). In this vein, noted economist Peter Kenen has suggested that the European Parliament be given greater authority over the European monetary policy-making process (Kenen 1995). Again, more bluntly, Buiter suggests evolving a 'European Parliament with teeth' (1999: 207).

Clearly, the issue of transparency and accountability is framed politically in the context of a concern for the lack of democratic control over monetary policy-making and democratic legitimacy of the EMU project more broadly (see Elgie 1998 and Elgie 2001; Taylor 2000; Verdun and Christiansen 2000). In a democratic society, transparency and accountability are essential if central bank independence is to remain politically acceptable. Political scientists are concerned about the exceptional strength of the ECB's policy mandate and independence, the absence of counterbalancing EU institutions and the weakness of democratic accountability.[80] Verdun and Christiansen (2000) discuss the problematic nature of the establishment of a powerful ECB prior to the emergence of a political community, and notably the institutions of representative democracy, in which the bank's decisions, or, more significantly, the procedures for the taking of such decisions can be grounded (163). The ECB lacks the societal embeddedness that legitimizes the policy-making of other non-majoritarian institutions such as independent national central banks and supreme courts. Verdun and Christiansen (2000) write:

> The output orientation of much of the debate about the benefits and the costs of EMU signifies that policy-makers regard its economic and social effects as the strongest, perhaps even as the only, possible legitimating aspect of the single currency. Such a perception makes it hostage to the economic fortunes of the day… (176–7).

The legitimacy problem has placed increased focus on the matters of accountability and transparency. Monetary policy decisions will affect member states differently due to different national economic cycles (despite some convergence) and differently structured economies. Given the lack of financial transfer payments to compensate those parts of the Euro-Zone suffering from asymmetrical shocks, limited labour mobility and the strong constraints placed on the use of national fiscal instruments, the ECB's response to these shocks will be of considerable importance.

The risk remains strong that some member states may come to feel disadvantaged by ECB monetary policy, that the legitimacy of the bank will be called into question and the pressure will increase on governments to speak out. Doubts about the ECB's legitimacy increase the need for Executive Board members to give frequent interviews, press conferences and speeches about goals and instruments. National central bank governors need to do the same at the national level. Likewise, the decision to hold two Governing Council meetings a year in other member states was designed to improve the visibility of the ECB. Many call for strengthened links between the ECB and the EP as another move to improve the legitimacy of the ECB. However, this is inherently problematic given that the EP, despite being directly elected, is neither well understood nor well liked by many Europeans (Dinan 2000, 478). Other observers, led by the French government, argue that the legitimacy problem can be partially resolved by creating a stronger and more visible political counterweight to the independent ECB: the European equivalent of the American Treasury Secretary.

Despite the view of political scientists, the precise nature of ECB transparency and accountability is still a matter of some debate. Many economists and market analysts define transparency and accountability in terms of monetary strategy, communicative effectiveness, and co-ordination with other policy-makers. In particular, they focus on the two-pillar strategy of the ECB, the bank's ability to communicate its strategy to the public and the markets, and the ability of the bank to co-ordinate the strategy with leading policy-makers – whether at the national level or through EU institutions (the Eurogroup, for example). Central banks need to make the public aware of the benefits of price stability as memories of high inflation are fading. Clear monetary goals can also help to guide inflationary expectations and thus influence the behaviour of firms and workers. But perhaps most important of all, central banks need to communicate clearly with the financial markets. By becoming more predictable, central banks can help to make market reactions to interest rate changes easier to predict, which then makes monetary policy more effective. In this regard, and with the ECB's own admission – confirmed in a number of interviews – the ECB has not always performed effectively.[81] 'We need to sell it better,' confided one EC banker. Another EC banker indicated that transparency demanded that the ECB avoid mistakes and, if mistakes were made, to be 'honest' with the public about these mistakes.

The Treaty on European Union supplements the considerable degree of institutional independence granted to the ECB by extensive provisions concerning transparency and accountability. Articles 253–56 (ex 190–92) oblige the European Commission to provide extensive justification for its actions, to publish documents and studies, and provide access to documents and the like. Article 110(2) (ex 108a(2)) EC stipulates that this duty apply to regulations and decisions made under Article 110 EC. Article 110(2) EC notes that, while the ECB is under no obligation to publish recommendations, opinions and decisions, it may choose to do so. The national central banks of the Eurosystem currently produce full forecasts at six–monthly intervals. As noted above, the ECB began to publish full annual forecasts in December 2000. The ECB also publishes its *Monthly Bulletin* that can be used to provide updates on policy developments, while the press conferences that follow Governing Council meetings can be used to announce policy changes if the ECB thinks that the ECB and national central bank forecasts have become too out of date to be useful.

Economists – concerned about the dangers of separating monetary from fiscal and macroeconomic policy (the 'assignment problem') – have also tended to focus on policy-making transparency and accountability as a way of helping the ECB maintain price stability by improving coordination with national fiscal and macroeconomic policy makers (Favero *et al*. 2000; Issing 1999; Mayes 2000). There is considerable disagreement as to precisely what the ECB should publish and how often it should do so. Most central banks only publish a discussion of published indicators and very few publish disagreements and voting records. Those which do so will either produce a single set of indicators or supplement them with simulations or a discussion of 'risks' or discuss the range of possible outcomes on the basis of an agreed distribution of risks. Because the ECB Governing Council has not agreed upon publishing the kinds of detailed texts produced by national central banks. The Governing Council has opted for a form of '*ex ante*' transparency that involves the establishment of a map that sets out the rules by which the ECB makes monetary policy and reacts to fiscal and macroeconomic policy developments and external shocks. The annual publication of detailed forecasts – based on what the ECB sees as the two pillars of monetary policy: a reference value for money and a broad based assessment of price developments – was begun in December 2000. However, this is only part of the required map which will include documentation on monetary models, simulation properties and a discussion of how they are used in policy formulation. Most national central banks do not publish the whole map. The Eurosystem's currently published map is, one could argue, vague and consistent with a large range of policy reactions. In order to improve transparency and meet the demands of many observers a great deal more information must be made available.

Mayes (2000) and Issing (1999) all point out that the map will never be crystal clear: some eventualities will not be covered and monetary policy will always tend to be more contingent than other policies because of the characteristics of the decision-making procedure involved. Government expenditure can vary frequently while the formulation and implementation of structural policy is a slow process and can be altered at any time. Co-ordination between monetary and macroeconomic policy in the Euro-Zone has not been successful. As Mayes (2000) writes: 'No central bank can commit itself either to maintaining current monetary conditions or to following some explicit path in the future come what may. It can only commit itself to following a predetermined strategy' (15) (see also Issing 1999b, 517). The Stability and Growth Pact obligation to present fiscal and structural *plans* also works in this way and helps the ECB formulate its own strategy. However, effective co-ordination is inherently difficult because different policies (structural, fiscal, monetary and so on) take different lengths of time to affect the same variables (Mayes 2000, 16).

In sum, from an economic policy perspective, monetary policy should be considered an integral part of the government's overall economic policy. The government's ability to successfully deal with economic difficulties would be strengthened if fiscal and monetary policy were co-ordinated. Working from this idea, Dyson, Featherstone, and Michalopoulos suggest that the lack of linkage between fiscal and monetary policies within the EU worsens the problem of the 'insularity' of the EMU process (Dyson, Featherstone, and Michalopouls 1995). Although most governments now accept that low inflation is essential for sustainable growth, the trade-off between a bit more inflation and a bit more unemployment can still be made in the short term – especially with elections looming in the horizon. As a result of this short-term motivation, an independent central bank and monetary policy could very well lead to government frustration, friction and conflict. In this view, monetary policy and the central bank should be considered one important part of a government's overall arsenal in dealing with weighty economic problems.

Independence and accountability: a balancing act for the ECB?

It is clear that both sides of this argument carry with them considerable merit. The position of the authors is one of balance. The recognition that the decisions surrounding monetary policy in the Euro-Zone already carry with them an almost extra-governmental aura, limits of some degree to the role citizens, the government, and interest groups should have in monetary decisions must be accepted. History provides a painful reminder to many Europeans, especially the Germans, of the dangers to the state if there exists too much 'political' involvement in monetary policy. The ECB for its part must attempt to walk a very fine tightrope between complete institutional independence and direct political accountability. When the bank pushes toward either end of the independence–accountability spectrum, conflict within the Euro-Zone will erupt. Restoring a careful equilibrium between absolute independence and close cooperation with the Euro-Zone governments will be an ongoing task of the European Central Bank.

At the same time, within a democratic order (within which the ECB operates), there must remain some mechanism of accountability to all governmental and administrative institutions and agencies. Only with some stronger mechanism of democratic accountability can the emerging European Union gain and retain the legitimacy and credibility of its constituents. The fear for many analysts of the European Union is that the EU has sold its democratic soul in return for the security that the ECB can provide in a world of globalized financial markets (Buiter 1999). The volatility, instability, and near anarchy of the global exchange markets have led the EU to contract with the ECB for some measure of monetary stability. Have EU and national leaders created a new Leviathan for Europe? If so, the ECB and the EU may be in urgent need of institutional modification.

The following section explores the level or degree of ECB independence in order to better assess the question of accountability and transparency.

The independence of the European Central Bank

Given the arguments both in favour and against central bank independence, did the Treaty on European Union create an independent ECB? Specifically, there are three distinctive contexts that we can identify within which the influence of the government, societal interests and international actors must be excluded or greatly curtailed in order for a central bank to be considered independent. These three contexts are political independence, personal independence, and financial independence (Alesina and Summers 1992; Bernhard 1998; Loedel 1999a). Within each one of these contexts, a range of possible constraints on the ECB's independence will be analysed. In order to draw some useful conclusions about the degree of ECB independence, we compare the ECB's independence to that of the Bundesbank (before the euro).

Political independence

Perhaps the pivotal concept in the study of central bank independence is its functional or political independence. For purpose of definition, Woolley distinguishes two types of independence that prove useful here (Woolley 1984). Political independence refers to the ability of a central bank to choose a course of action independently without yielding to the pressures of others as to what that action should be. In the second sense, functional independence refers to the central bank's ability to achieve its objectives without being affected by the actions of others. Functional independence, as Woolley argues, is generally not characteristic of monetary policy (Woolley 1984: 13).[82] For our purposes, we will focus on political independence.

Political independence refers to the formal legal competence of the ECB to choose a course of action independently and without yielding to the overt or covert pressures of other political actors. By almost all accounts and universal consensus among analysts, political independence should characterize the monetary policy of the ECB. The ECB's independence is enshrined in the Maastricht Treaty – a Treaty that would be extremely difficult (and unlikely) to revise. Article 107 of the Treaty clearly states that 'neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from community institutions or bodies, from any government of a member state or from any other body'. Furthermore, the Treaty narrowly defines the ECB's primary objective as maintaining price stability (Article 105). The ECB is also required, albeit in vague terms, to support the economic policies in the European Union but 'without prejudice to the objective of price stability'. The President of ECOFIN and a member of the Commission may participate on the Governing Council of the ECB, but they do not have the right to vote (Article 109b). Given the clear legal mandate, there is little chance that the ECB's political independence will be watered down in the areas it has sole responsibility.

Most significantly, the informal body made up of the euro-twelve finance ministers (originally called the Euro-XI, now known as the Eurogroup) will likely be the most consistent political threat to the political independence of the ECB. Demanded by the new French Socialist-led government in 1997, the Eurogroup concept was presented as part of an attempt to limit the austerity measures imposed by the convergence criteria which were explicitly prolonged into Stage Three of the EMU project by the Stability and Growth pact. Within the Eurogroup, the voices and concerns of national governments regarding the ECB's monetary policies will be articulated – a necessity given the belief among the Euro-Zone members that non-euro members (UK, Denmark, and Sweden) should not have a say over the ECB's monetary policy. Resisted by the German government under Kohl, the Eurogroup has somewhat ironically become a forum of German concerns with the ECB's monetary policy, given the persistent high levels of unemployment in Germany. From the French perspective, the Eurogroup was their creation and fits within the traditional French view of a more politicized monetary policy serving national employment interests, not just price stability measures. The French also see the Eurogroup formulating positions on exchange rates (more below) as the French also tend to see the link between the price of a currency and competitiveness – albeit now the competitiveness of the Euro-Zone.

As a result, the ECB has already faced overt political pressure from national governments within the Euro-Zone to pursue a particular monetary policy. The governing council faced concerted pressure and attacks on its policies including heated pressure from the former German Finance Minister Lafontaine prior to a 4 March 1999 council meeting.[83] Along with some of the other left-of-centre European governments, Germany's new Socialist Government led by Gerhard Schröder had also raised the issue of political independence to the forefront of debate. Schröder stated that the ECB 'doesn't only have responsibility for monetary stability but also for economic growth in a sensible way'.[84] With a general shift to the left across many European governments, there has been a sense of an increase in the willingness of governments to use fiscal and monetary policy to stimulate growth and reduce unemployment. The euro's stability and the Stability and Growth Pact's credibility have in part been undermined by this manner of questioning – particularly from Germany. The ECB has responded to such pressure by indicating that it would be forced to act with interest-rate increases if governments were to fail in their attempts to keep government deficits under control.

Lafontaine and others have also criticized the bank's secretiveness and refusal to reveal the minutes of the governing board meetings. Christian Noe, State Secretary at the German Finance Ministry accused the Bundesbank – and by extension the ECB – of engaging in 'pre-democratic' behaviour.[85] The issue of transparency and accountability is critical here. While the President of the ECB Wim Duisenberg has gone out of his way to speak openly of the ECB's policies,[86] including ongoing presentations within the Monetary Committee of the European Parliament, he has stated cogently that some measure of secrecy is needed in order to keep the market off balance. Indeed, speculation that the ECB would never lower interest rates so soon after the resignation of Lafontaine proved wrong as the bank lowered rates a full half percentage point in early April 1999. Keeping the markets and analysts guessing, and guessing wrong, are early signs of independent-minded ECB.

In summary, even with the Eurogroup body, there is no clear institutional political context within which the ECB will have to answer for its policy. As noted, the President of the ECB will be called before the European Parliament – but the Parliament lacks its own credibility among the electorate. Also as noted, the President will attend meetings of the Eurogroup where he will face questioning and possible pressure, but these meetings are also secret and will not serve a true 'accountability' forum. Moreover, as the ECB has already firmly demonstrated, it takes its price stability mandate and its institutional protection of political independence seriously. The ECB to date has not once backed down on any serious decision it has made whether on interest rates, monetary objectives or indicators, or secrecy. The ECB has had a baptism of fire in its first years of operation, but in terms of political independence, it has largely emerged unscathed and focused on its mandate of price stability.

Personal independence

Personal independence is a second crucial determining factor of central bank autonomy and is intricately related to political independence. If the members of the ECB are selected for political, ideological, and/or national reasons, one would have to question the overarching independence of the ECB to pursue its price stability mandate unfettered by national or political constraints. The ECB's decision-makers will have to assume a transnational identity and act in the interests of Europe first instead of national interest. If one senses the slightest national bias in the bank's decision-making, one would have to question whether it has established a transnational European identity and whether personal (read 'national') interest has trumped the interests of the institution.

Institutionally and personally, the ECB is a hybrid of transnationalism and intergovernmentalism. The two key bodies in the ECB are the executive board, made up of a president, a vice-president and four additional members, each appointed to eight-year, non-renewable terms; and a governing council, comprising the Executive Board and the central bank governors of the euro-twelve members. The national central bank governors will also have, at a minimum, five-year contracts so as to ensure some continuity on the Council. The Executive Board is appointed by agreement (consensus) of the political leaders of the European Union, after consulting the European Parliament and national central bankers. The Executive Board is clearly the transnational European part of the ECB and is seen as the leading articulators of the bank's European policies. While undoubtedly interested in supporting the ECB's European price stability mandate, the national bank governors will also be representing the concerns of their respective nations. As such, they will undoubtedly bring an intergovernmental voice to ECB deliberations.

The Executive Board has not always found its footing as a strong united body pursuing the interests of the Euro-Zone. While detailed more specifically in Chapter 6, the Governing Council has at times experienced divergent views on ECB policy – especially in the area of exchange rate management. Moreover, the high-profile squabble over the appointment of its first president, Wim Duisenberg, has given some tarnish to the personal independence of the ECB. All the member governments except for the French, who desired their own candidate, Bank of France President Jean Claude Trichet, favored Mr. Duisenberg. At the May 1998 summit to decide euro participants and to finalize the 1999 launching date, Duisenberg was appointed for a full eight-year term, but 'volunteered' to step down after four years to allow Trichet to take over. Duisenberg will in fact step down after five years in office. And while no one doubts the anti-inflationary credentials of Trichet, the embarrassing episode may lead some to question the future personal independence of the ECB. Nonetheless, with the lengthy eight-year terms of office and the squabble over the presidency receding in memory, one can argue that the executive board will continue to emerge as a forceful independent and transnational voice of European monetary politics. Such a view of consensus and Europeanism is confirmed by a number of interviews conducted by the authors of the staff and leadership of the ECB.[87]

The role of the national central bank governors in ECB deliberations has been extremely important. The ECB is really the European System of Central Banks (ESCB) based on a Bundesbank-modeled 'federalist' structure. Power within the Governing Council is therefore decentralised in favour, based on numbers, of the national central bank governors. Monetary policy decisions will be taken by a simple majority on the Governing Council. Small countries arguably could carry undue weight in the system. Austria, Belgium, Finland, Ireland, Greece, Luxembourg and the Netherlands and Portugal will between them have nine of the 18 votes on the governing council (including members of the executive board) compared with Germany's two, even through their combined GDP is only half of Germany's.[88] Not surprisingly, the Bundesbank and Bank of France Presidents have often spoken with a louder voice within the forum. One might also expect that the national central bank presidents to have their own views and data. This makes co-ordinating the ECB's message quite difficult. Therefore, the role of the President Wim Duisenberg has been especially important in moving the governing council in his and the executive board's direction – something he has not always been able to do. More problematic for the Governing Council will be enlargement and the difficulty in incorporating new national central bank governors into the decision-making process. The one country one seat on the Governing Council rule might have to be restricted (see Chapter 7 for more discussion on enlargement).

One important reason why we should still expect a generally united voice within the ECB's Governing Council on euro-policy is due to the overriding 'economic culture' of its membership (Kaltenthaler 1999). Economic culture can be see as the social perceptions that structure macroeconomic policy. Based on the membership of the executive board and most of the national central bank governors, one can argue that the ECB's economic culture is structured by a strong interest in fiscal rectitude and a deflationary macroeconomic policy targeting price stability. The members of the governing council are what most analysts would describe as believers in the benefits of an independent central bank; almost all members retained strong anti-inflationary credentials – a bank full of Bundesbankers (residing in Frankfurt no less), but even more powerful. They believe that safeguarding the value of the euro and maintaining price stability are the preconditions to a sound European economy. Too much inflation, even at an annual rate of 2–3 per cent, is seen as a cancer on the economy that will destroy the European economy over the long term. In other words, there can be no short-term tradeoffs between a little bit more inflation for a little less unemployment. Keynesian-inspired macroeconomic policy finds little if no support among the ECB's Executive Board and, in large part, the national central bank governors.

Financial independence

The third and final important aspect determining the level and degree of central bank independence is its financial independence from either the obligatory financing of government debts (internal) or exchange rate arrangements or obligations (external) such as those that existed under Bretton Woods and more recently within the EMS.[89] The latter concern is especially relevant as the euro emerges as an international *numéraire*. The euro will likely, albeit modestly, increase its role as a unit of account, a means of payment, and a store of value (Hosli 1999). If so, the euro's influence in global monetary relations will increase pressure on the ECB to stabilize the value of the euro externally.

First, regarding government financing, a government can exercise influence over and limit the discretion of central bankers if there exists the possibility that the government can finance its expenditures either directly or indirectly via central bank credits. Access to central bank credits, especially direct access, can result in an overlapping or fiscal circular flow of money into the money supply. If such financing mechanisms exist, monetary policy is by necessity subordinated to the diktat of fiscal policy.[90]

Currently, the ECB is not directly subordinated to the fiscal demands of member states. However, the bank is necessarily concerned about the potential of national governments to increase spending during the transition phase to the full implementation of the euro by 2002 – and after. For example, the ECB fears the very real scenario in which Italy, now comfortable in its inclusion within the Euro-Zone, might be tempted to fall back into past proclivities of fiscal profligacy. As a result, bolstered by the Stability and Growth Pact, which demands continued fiscal discipline within the boundaries of the convergence criteria (with exceptions for recessions) under the threat of stiff penalties, the ECB continuously warns the Euro-Zone governments to maintain fiscal discipline. While it is not impossible that member states might stray from the convergence criteria (even with Italy's additional room for fiscal spending, it remains well within the criteria), one suspects that the fear of penalties, the ongoing political commitments in each country to fiscal stability, and with the ECB ready to pounce on any divergence, states will try to hold spending steady. It remains to be seen whether a future centralized EU fiscal policy might alter this arrangement. But for now, no such scenario looks imminent.

Most importantly the ECB may face the financial constraints associated with the intervention requirements, institutional commitments, and interest rate pressure associated with exchange rate mechanisms.

Exchange rate policy for the Euro remains unclear and the debates over clarifying exchange rate policy remain extremely controversial (Henning 1997). More importantly, the ECB and the EU will face the very same choice as faced by the Bundesbank: pursue monetary autonomy (albeit within the Euro-Zone member states) or sacrifice a measure of autonomy in return for exchange rate stability vis-à-vis the dollar, yen or some other currency. The scenario sounds like one drawn straight from German monetary history: a powerful independent central bank with the goal of internal price stability pitted against an external monetary policy subject to the domain of the politicians – in the European Union, the Eurogroup, or other EU actors.

Specifically, Article 109 of the Maastricht Treaty lays down the legal relationship and general parameters between the ECB and the Council of Ministers on exchange rate policy. While still not entirely clear, it is assumed that representatives of the Council hold authority to negotiate formal and informal exchange rate agreements with foreign governments under consultation with the ECB. Formal agreements that peg the euro, for example, to the dollar or yen would require a unanimous vote within the Council after it consulted with the ECB, the European Commission, and the European Parliament. Such an arduous process of agreement or ratification will likely decreases the likelihood of increased exchange rate management at the international level. Exchange rate flexibility – or European monetary autonomy at the expense of exchange rate stability vis-à-vis the dollar or yen – will likely be the result.

Nevertheless, as Henning observes, if cohesive, 'national governments, operating through the Council, appear to hold a strong position vis-à-vis the ECB on the matter of formal arrangements' (Henning 1997: 36). While the search for consensus on exchange rate policy is required, actually attaining consensus is not required. Moreover, it is not clear which institution, the ECB, the Council or some other institution, would determine whether an exchange rate agreement would do damage to the price stability mandate of the ECB. In Germany, the government held the final say over such questions. A similar scenario for the EU depends on the cohesiveness of national governments – a pattern for which the EU national governments are not often known.

However, in an interesting set of exchanges in April and May of 1999, Tietmeyer and Trichet openly questioned Duisenberg's decision to take a hands off approach to the sinking euro. Tietmeyer (now replaced by Welteke as head of the Bundesbank) and Trichet were responding to domestic pressures in Germany and France, especially among the general public, which had been promised a 'strong' euro, and savings and financial interests intent on preserving euro-denominated assets. In this way, Tietmeyer and Trichet were advocating 'national' interests within the supranational Governing Council. More interestingly perhaps, within the German Länder (mainly those dominated by SPD governments) and among Germany's leading export industries, voices could be heard counter to those of Tietmeyer. Parallel interests were expressed in France. The sinking euro actually was improving the export dependent economy, creating new jobs for workers, and enhancing the general Euro-Zone's competitiveness.

Moreover, informal exchange rate arrangements such as those of Plaza and Louvre can be negotiated by the Council under the rubric of setting a 'general orientation' of exchange rate policy. The general orientation must not, however, prejudice the primary objective of the ECB 'to maintain price stability'. This would suggest that the ECB would have a right to reject such orientations, although this again is not clear and will be subject to later determination under actual practice. If the ECB is bound to keep exchange rates stable – a political decision made by ECOFIN – the ECB may be forced to intervene automatically in foreign exchange markets or may be pressured to pursue an interest rate policy so as to ensure the proper exchange rate levels. In a system of freely fluctuating exchange rates, this constraint does not hold true and the central bank can pursue a policy solely concerned with domestic affairs. However, in a system of dirty floating as exists in the international monetary system, the ECB may be placed in a situation where it might have to buy and sell foreign currency or pursue an interest rate policy in order to meet some form of external exchange rate commitments. In fact, in the Fall of 2000, the ECB intervened jointly with the US and Japan in order to ease pressure on the sinking euro. This decision was made largely by the ECB and carried out by the ECB. The success of these operations were limited (see Chapter 6).

The ECB may also face pressure from the United States, Japan or the IMF to intervene in the currency markets in order to achieve a prearranged euro–dollar–yen rates (Henning and Padoan, 2000). Already the US has voiced concern about the euro's weakness vis-à-vis the dollar and what impact that is having on US competitiveness.[91] As noted at the beginning of this paper, the ECB has already found that the external scope of its monetary policy range has narrowed, certainly with the increasing integration in financial markets and with greater global interdependence. Although no formal exchange rate system currently exists between the euro and the dollar, external exchange rate commitments may circumscribe the ECB's financial independence. For example, during his short tenure, Lafontaine sought to resurrect a 'target zone' scheme for the Euro. From the perspective of the ECB, the proposal fortunately disappeared along with Lafontaine.

Summarizing ECB independence[92]

Table 5.1 compares the independence of the ECB with that of the Bundesbank.

Table 5.1 cont'd Comparing European Central Bank and Bundesbank independence

	European Central Bank	*Bundesbank*	*Comparison*
Political	Primary Objective of Price Stability	More general mandate to 'safeguard the currency'	ECB has a more clearly articulated mandate on price stability
	Free from 'instructions' of community institutions and member states	'Independent' of the advice of the government	'Freedom' of ECB and 'independence' of Bundesbank from political pressure provide roughly similar protection for each institution.
	Mandates enshrined in Maastricht Treaty	Bundesbank Law not guaranteed constitutional protection	Hard to envision Maastricht Treaty being revised.
	Threat of pressure from Eurogroup and other actors (US, IMF).	Threat of pressure from Federal Government and domestic interest groups	Bundesbank Act had aura of 'constitutionality' but could be amended by simple majority in the Federal Parliament
Personal	Executive Board selected by consensus of member states	Directorate has eight-year terms.	Bundesbank was subject to personal issues related to Chancellor preferences, party preferences, Land Bank Presidents.
	National Bank Governors chosen by	Land Bank presidents in	Eight-year terms similar.

Table 5.1 con't Comparing European Central Bank and Bundesbank independence

	European Central Bank	***Bundesbank***	***Comparison***
	member states (majority in the Federalist structure)	majority on council; Federalist structure	
	Eight-year terms (non-renewable) on Executive Board	Strong sense of German monetary culture *Stabilitätsgemeinschaft* (culture of stability)	ECB will face similar pressures, but culture of central bankers will be strong – like Bundesbank – but maybe no culture of stability within the European public? Conflict over Duisenberg embarrassing; will likely not affect independence
Financial	Not required to finance government debt	Bundesbank not required to finance government debt	Bundesbank and ECB have to deal with government spending.
	Must contend with member state budgets (strengthened by Stability and Growth Pact)	Had to contend with government spending.	Similar scenario for ECB and Bundesbank on spending since con vergence criteria in place.
		Required to hand over profits to government	
	No centralized European Union budget	Finance Ministry controlled exchange rates	Bundesbank faced more exchange rate pressure within EMS.
	No formal (external) exchange rate commitments	Often found itself constrained by exchange rate regimes (Bretton Woods and EMS)	ECB will face possi ble exchange rate pressure as ECOFIN controls exchange rates; No strong pressure currently
	Possible exchange rate pressure as ECOFIN controls exchange rate policy		

First, in terms of political independence, we can state that the ECB has perhaps an even greater level of independence than that of the Bundesbank, at least as based on the statutes creating the ECB. The role of the Eurogroup remains a bit of wild-card, but given the first example drawn from the clash between LaFontaine and the ECB and other rather weak efforts on the part of the Eurogroup to speak with one 'political' voice vis-à-vis the ECB, the ECB has maintained its political independence with full vigour and clarity. Moreover, the ECB's statutes are part of the Treaty on European Union – and will not be subject to revision (other than when enlargement becomes problematic). The constitutional protection for the ECB remains indeed stronger than the Bundesbank's own constitutional protections (simple majority vote could change the Bundesbank act). The ECB, however, does not operate in a complete political vacuum. The bank's decision to lower rates in April 1999 (after Lafontaine resigned) and May 2001 (following US and IMF pressure) does show a pragmatic political side to the bank. Nevertheless, the ECB appears to be the model for a political independent central bank.

In terms of personal independence, the ECB faces some complementary concerns that often plagued the selection of personal on the Bundesbank. The much-cited problem with Wim Duisenberg's appointment does raise some concern about future manipulation of the selection process. These concerns have been raised again given the speculation over who will replace Duisenberg in 2003. But we would contend that the overriding economic culture of the Governing Council will moderate any concerns about national bias or national governments manipulating the selection process of Governing Council members to serve national or personal interest. More interestingly, perhaps, is the role that the national central bank governors will play in the determining the outcome of ECB policy. While most if not all of the current governors subscribe to the dominant economic and monetary culture of European central bankers, if more difficult economic times develop national interest may increasingly play a role in the decision-making dynamic of the ECB. German preferences may diverge from Irish or, imagine in the future, British preferences. To date, while not always speaking with one voice, the ECB has chosen to act in consensus and avoided the appearance – through the decision not to take any published vote on interest rates – of division within the Governing Council. One could speculate that the Executive Committee is fearful of being outvoted by the national central bank governors. For now, these issues are still difficult to assess but will not likely weigh significantly in the ECB's independent room for manoeuvre.

Financial independence is a bit more complex and depends on whether one examines internal or external sources of constraint. Even with the decision in mid-1999 to relax some budgetary constraints on Italy (the Germans' worst nightmare), internal financial independence appears for the moment to be quite strong. However, even with the Stability and Growth Pact, modest economic growth in Europe, and the overriding commitment among the Euro-Zone members not to stray far from the price stability model, especially during the transition phase to 2002, the ECB will still expect in the near term to face mounting budget deficits among member states. External financial constraints, in the form of exchange rate pressures and the declining euro, will continue to pose very difficult and serious dilemmas for the ECB. While no formal exchange rate agreement between the euro and the dollar, for example, currently exists – providing the ECB with greater policy latitude in the near term – the euro's problems accentuate the concerns over democratic accountability and the bank's own monetary credibility. The last section of this chapter focuses largely on these external policy dilemmas.

In sum, the ECB has in many respects – political, personal, and financial – to have at a minimum the same level of independence as the Bundesbank. In some areas, particularly political and financial independence, the ECB can be seen as perhaps maintaining even greater amounts of independence (see also, Elgie 1998). In its brief history, the ECB has already established itself as an independent actor focused on its primary objective of price stability. However, internal pressure from the Eurogroup, national governments, and external exchange rate pressures will make the ECB's balancing act a difficult one indeed. Here we must return to the question of credibility – developed in Chapter 6.

Institutional expectations of the ECB

Based on the above analysis, European monetary politics under the ECB will take on the institutional dynamics of the German model – a highly independent central bank (the ECB) obligated to pursue price stability as its primary objective within the Euro-Zone member countries. The objective of price stability is potentially constrained, however, by political institutions within the structure of the EU and external exchange rate arrangements governed by the ECOFIN or some other body like the Eurogroup.

Initially, the euro will be less vulnerable to speculative attacks that often beset the old ERM.[93] However, the steady slide of the euro from 1999–2001 has confronted the ECB with the dilemma of accepting depreciation of the euro vis-à-vis the dollar (and the inflationary impact of the depreciation) or raising interest rates that might force one or more euro countries deeper into recession, and conceivably, one might argue, out of EMU. Or, the ECB might have to engage in exchange rate politics within a reformed G-7 (and IMF) that would require intervention to shore up the euro within various ranges or zones. Given the fact that each Euro-Zone member has forgone using exchange rates as an instrument of adjustment, conflict among euro countries and conflict between the ECB, ECOFIN, euro-member countries and non-euro members like the UK will likely erupt. The decision to stick with the euro in difficult times will ultimately be a political one. Much will depend on the public's acceptance of the sacrifice of their particular currency for the historic leap to EMU and the euro. The member countries, the European Commission, and ECB will have to continue their public relations campaign. Neither the euro nor the ECB will be de-politicized. The euro will be by definition politicized and, in many ways, it will still retain a nationalized context through the EU's traditional governing institutions.

The lessons of Bundesbank independence should not be lost on the ECB, European Union officials, EMU member countries, or the European-wide public. The ECB will be more powerful and independent than even the Bundesbank. The ECB's mandates for price stability are unambiguous. Its political independence is unquestioned. However, unlike the Bundesbank, which did have a political counterweight in the form of the German government, a political counterweight of any importance does not exist – the Eurogroup notwithstanding. The euro will thus be a challenge to all Europeans to accept the implications of a stability-oriented monetary union. More precisely, does a *Stabilitätsgemeinschaft* exist in Europe that would be willing to accept the costs of a strict price stability policy? We know that the German economic culture supported such a mandate and undoubtedly supports the same mandate for the ECB. But no such consensus or European economic culture exists across the EU. While the Bundesbank could call upon a collective German understanding of the problems of inflation, the ECB will not be able to call upon a similar collective European understanding. As such, it will make the ECB's initial actions more difficult than the Bundesbank's own early efforts at securing public support for its price stability policies. This difficulty will be accentuated by the likelihood that the ECB will first pursue an aggressive anti-inflationary monetary policy in order establish its credibility in the eyes of the markets.[94]

Furthermore, clarifying how exchange rate policy will be determined is undoubtedly a difficult task. If the lessons of German monetary politics are of any relevance, the degree of political control that the Eurogroup (or some other body) has over the ECB in the matter of exchange rate policy will be crucial to determining the full extent of ECB independence from the political fetters of exchange rate policy. The Eurogroup has only begun to detail some of the conditions that it would pursue an exchange rate policy. As agreed to at the Luxembourg summit in December 1997, the conditions that could lead to the development of an exchange rate policy are cited as 'definite exchange rate distortions'.[95] These conditions were, however, not clearly defined. Nor was it determined who would decide when exactly such 'distortions' demanded action. Without prejudicing price stability or the independence of the ECB, it is thought that the Eurogroup will undertake this role. With consultation with the ECB and Commission, the Eurogroup will act to formulate a policy. How this all will develop over time remains unclear.

Specifically, informal exchange rate agreements will likely not find much support within the ECB and will thus have a limited impact on the ECB's monetary policies since the bank will likely find it easier to disregard such arrangements and/or frustrate any new initiatives. With weak governance structures of the G-7 existing today, the European Council will have a low level of political leverage over the ECB to go along with any exchange rate initiatives coming from the G-7 forum. As a result, given the difficulty in securing the ECB's support for such arrangements, we should expect ECOFIN to be hesitant to enter into any serious exchange rate negotiations. Assuming that the Council is responsible for negotiating exchange rate agreements, we should not expect any new major exchange rate initiatives in the international monetary arena.

We would argue that the experiences of German monetary authorities under the Bretton Woods system now frame the ECB's view toward the international monetary system. Proposals to resurrect some new form of global monetary regime (a fixed exchange rate system, a gold standard, and a basket of commodities) will be met with a large measure of scepticism and rejection by the ECB. The ECB will likely not be interested in returning to a system that might undermine the its efforts to maintain European price stability or the EU's efforts to solidify and enhance the processes of collective European monetary cooperation. Automaticity and supranationality, at least at the international level, are not concepts that are accepted easily among European central bankers. The ECB will likely prefer not to rely on mechanical rules, obligatory standards, or automatic guidelines in external monetary affairs. Price stability and securing the value of the euro will take priority over exchange rate objectives. If it has not already, the German monetary norm will likely become the European monetary norm guiding Europe's exchange rate policy.

Conclusion

Even with the exceptional amounts of independence, the ECB sees its status and its policies as accountable and transparent. This view is not shared by all – the public, the markets, and national governments. While no one suggests anything that might undermine the ECB's mandate on price stability or that threatens its independence, many argue that the ECB must make a better effort to legitimize its policies with the public and the markets. While the ECB's interest rate policy has, by most accounts, been appropriate to the conditions of the Euro-Zone, it does not mean that all has been smooth sailing or without negative consequences. As a result, some analysts go further and demand stronger democratic controls and constraints in the form of EU institutional checks on the ECB.

Our analysis suggests a stronger effort on behalf of the national governments, the European Union, and the ECB to sell the policies of the ECB and the benefits of the euro. We accept the notion of an independent ECB (and its requisite desire to focus on price stability and monetary targets), but also recommend increased efforts to balance the ECB's policies with political input from national governments, the Eurogroup, and the European Parliament. Until a proper balance of independence and accountability can be achieved, the ECB will continue to find itself exposed politically in the rapidly transforming political and economic context of the Euro-Zone and the European Union. This exposure will cost the ECB some of its credibility – to say nothing of the entire process of European integration.

6
A Question of Credibility: a Short History of ECB Monetary Policy

> Any monetary policy that lacks credibility must be paid for with higher interest rates. The expectations of a well-informed and fundamentally critical general public must not be disappointed. Central banks have to take this into account in pursuing their policy; above all, they should take care not to exacerbate any prevailing uncertainty through their own policy.
>
> Otmar Issing, ECB Governing Council[96]

> Monetary policy is a matter of confidence. You don't get confidence for nothing; you have to work and earn it. It's a great effort for us at the Central Bank to explain why we are doing it. I believe we are more open, more transparent than any central bank in the world.
>
> Wim Duisenberg, ECB President[97]

Introduction

As noted in the previous chapter, credibility centres on whether and how central bankers can make credible commitments about their future conduct. Importantly, central bank independence and the credibility that flows from it needs to be understood in terms of actual policy and behaviour. It is one thing to proclaim a central bank independent – and, as we have demonstrated, the ECB maintains high levels of independence. It is another thing to proclaim the central bank's policies credible. Monetary policy credibility must be measured over time and must be evaluated in terms of the monetary policies and behaviour of the bank. Moreover, the structure of the economy and internal politics may present the ECB with difficult tradeoffs between short-run policy benefits and long-run policy costs that may have an impact upon credibility. Such tradeoffs present the central bank with difficult policy choices that will be analysed in minute detail by politicians and markets alike. Such choices are the basis of evaluating central bank credibility.

Are the ECB's policies credible? Has it earned the same level of credibility that the Bundesbank, for example, earned over its long history? One could argue that the ECB's interest rate policies have remained largely consistent over the period 1999–2001; in fact the bank's interest rate policies have, some would argue, benefited Europe's economy by maintaining control over inflation. Its mandate of price stability has largely been fulfilled. However, the ECB's credibility in terms of communicating a consistent message, formulating a coherent monetary strategy, and developing a clear line on exchange rate management has suffered noticeably. In one sense, the euro's weakness vis-à-vis the dollar (losing over 20 per cent of its value since 1 January 1999) indicate that the ECB's credibility has deteriorated due to the varying pressures coming from the markets, the public, and politicians. Currency traders and other ECB watchers point to a number of public misstatements and other communication gaffes by Duisenberg and the Governing Council. These statements, coupled with the apparent inability of the ECB Governing Council to speak with a single voice in public, have exacerbated existing uncertainty in the market and the public about the euro project. Finally, the lack of clarity over which EU body is responsible or accountable for the external valuation of the euro has also eroded some of the bank's reputation.

This chapter analyses the actions of the ECB starting in mid-1998 when the ECB came into its formal institutional role through the launching of the euro on 1 January 2002. While not every action and policy shift is highlighted in detail, the analysis focuses on the major flow of ECB policy. Although discussed in the chapter, our analysis is not necessarily focused on whether the ECB has acted independently without regard to political pressure. Indeed, the ECB has consistently resisted any pressure for rate cuts. Rather, our focus is on the credibility question. Despite an independent track record, credibility has not flowed easily or smoothly to the ECB. Answering this question is crucial to developing a comprehensive understanding of the policies and politics of the ECB.

Our analysis also must also be tempered by the relative short history of ECB policy-making; however, some basic trends and patterns have already emerged. Using the framework of policy credibility and our earlier analyses of the independence of the ECB, we highlight the twists and turns and ups and downs of the ECB as it has struggled to find solid footing in the slippery world of globalized foreign exchange markets and political trap doors. From the initial pressure on its independence, to the crisis of the weakening euro (and its first forays into intervention), to the ongoing question of transparency, the ECB has had a difficult start.

At the same time, the fact that the launching of the euro on 1 January 1999 was a notable success and the fact that the ECB has found more solid footing give grudging acceptance to the notion that the ECB has learned from earlier missteps. Moreover, the ECB has carefully struggled to balance political input and an independent policy so as to assure its long-term credibility on the key issue of price stability. Moreover, we contend that the ECB has found a stronger focus with the generally successful changeover to the euro on 1 January 2002. With an emphasis on the introduction of notes and coins, the ECB's power and competence should come into sharper focus as well.

The ECB gets started: early controversies and successes

Commenting shortly before taking office on June 1998, Duisenberg suggested that the ECB would not conduct an 'extra tight monetary policy' just to make the ECB more credible. Credibility 'must be earned. You do not gain it in one day'.[98] Nevertheless, with money supply targets (based on the broader measure M3) above 5.5 per cent annually, some senior European monetary officials were suggesting that interest rates would have to go up in the third or fourth quarter of 1998.[99] While prediction was difficult, estimates of the official ECB interest rate for the launch of the euro stood somewhere between 3.5–4 per cent. At the same time, others commentators – mostly politicians and government ministers – warned against stifling economic growth which stood at a sluggish 2.5 per cent across the Euro-Zone.[100] Almost immediately upon inception, the ECB was thrown into the middle of a classic monetary dilemma: raise interest rates to satisfy the currency traders and monetary hawks in national central banks or keep rates stable (or even lower rates) and satisfy the politicians. Whichever side the ECB came down on, it would immediately be placed in the pressure cooker of European politics.

In addition to facing possible problems over its early stand on interest rates, the ECB was warming to its first public confrontation with

Euro-Zone governments over public spending. In a July 1998 ECB announcement, Duisenberg stated bluntly that governments in the Euro-Zone should aim to run balanced budgets in accordance with the mandates of the Stability and Growth Pact. Fiscal profligacy would, according to the bank, have negative consequences for monetary policy – a thinly veiled threat of higher interest rates. More specifically, he suggested that countries with particularly high levels of national debt should be running surpluses.[101] Furthermore, Hans Tietmeyer, still at the helm of the Bundesbank, supported Duisenberg by suggesting that some states – including Germany – would soon be in the danger of running an inappropriate fiscal–monetary mix. Even with inflation virtually absent and economic growth just starting to pick up, the ECB was staking out what it argued was the higher ground in any future debate on monetary policy and fiscal policy.[102]

Taking the financial markets by surprise, on 3 December, the Bundesbank, followed by the 10 other central banks of the countries that were to join EMU on 1 January 1999, cut interest rates. Based on the earlier statements of Duisenberg, economists had largely predicted that there would be no interest rate changes before the 1 January launch date. The economic data supporting a rate cut was mixed (low inflation, sluggish growth – but money growth slightly above targets) and the reliability of Euro-Zone data was still an unanswered question – an early indicator of the troubles the ECB would face in communicating its strategy and decisions to the public and the markets. Nonetheless, the Bundesbank cut its repo rate from 3.3 to 3 per cent. The other euro countries trimmed their interest rates to the same level. Italy cut its rate to 3.5 per cent under the assumption that its rate would converge to 3 per cent by 1 January. One explanation for the co-ordinated rate cut was to signal the markets prior to the launch that all Euro-Zone members were strongly committed to the success of the euro. It would also likely ease pressure off the ECB to cut rates at its first meeting in January. Finally, the ECB also mentioned the ongoing monetary and financial troubles in Asia, Russia and Turkey that might put a drag on economic growth in Europe. Despite widely different explanations for the co-ordinated move, a statement issued by the ECB suggested that the decision was the result of a 'common assessment of the economic, monetary and financial situation in the euro area'.[103]

One can perhaps interpret the rate cuts more cynically. The decision was the national central banks' last moment of power as interest rate policy would then slip beyond their sovereign control. In its last decision as the sole protector of German monetary stability (and true to form), the Bundesbank argued that strict monetary considerations were behind the decision to lower rates. The decision was a 'sovereign decision of the Bundesbank that was uninfluenced by political expectations … We are deaf to political pressure, but not blind to arguments and facts'.[104] For Tietmeyer, the move to co-ordinate interest rates and to move them in line in anticipation of the launch date was desirable based on low inflation levels in the Euro-Zone. The Bundesbank was adamant that it was still in sovereign control of German monetary policy and still firmly independent in its capacity as a national central bank.

One reason for the Bundesbank position was the increasing political pressure on the ECB that had been coming from the new German Finance Minister Oskar Lafontaine. Discussions between Lafontaine and his French counterpart, Dominique Strauss-Kahn, over co-ordinated economic policies and target zones for the euro signalled the turbulent time to come once the euro had been officially launched. Lafontaine envisioned the Euro-XI group as a political counterweight to the ECB (and as a symbol of the price the United Kingdom would have to pay for remaining outside EMU). For Lafontaine and others in the leadership of the new German government, questions needed to be raised in terms of the public interest – not the narrow monetary or financial interests advocated by the ECB and the Bundesbank. As Lafontaine suggested, 'we have to carefully ask ourselves: does our monetary policy hinder the reduction in joblessness or not?'[105] Raising these issues could, according to Lafontaine, be legitimately done in the Euro-XI forum. As the ECB began its activities in July, the Euro-XI also held its first meetings. France pressed for a body that would meet regularly, schedule a rough timetable for future meetings, develop more reliable Euro-Zone economic statistics (perhaps in competition with the ECB), and reach an understanding on contacts with international bodies such as the IMF. With strong resistance from the Bundesbank (and Great Britain on the sidelines), the more moderate Socialist German Chancellor Gerhard Schröder did not fully support France's or Lafontaine's efforts to build the Euro-XI into a de-facto decision-making body. As it would turn out, the Euro-XI (Eurogroup) would remain largely impotent and without clear guidance as an effective counterweight to the ECB.

Launching the euro: 'an abrupt change in regime'[106]

The launch of the euro truly marked a momentous change in terms of monetary governance in Europe; the ECB would now have sovereign control over interest rates within the Euro-Zone and currencies would be permanently fixed. Despite the historical nature of the change, the ECB would have no honeymoon period in which to act. 'Extreme uncertainty', as one EC banker noted, pervaded the minutes before the launch. But the fact that nothing dramatic happened was an indication of the relative success of the euro's birth. The target system of payments was up and running and the ECB was calling bids on 13-day refinancing agreements. All appeared normal accept Duisenberg's interview in a French newspaper indicating that he might not retire after four years.[107] In its first full day of trading, the euro opened at 1.17 and climbed to more than 1.19 before settling at 1.18. Stock markets in Frankfurt, Paris, Milan, and Madrid all jumped by 5 per cent or more. Banks reported minimal problems as they spent most of the weekend prior to the launch reprogramming computers to use euros. The long anticipated day had come and gone without a hitch.

Despite the relative smooth start, with no honeymoon period or '100 days' to seize the agenda, the ECB was immediately having to defend its policies. Shortly after the launch of the euro, the ECB's Vice President Christian Noyer was questioned in an interview about the ECB's independence. Given the pressure coming from France and Germany and the co-ordinated effort to lower rates in December of 1998, had the ECB given in to political pressure? Noyer responded that the ECB did not cave in to German and French demands for a decrease of interest rates. Given the sluggish Euro-Zone economies, Noyer focused instead on the fact that inflation was well under the target rate of 2 per cent – giving the Euro-Zone central banks room to lower rates. Noyer argued that the 2 per cent inflation target was useful because 'it is what the people believe is stable prices',[108] and that the ECB would focus its energies on attaining that goal. Noyer went on to warn states of going beyond the limitations of the Stability and Growth Pact and cautioned, too optimistically in retrospect, about the possible effects of a strong euro on exports.

Noyer's comments would become the theme of the ECB's first six months in office. German analysts in particular were watching the ECB with a keen eye and with a focus on the transparency and clarity of the ECB message. For German ECB watchers, the key was the '*glaubwürdigkeit*' – or believability – of the ECB.[109] The more believable the bank, the more transparent would its policies be. The ECB would still need to earn the same level of believability that the Bundesbank had established over the last 40 years. For German ECB watchers, the monthly reports of the ECB would be crucial in laying out a strategic vision for the ECB's monetary policies.[110] This fact was not lost on the ECB. Showing its debt to the Bundesbank, in its first monthly report, the ECB launched a renewed broadside against the spending policies of the Euro-Zone governments. The ECB also warned of lower economic growth as a result of economic troubles abroad, indicating a possible softening view on interest rates, but its aim was primarily at the socialist-led governments in France and Germany. From the ECB's perspective the government's of the Euro-Zone still maintained weakened commitments to fiscal discipline.

With no ECB movement on interest rates, February and March continued to be dominated by the debates over the Stability and Growth Pact's requirements that governments restrain their budget deficits to under 3 per cent of GDP. The pressure on the newly elected Social Democratic government of Gerhard Schröder and his fiery finance minister to do something to stimulate employment in Germany intensified as economic growth remained sluggish. As Lafontaine stated, 'if the monetary authorities cannot find a response to the negative shock to demand, other options will have to be considered'. The thinly-veiled threat to the ECB indicated Lafontaine's intention to push for a fiscal stimulus package. The French Finance Minister Strauss-Kahn was also pushing an idea of a euro-wide standard for the 3 per cent budget cut-off. If the Euro-Zone budget deficits – taken together – remained below 3 per cent, then individual countries could briefly surpass the 3 per cent GDP mark. The idea was floated among the Euro-XI as a possible strategy to counteract the ECB's perceived hard line monetary policies. The implication: Germany and France might be able to spend more if the combined Euro-Zone cut-off stayed at or below 3 per cent – supported by fiscal discipline in the Euro-Zone's growing economies (Ireland and the Netherlands, for example).

The spectre of Germany and France falling short on the budget deficits haunted the ECB and raised doubts about its ability to withstand the political pressure. It was becoming immediately clear that the Euro-Zone, despite the conservative ECB at its core, faced an urgent problem of draining credibility. The ongoing conflicts and public divisions between the ECB and Euro-Zone finance ministers (especially in France and Germany) hurt the external value of the euro and indicated that a strategic long-term view of the Euro-Zone's future was lacking.[111] As one currency analyst suggested, '[t]he loss of credibility is a slippery slope. Once you start down the slope and lose traction, it is hard to crawl back up again'.[112] Some hoped that the new European Commission President Romano Prodi could bring some stability and order to the EU's policy-making process and encourage fiscal consolidation, as demanded by the ECB, among member states. Some felt that Prodi's own experience in bringing Italy's fiscal side under control would add some credibility to the EU's own efforts to restore financial order. The reality, however, was that there would be little that Prodi or the Commission could do to control France or Germany.

In addition, through the first few months, many analysts were focusing on the inevitable question of when the ECB would actually make its first decision on interest rates. In which direction would it go and when? Speculation was rampant. For example, the decision on 19 March to keep interest rates unchanged found the ECB in the classic dilemma: Did the ECB keep interest rates stable in order to look independent? Or should the ECB have lowered rates – as many economic analysts, not just Lafontaine – were arguing? The ECB was in a no-win situation. Was it not acting just for the sake of not acting or should the ECB have made a decision based on the real economic needs of the Euro-Zone? Not only was pressure coming from member states, but the ECB was also receiving calls from the IMF to lower interest rates (although divisions in the IMF board revealed a decidedly Anglo-European continent split on euro interest rates). The pressure on the ECB to act was intensifying.

The cloud of controversy surrounding the ECB lifted briefly with the resignation of Oskar Lafontaine in March. His resignation was seen at the time as a major triumph for the ECB in securing its political independence. Internal SPD rifts between the more moderate Schröder wing and the left-wing Lafontaine led to the resignation – but certainly Lafontaine's ongoing efforts to hem in the ECB with pressure for rate cuts and exchange rate target zones further exacerbated the split. With Lafontaine gone, the ECB regained its political footing. The bank warned in its March *Monthly Bulletin* that the financial and structural policies of the Euro-Zone member states were not focused enough on deficit reduction. The report went on to conclude that further fiscal and structural reform was needed. The ECB's opinions, one could argue, expressed avowedly political point of views. Was this a signal of renewed confidence in the ECB?

Yet even after Lafontaine's exit (and the euro rising 2 cents in a day), the euro continued to sink in value as April proved a difficult month for the ECB.[113] Duisenberg tripped himself up repeatedly.[114] Shortly after the 8 April decision to lower rates (to 2.5 per cent – more than was expected), Duisenberg stated emphatically that the decision to lower rates ruled out any further rate changes for the foreseeable future. However, within several weeks, new signals from the head of the ECB indicated the possibility of further rate changes (albeit it was not clear in what direction). Moreover, references in the media to the effect that not all members of the governing board were enthusiastic about the April rate cut also raised some concern among ECB watchers. More problematic, however, was Duisenberg's comments stating that he was not worried about the euro's decline. Referring to an ECB policy of 'benign neglect' vis-à-vis the euro, Duisenberg sparked renewed sell-offs of the currency. In order to address the concern that the ECB was out of touch with the public's view of the euro, at the G-7 meeting in Washington at the end of April, the Germans sought to shore up the ECB's credibility. In particular, Hans Tietmeyer, then Bundesbank President, explicitly renounced Duisenberg's reference to 'neglect'. Specifically, Tietmeyer stated that 'a policy of neglect would be inappropriate, and I would like to add that, all in all, a significant further change in the euro's level would not be appropriate'.[115] Verbal discipline was now needed more than ever or else the ECB's traction would continue to slip down the slippery slope of credibility.

By May 1999, the euro had lost 10 per cent of its value against the dollar. Despite some pressure to act, the ECB resisted. Otmar Issing, Governing Board Member and chief economist on the board, stated bluntly that concentrating on the exchange rate so soon after its launch would be a mistake. Issing implied that there existed in the media and the markets a far too narrow focus on exchange rates. 'Everything we observe is either a historic low or a historic high'.[116] At the same time, there was increasing talk of co-ordinating exchange rates in some fashion or another, although the idea of target zones had disappeared along with Lafontaine. Sirkka Hämäläinen, one of the ECB's directors, suggested the possibility of increased exchange rate and, in general, macroeconomic co-ordination between the Euro-Zone, the United States, and Japan.[117] The context of global monetary instability and financial crises in Asia and Russia stimulated active discussion about the role of the big three financial powers and how they could bring some stability to the international monetary system. Indicative of the problem of co-ordination was the ongoing problem of devising a clear role for a Euro-Zone representative to the IMF or the G-7. Would the ECB president speak on behalf of the Euro-Zone members (Italy, Germany, and France) within the G-7? These issues had not yet been settled.

Brushing off some of the earlier criticism, in an interview in late May, Duisenberg expressed his personal confidence in the euro and his view that the overall first months of the euro experiment had been successful. He noted that the pressures on the euro could be explained by stronger US economic growth and the crisis in Kosovo as the dollar remained a safe haven in times of crisis. Duisenberg also indicated that the euro had settled into a more normal and constant phase of valuation – given the euro's rise (albeit brief) after the immediate launch of the euro. Moreover, he suggested that the ECB could not intervene verbally on behalf of the euro, that such actions would be counterproductive and damage the credibility of the ECB. Finally, with interest rates at record lows, it was not surprising that the euro was weak. The weak euro in fact supported the general economic developments of the Euro-Zone (especially through strong export-led growth) without threatening price stability. Economic growth, low inflation, and the euro's emergence as one of the world's main investment currencies were clear indicators of the euro's successful launch. In Duisenberg's view, the situation was quite good, the record of the ECB solid.[118]

Duisenberg could not rest on his own positive assessment for long. Concern among the ECB watchers, the markets, and the German public was generated by a deal agreed upon by ECOFIN for Italy that relaxed its 1999 budget deficit target from 2 to 2.4 per cent. This decision increased fears that fiscal discipline would weaken throughout the Euro-Zone now that the launch of the euro had been relatively successful. In addition, statements by various ECB leaders appeared contradictory on the issue of the euro exchange rate. The lack of a single voice gave evidence to support the contention that leading ECB officials did not talk among themselves, let alone speak coherently with the market. At this early stage, no one was suggesting currency intervention as a solution to the euro's weakness. For ECB officials, intervention would only further damage the bank's credibility. The common (and correct) view was that the ECB could not reverse the trend, only support a trend (swim with the current, not against). By the end of May, only the Bundesbank had taken on the role of leading euro cheerleader trying to stave off euro parity with the dollar.

At the Cologne European Union summit on the weekend of 5/6 June, attempts to speak with one voice were undermined by further differences over the wording of a statement that sought to boost the euro. The 15 heads of government sought to expunge wording in a draft communiqué that made reference to the euro's decline. But the draft had already been widely disseminated and reported upon in the media. The appearance of summit disarray permeated the press.[119] The situation was further complicated by a speech by Commission President Prodi indicating the possibility, at least theoretical, that Italy might have to exit EMU if it could not keep costs down and its finances in order. Was Prodi speaking for Europe? Or for Italy? Or was he speaking on behalf of the euro? The cacophony of differing statements and opinions on the euro was eroding public and market support for the currency.

Largely as a result of the global financial crisis and banking failures in Japan and the US, another controversy erupted over the issue of whether the Euro-Zone area had adequate power to regulate the increasingly dynamic Euro-Zone financial system and banking industry. As consolidation and mergers became the dominant strategy of the financial services industry, the ECB argued that it had to increase its regulatory oversight of this industry in the Euro-Zone. Some members of the ECB envisioned something along the line of a central 'European Financial Regulatory Committee'.[120] Some of this thinking was based on the work of Barry Eichengreen (see Eichengreen 1993; and 1998). Eichengreen noted in his own work on the Federal Reserve that the lack of a strong centralized regulatory framework for the US contributed to the financial chaos and crisis of the Great Depression. Eichengreen and others warned that the ECB may be in a similar situation because it would not have enough power to deal with a crisis euro-wide – especially through the emerging euro-financial markets. While no such crisis has yet emerged, the potential for a problem certainly does exist in the Euro-Zone. The issue of banking and financial services regulation would continue to be one of the more controversial issue areas still to be addressed by the ECB and EU members governments.

National central banks, however, were resisting the idea of a centralized European Regulatory Committee. In particular, the Bundesbank advocated a decentralized system emphasizing national control. For the Germans, the decentralized system of regulation best served the German financial industry (and large banks). Besides, the Bundesbank (and some of the Länder central banks) would still retain some power that it felt was increasingly slipping away toward the ECB. Moreover, the principle of subsidiarity, a concept the EU was always constantly trying to promote, laid the groundwork for a decentralized confederal structure to EU governance. Besides the ESCB was based on an existing decentralized, confederal model. Why reinvent the wheel? The division within the ECB's own ranks was symptomatic of a new institution going threw growing pains.

The euro's continued slide (July–December 1999)

Discordant notes among the ECB's Governing Council continued to have a noticeable effect on the value of the euro. With the replacement of Hans Tietmeyer with Ernst Welteke as head of the Bundesbank, differences of opinion between the Bundesbank, the ECB, and the French central bank on the value of the euro emerged. During the summer of 1999, Welteke suggested that the euro find a target of around 1.05 euros to the dollar. According to Welteke, such a value would be appropriate given the existing macroeconomic conditions of the Euro-Zone. This view reflected, one might suggest, the usefulness for German exports of the weak euro. At the same time, Jean-Claude Trichet, the President of the Bank of France, argued that the euro had room to appreciate, reflecting in part the fact that the French economy was doing better than the German. And as the *Financial Times* suggested, 'it also underlined France's long-term goal of making the euro a rock-solid currency capable of challenging the dollar's supremacy'.[121] Differences also emerged between the ECB (and its Vice President, Frenchmen Christian Noyer) and Germany over the proper direction of interest rates. Christian Noyer testified to a European Parliament committee that there might be a need to raise interest rates given monetary aggregate targets that were rising above the loose reference target of 4.5 per cent. Welteke responded that he saw no reasons for any shift in interest rate policy and downplayed concerns about the money supply. Ironically, it almost appeared that traditional monetary roles were now being reversed – France as the inflation hawk and Germany appearing 'soft' on inflation. For his part, Duisenberg was caught in the middle trying to balance competing views on the euro's value and ECB's interest rate policy.

In an interesting study cited in the *Financial Times*, an analysis done by an economic consultancy group, 4Cast, found an inverse relationship between the number of official statements on the euro and the performance of the currency.[122] The three quietest periods for official ECB comments in the year 1999 had coincided with relative stability or appreciation for the euro against the dollar. Of course it was also possible to suggest that ECB officials only were asked to comment on the currency during episodes of weakness or instability – thus triggering the relationship discovered in the study. Whatever the direction of causality, the problem was clear: the credibility and communication strategy of the ECB had yet to be effective.

Driven in part by what it felt was a weak public front for the euro, members the Euro-IX decided that more co-ordination and cooperation in its activities were necessary. The Finnish presidency of the EU in the second half of 1999 and its chairing of the Euro-XI group helped formalize some of the activities that the French Finance Minister Strauss-Kahn had initiated earlier. Strauss-Kahn, who resigned in November of 1999, had steered the group in more structured discussions and informal agendas were prepared with the chair guiding the debate. Suaili Niinisto, Finland's Finance Minister, took Strauss-Kahn's developments a bit further. Niinisto developed a strategy of informally summing up the discussions at the Euro-IX meetings. He would also write follow-up letters to fellow ministers, summarizing any policy advances or problems and suggesting points for later meetings. Better organization was matched with more serious, less flamboyant ministers including Hans Eichel (replacing Lafontaine) and Christian Sautter of France (replacing Strauss-Kahn). The forum would prove useful to explain domestic policy problems and to employ the backing of colleagues in the Euro-Zone to add to each finance minister's political influence at home when arguing for controversial policies such as spending cuts. The Euro-XI group also took a more active role in verbally boosting the euro.

Building on these concerns the Finnish Prime Minister Paavo Lipponen, who held the presidency of the EU, suggested that 'in articulating its monetary policy objectives, the ECB falls short of the ideal. Clearer objectives are needed'.[123] In particular, Lipponen focused on the ECB's two-pillar strategy and strongly suggested that the ECB publish economic forecasts so as to remain a 'credible partner in economic policy dialogue'. Lipponen's comments were echoed in Germany by a report released by the so-called 'five-wise men' – the German government's council of economic advisors – who recommended in their annual report that the ECB abandon the two-pillar strategy. 'Only with a clear concept will the ECB be able to maintain a strong reputation over the long term as a guarantor of stability of the value of money'.[124] Internal splits within the ECB, however, over the wisdom of publishing forecasts, given the continuing uncertainty over how the money supply had been affected by the launch of the euro, precluded any immediate movement in that direction.

Despite the political and market pressures, most analysts believed that the concern over the slide of the euro was 'much ado about little'. In terms of domestic purchasing power, in terms of boosting exports, in terms of a longer-term perspective on the value of the euro, the picture was not too worrisome. 'One euro is one euro', according to Duisenberg.[125] Moreover, with a November interest rate increase from

2.5 to 3 per cent – the first increase by the ECB – the ECB was in its view responding appropriately. The ECB had hinted at possible interest rate increases over the summer by citing recent growth in the money supply (around 6 per cent on an annual basis). For now, though, the ECB focused on devising a neutral setting for monetary policy. With rising price pressures in some sectors (energy in particular), solid economic growth in Germany, Italy and France, and the ongoing concerns over the weakened euro, the ECB was intent on setting a more stable course for its second year of operation.

The ECB moves toward year two (January–May 2000)

Reflecting on one year of activity, Duisenberg was proud of the ECB's accomplishments. In a revealing interview in the *Observer*, Duisenberg stated that the ECB had delivered on its mandate – that is to provide 'price stability'. In that respect, he was correct. Inflation on an annual basis (for 1999) within the Euro-Zone had hovered at the 2 per cent target. Duisenberg also admitted the difficulty in developing a one policy fits all for the Euro-Zone. But he suggested that the euro had brought increased dynamism to the European economies and helped revive the sluggish economic growth rates of France and Germany. In regard to the previous year's exchange rate controversies, Duisenberg was clear. He stated:

> I always find it a bit unfair to say that the euro has fallen by 12 to 14 percent. What you do then is compare the current rate of the euro with the exchange rate that emerged on one day … . It is more relevant to compare the rate over the last three months with the very stable rate of between 1.08 and 1.10 (against the dollar) that existed prior to the birth of the euro in 1997 and 1998. Depreciation vis-à-vis that rate: that is relevant, and there is no denying it.[126]

Furthermore, Duisenberg elaborated on the question of the ECB's accountability. That issue, Duisenberg contended, has 'more to do with emotion than rationality. It (the ECB) is accountable to the public at large, and that comes through various channels: the European Parliament, the Council of Ministers, to the public directly through interviews like this and speeches'. From the ECB's perspective, then, all was well.

While the ECB had delivered on price stability (keeping the annual rate of inflation at or lower than 2 per cent), the euro had also been sold to the public as a stable currency – solid on price stability, but also its external value. Certainly, the weak euro was based on the continued credibility problems of national governments in restraining fiscal budgets. And, interest rate differentials and the business cycle in the US compounded euro problems as capital continued to pour into the US, financing record trade deficits and current account deficits. But the ECB's credibility had suffered noticeably due to the confusion in the public and the markets over the ECB's two-pillar strategy and the mixed messages coming from ECB board members and Euro-Zone finance ministers. These problems would in fact worsen in the months ahead.

In successive steps in February and March of 2000, the ECB raised interest rates from 3 to 3.5 per cent in response to the weakening euro, rising oil prices, and strengthening European economic growth that was contributing to the core inflation rate. Many analysts argued that the ECB's interest rate policy was effective but that it sometimes reacted slowly to changing economic and monetary conditions and that its policy pronouncements and communications were still not focused on a coherent long-term strategy for monetary policy and exchange rate management. For example, throughout January of 2000, the ECB had been suggesting that no further movements on interest rates would soon be forthcoming. Yet, as noted, it acted quickly in February to lower rates. Part of the confusion stemmed from the mixed signals of the two-pillar strategy.[127] It was not clear which pillar was emphasized more at any given point in time. What was the ECB's strategy if each pillar pointed in a different direction? Under what conditions would the ECB emphasize one pillar over another? Perhaps it was asking too much of the ECB to reveal publicly its own internal policy struggle, but it had in part set itself up for these kinds of debates.

Driven by political and market pressure, the euro had lost 20 per cent of its value by the end of April, hovering around .92 to the dollar. A further increase in interest rates in late April, from 3.5 to 3.75 per cent, did nothing to halt the slide. Parity with the dollar – which once seemed to represent an unthinkable decline in the euro's value – now looked to many market analysts as an impossibly high target. The chorus of supporters for intervention were increasing.[128] As noted, the primary culprit of the euro's weakness was the spectacular economic growth in the US as well as doubt about the willingness of the governments of the Euro-Zone to enact a number of structural reforms and tax cuts. But more problematic was the question of the credibility of ECB officials and Euro-Zone finance ministers. The euro's habit had been to undermine every single pronouncement in support of the euro. As the German Finance minister Hans Eichel declared, 'There is strong economic growth and all the economies of the Euro-Zone are better than before the introduction of the common European currency 15 months ago. I calmly say and agree with the president of the ECB and other finance ministers that eventually the markets will also realise this'.[129] But neither the markets nor the public 'realised' this. The euro would continue to weaken throughout the spring.

Partly in response to the lack of a united voice on the euro, in May 2000, a proposal by the Belgium finance minister Didier Reynders was put forth to have the Euro-IX group (soon to be known simply as the 'Eurogroup') participate once a month in the Governing Council of the ECB. The proposal was based on the fact that a normal exchange of information and ideas between national central banks and finance ministers already existed at the national level. Why not make that a normal part of ECB policy-making? Reynders was clear that his proposal was in no way designed to limit the independence of the ECB. In similar spirit, the Eurogroup produced its first-ever joint statement in support of the struggling euro. But the statement received only minor interest from the markets. Having heard repeated and mixed signals from finance ministers – whether singly or collectively – it did not seem to matter. Informal proposals were also floated among ministers, one of which emphasized the creation of a 'Mr. Euro' to speak on behalf of the euro externally and to curtail the mixed voices and signals and messages of finance ministers (see Chapter 3 for more details). While all of these ideas were interesting and in part discussed, they were never seriously considered by national governments or the ECB.

The most dramatic manifestation of the problems besetting the euro and the ECB came in a statement issued in early May by the ECB. The statement was addressed – rather unusually – to 'European citizens' rather than national governments or the financial markets. In many ways, Duisenberg's statement seemed particularly aimed at the Germans. He stated that the weak euro would 'undermine the perception of the euro as a stable currency'. Duisenberg argued that 'European citizens can be assured that the future of the euro is that of a strong currency, based on price stability and the strength of the European economy'. But the euro's weakness was more than just a perception to the Germans and many Europeans; it was a reality as the euro dropped to new record lows of 88.45 cents following Duisenberg's statement. Up to that point, there was nothing in the record of the

ECB's pronouncements to fully support Duisenberg's point of view. Perhaps it was more of a problem of Duisenberg's credibility, rather than the ECB itself. But the surprising statement by Duisenberg demonstrated the extent of concern of the ECB about the public's perception of its credibility.

Duisenberg's statement was met with much criticism, even ridicule – especially in Germany. As Peter Bofinger, a leading German economist noted, 'If there were a price for poor marketing, the ECB would have won it'.[130] Bofinger noted that the ECB still lacked the confidence that was required of the single most powerful European institution. Furthermore, the ECB continued to act defensively rather than as an institution fully in command of its field. For those outside the Euro-tower, it was a wonder that the euro had not fallen even further.[131] It was critical for the ECB to have the confidence, which the bank seemed to be on occasion lacking, or else it would continue to undermine its own ability to function. Moreover, the three interest rate increases since November 1999 had done nothing to stem the slide of the euro. And for socialist-led governments within the Euro-Zone, the rate increases were threatening the first real signs of strong economic growth and job creation in years. Fully 18 months into the EMU, one might have assumed that the job of the ECB would have slowly become easier. Instead, the task had become more difficult as the ECB faced an avalanche of pressure – political, public, and market – to do more to support the euro.

The euro-gloom continues (June–December 2000)

On 9 June, the ECB raised interest rates again by a half of a percentage (to 4.25 per cent). At the time, the euro hovered around record lows of .88 to the dollar. In countless interviews at the time, the ECB predicted that the decline in the euro was now coming to an end; the 'turnaround for the euro' was imminent. It was hoped that this latest interest rate increase would make returns more attractive on investments denominated in euros – hence boosting the sagging euro. Moreover, with M3 at 6.5 per cent (at an annual rate) for April – too high given the ECB's target rate of 4.5 per cent – the hike in the interest rate was clearly justified. Inflation was also pushing just above the 2 per cent target. Compounding the problem, in economically booming Finland, annual growth stood at 5.2 per cent with annual inflation over 3 per cent. In the June *Monthly Report,* the ECB warned that further rate increases might be needed in order to offset threats to price stability.

The ECB appeared confident that its policies were appropriate for the Euro-Zone.

But some politicians, especially in Germany, were attacking the ECB for making the citizens of their countries 'poorer'. While not entirely accurate, the perception among the German public (and German tourists outside the Euro-Zone) was that the euro had quickly become the poor cousin to the deutsche mark. Economists continued to attack the ECB's two-pillar strategy. Financial markets dissected every signal and every word from Duisenberg and other EC bankers. As the German *Süddeustche Zeitung* summed up, Mr. Euro (Duisenberg) needed 'strong citizens, strong politicians, and strong words'.[132] But it appeared that he did not have any of these things. By September, the euro had dropped to record lows at .87 to the dollar. Market analysts and traders were further balking at buying the euro after comments by German Chancellor Gerhard Schröder that implied that he was not concerned about the euro's steep decline as it continued to help German exports. Schröder's comments were intended to soothe the concerns of unnerved German citizens who had lost confidence in their new currency. Yet, his statements contradicted everything that the ECB (and Schröder's own Finance Minister Hans Eichel) was doing to bolster the euro verbally. National interests – it seemed – still prevailed when it came to a specific euro exchange rage policy.

The ECB counterattacked by suggesting that the German government was itself to blame for the euro's problems. Germany was on the implied receiving end of the ECB's repeated warnings to Euro-Zone governments on the necessity of fiscal control. With annual wholesale prices pushing at an annual rate of 5.4 per cent in Germany and with tax cuts likely to push the government's budget deficit to slightly over 1.5 per cent of GDP (still considerably below the 3 per cent targets of the Stability and Growth Pact), the German government was seen by some ECB officials as a contributor to the weak euro.[133] Not surprisingly, with the annual rate of inflation in the Euro-Zone peaking at 2.4 per cent in July (driven by rising energy/oil prices), the ECB raised interest rates another quarter point to 4.5 per cent. Some people within the ECB felt that a further increase in interest rates was needed in order to stem the decline of the euro and to send a signal to governments to control spending.[134] While tension between the ECB and the German government did not come close to matching the tension that existed during Lafontaine's short tenure, the underlying conflict demonstrated the ECB's struggle in asserting its priorities on Euro-Zone governments.

At a press conference following an ECB meeting in early September, Duisenberg admitted he did not understand the euro's slide to record lows given underlying 'strong economic fundamentals'. Instead, Duisenberg placed the blame on 'short term phenomenon' in which 'markets have a tendency to overshoot in one direction or the other. That means they will, at some point, reverse their direction, and it's that point for which I'm so anxiously waiting'.[135] What was clear was that the short-term phenomenon Duisenberg identified was the result of the market's perception that the ECB's credibility was being undermined by conflicts with national governments, by misstatements coming from the President himself, and by the lack of coherent ECB strategy for addressing the euro's decline. In other words, the short term euro depreciation had now turned into a long-term evaluation by the markets.

Anxiously waiting, but not trusting the markets to react to economic fundamentals any time soon, on 14 September the ECB responded with its first major interventions in the currency markets in the amount of $2.2 billion. The intervention failed to boost the euro. Most analysts called the intervention a modest or limited step on behalf of the downtrodden euro. Duisenberg claimed that the move was a routine portfolio adjustment and that 'intervening in the market' on behalf of the euro 'was not part of the motive'.[136] At a press conference following the intervention, he stated clearly that the ECB was unhappy with the euro's slide. 'The fact that the euro has continued to depreciate over recent months is not in line with these economic fundamentals. Our concerns on this issue remain serious and we shall monitor developments closely'.[137] But his justification for intervention was not credible to most analysts. Even the European Commission stepped into the fray suggesting that the ECB do more to prop up the euro which now stood at .86 to the dollar. Interest rate increases – six of them since mid-1999 – had not done the trick, interventions in the market (however modest) did not appear to work, and repeated castigation of Euro-Zone governments' spending policies had failed to convince the markets. The problem for the ECB was one of credibility.

The unexpected decision by the US to join market interventions to support the euro on Friday 22 September surprised investors and supported the efforts of the ECB to enhance the credibility of its strategy of supporting the euro. Yet after initial support in the markets, the currency continued its slide back down from .90 to .87 to the dollar. Following the multilateral intervention, the short-lived consensus on supporting the euro was quickly undermined when US Treasury

Secretary Lawrence Summers issued ambivalent statements following the intervention that further US support in the markets might not be forthcoming. More significantly, according to Summers, the US had not changed its view that a strong dollar was in the US interest.[138] His statements undermined any possibility of further co-ordinated interventions in support of the euro. Duisenberg had hoped that further co-ordinated interventions would bring about an orderly reversal in the euro's decline. However, with the US wavering in its support, any further failed interventions would do even greater damage to the euro and to the ECB's credibility.

The situation continued to worsen for Duisenberg and the euro through the early autumn. First, the ECB raised interest rates one more time on 5 October to 4.75 per cent largely, as it argued, to keep inflationary pressures in check, but also to support the euro. The rate increase did not have any effect on the euro's value. At the same time, the move angered some politicians who suggested that the ECB was stifling economic growth. Second, while support for joining EMU and the euro was driven largely by domestic politics, disarray on the euro intervention further damaged the pro-EMU forces in Denmark. In a referendum, the Danes rejected entry into EMU 53 per cent to 47 per cent. Recognizing the problems the ECB confronted, Duisenberg suggested in an interview in *The Times* that the European Central bank would not intervene again soon to strengthen the euro. He had also acknowledged that he had tried and failed to persuade Secretary of the Treasury Summers to soften his calls for a strong dollar – suggesting that US support for further interventions was unlikely in the future. The markets pounced on the news and the euro sank to a record low of .83 to the dollar. Admitting that he had blundered in the interview, Duisenberg vowed to hold his tongue more in the future and conceded that he had slipped. 'I do realise that some of my recent remarks gave rise to critical comments, and certainly they gave rise to a lot of advice. I draw my conclusions and I accept the advice and thus I'm not going to answer any questions related to that recent interview and any questions related to interventions'.[139] But Duisenberg had committed the cardinal sin of all central bankers – talking of intervention when no credible commitment existed.

Perhaps not learning from their earlier mistakes, European central banks intervened unilaterally (without the Americans) in the markets in early November in another failed (and perhaps desperate) attempt to give their ailing currency a needed boost. As one European economist stated, 'They have put their head on the chopping block ... They can't just suddenly stop because then everybody would ask, do these guys have any intervention strategy at all?'[140] But that was exactly the paradox the ECB confronted: should the NCBs intervene and have their head cut off by currency traders or should they not intervene and have the same thing happen? The market seemed determined to keep the euro where it was – despite the interventions. As one currency trader commented, repeated statements by the ECB that 'intervention is an instrument available at any time' lacked any real 'teeth'.[141] At least when it came to an external euro policy, the ECB had severely damaged its credibility.

Partly in response to the euro's problems and ongoing pressure from its critics, at the end of the year, the ECB decided to publish twice-yearly economic forecasts – especially with a focus on economic growth, inflation, and money growth. Duisenberg hoped that the decision would improve the bank's transparency with the markets. He said the bank was 'trying to improve communication'.[142] Even so, Duisenberg tried to downplay the decision by suggesting that the economic forecasts would not offer a long-term guide to interest rate decisions. However, the move was clearly a grudging acceptance of the fact that the ECB needed to improve its public standing and its communication strategy. It would also allow the ECB to argue more effectively its two-pillar strategy. The effectiveness of these forecasts – and its effect on the credibility of the ECB – would have to stand the test of time.

A stabilizing euro? (January–June 2001)

The first months of 2001 would prove at first to be much better for the ECB. While the elimination of further ECB missteps helped, the small boost for the euro was largely the result of forces beyond the ECB's control. With the ECB keeping interest rates stable at 4.75 per cent, with European economies growing, and with the first signs of economic slowdown in the US, economic fundamentals were finally shifting in the euro's favour. Moreover, with the US Federal Reserve sharply and quickly cutting interest rates in January and April, interest rate differentials began to move more favourably in the direction of investments in the euro. Even with the lingering effects of the Turkish monetary and financial crisis of February, the euro had gained in value from its record lows in the early 80 cent range and was now hovering around .93 to the dollar. Considering the past problems with the euro, the ECB saw the euro's appreciation as a sign of success in its long term policies on price stability.

Most analysts predicted that the ECB would lower rates, perhaps 50 basis points, toward the spring months. Prices remained stable, albeit still above the target rate of 2 per cent. Some were even suggesting an immediate cut in order to offset any potential effect of an anticipated slowdown in the US economy. More directly, at the annual meetings of the G-7 and IMF/World Bank in Washington, DC in April, the IMF (and Canada within the G-7) specifically and rather bluntly targeted the ECB for pressure to reduce interest rates. The ECB resisted the pressure given what the bank felt were continued concerns about national inflation rates over the 2 per cent mark in the Euro-Zone. Further confusion of the final draft of a G-7 communiqué – with Duisenberg insisting that a draft statement included understanding of the ECB's position but the statement not appearing in the final draft – added to the rising confusion within the G-7. It still appeared that the ECB and Euro-Zone finance ministers were not all on one level with the non-Euro-Zone members of the G-7.

But the general economic situation remained relatively good in the Euro-Zone, easing any pressures within the G-7. The ECB was instead preoccupied with press reports citing problems in the actual printing of enough euro banknotes for the 1 January 2002 launch. The ECB responded to the rumours by strongly stating that they were totally 'unfounded'. The 'production is on schedule'.[143] But given the ECB's other problems, the bank's handling of the changeover to euro notes and coins would have to be flawless.

In May, the ECB surprised the markets with a cut its key interest rate by a quarter point to 4.5 per cent. The news gave a brief boost to the euro and triggered optimism in the stock markets. Given the intense pressure coming from the IMF and the G-7 meetings and given the fact that the ECB was the last of the major central banks to lower rates, many still had widely anticipated a move. After insisting for months that inflation remained the number one concern for the ECB, the bank may have been reacting to criticism that it was doing to little to shield the Euro-Zone from the impact of economic trouble in the United States. Duisenberg justified the rate cut based on lower inflationary pressure and a fall in consumer credit growth. But Duisenberg and the ECB could not ignore the largely depressing economic numbers coming from the Euro-Zone's signature economy – Germany. Industrial production, orders and jobs data had all signalled a marked downturn for the German economy. Whatever the interpretation and analysis of the rate cut (again indicating the difficulty that analysts were having in understanding the motivations behind ECB policy), the

ECB would increasingly be tested by the more troubling waters of an emerging Euro-Zone economic slowdown.

As in previous years, June proved a difficult month for the ECB. June 2001 would be no exception. By early June the euro had again lost its value in the financial markets and hovered at .85 euro to the dollar. The ECB once again found itself at the centre of the blame surrounding the euro's depreciation.[144] Comments from Duisenberg that appeared to suggest his lack of concern over the recent dip in the euro unleashed more speculation against the euro. In addition, despite the rate cut in May, some analysts feared the ECB was losing its battle against inflation – which hovered close to an annual rate of 3 per cent. To add to the confusion, speculation also emerged on the possible intervention by the ECB on behalf of the euro. Comments by Otmar Issing and Ernst Welteke (the two Germans on the Governing Council) suggested that the value of the euro had again dropped to potentially unacceptable levels. But given the stumbling intervention efforts of the ECB in the fall and winter of 2000, many doubted that the ECB would in fact intervene. With the August recess of the ECB fast approaching and the decision by the ECB to keep interest rates unchanged for 'some time to come' (in the words of Duisenberg), the euro plunged below .84 euro to the dollar. Any gains that had been made either in terms of the euro's value or the ECB's credibility had largely evaporated by July.

Euro-day approaches; Euro-Zone battles heat up (July 2001–February 2002)

Following the summer recess the ECB returned to work facing mounting pressure for some sort of rate cut. With economic indicators all pointing toward a more severe economic slowdown than previously predicted, Euro-Zone governments were itching for further interest rate cuts. Moreover, with the US economy sliding precipitously toward a recession (and with the Federal Reserve actively cutting rates seven times through the summer of 2001), many analysts were predicting a cut at the 30 August meeting. Indeed, the ECB responded with a quarter point cut to 4.25 per cent. According to Duisenberg, the new level of interest rates were 'compatible with the maintenance of price stability', and were driven by the 'duration and depth of the slowdown in the US'.[145] While government officials hoped for further cuts in 2001, many analysts suggested that the ECB would hold off on any further moves so as not to unsettle currency markets prior to the launch of the euro coins on 1 January 2002.

The terrorist attack on the World Trade Center – a centre for international currency and financial markets – on 11 September 2001 changed the world in so many ways. Its impact on the markets was immediate. With US stock exchanges shut down and currency markets interrupted, real concern about a major collapse of the market was widespread. The need for a co-ordinated response on all levels – diplomatic, political and financial – would be required in order to offset the immense psychological damage inflicted upon investors, markets and the general public. Indeed, the ECB and the Federal Reserve responded. On the day the markets reopened in the US (Monday 17 September), the ECB and Fed cut a half a percentage point off interest rates in order to stablize the markets. The ECB stated that cutting interest rates from 4.25 per cent to 3.75 per cent was made 'in concert' with the Fed because of the weak short-term prospects for European economic growth and as a result of the events of 11 September. Specifically, the ECB noted that 'following the terrorist attacks on the US, uncertainty about the US and world economy' had increased.[146] The ECB cut rates from 4.25 per cent to 3.75 per cent. The G-7, which had to cancel its scheduled meeting in Washington, DC for the end of September, issued a strong statement that it would stand ready to take further co-ordinated action if necessary. Currency intervention was also discussed another instrument that could be employed by the G-7 in order to stabilize currency markets.

Did the ECB and other G-7 central banks act in a timely and responsible manner? Most analysts suggest that they indeed acted correctly and wisely. It should be noted that the rate cut came just days after the ECB had indicated it would take no action on interest rates. Clearly the severity of the attack and the realization among all actors involved of the necessity for clear and concerted action fundamentally changed the playing field. The US stock market had plummeted around 5 per cent the day trading resumed on US markets. Much like the necessity of the co-ordinated efforts of G-7 banks following the market collapse of October 1987, this was not the time to hide behind arguments of inflation targets or indicators of M3. The ECB and other G-7 central banks reacted swiftly and decisively and should be credited with staving off even further panic. Moreover, given the market's rebound in the months that followed, the central bankers were doing their part to advance the interests of the industrialized world.

The 11 September attack and the ECB rate cut of 17 September marked a clear modification in the bank's policies and strategies. The emphasis of the bank's policies would shift away, albeit slightly, from its overriding preoccupation with inflation and growth of monetary aggregates and toward the need to revive the lagging European economy. Indeed, based on past ECB practice, indicators of annual inflation and M3 (which were still above the ECB's respective targets for both) should have suggested no further room for interest rate cuts. And with the ECB holding firm on no additional rate cuts through the rest of September and through mid-October, the prediction held largely true. But intense pressure from EU governments on the ECB to cut rates further increased. Other central banks, most notably in the US and the UK, had continued to cut rates. In addition, the US economy was now clearly in recession, a recession that would soon erode any hope for stronger economic growth in Europe. Yet Duisenberg defended the ECB's inaction by arguing that it was 'doubtful whether a range of rate changes coming quickly one after the other by themselves … would enhance confidence rather than maybe even undermine confidence', in the ECB.[147]

At an EU summit of heads of states in Belgium the debate over whether the ECB would cut rates further came to a head as German Chancellor Gerhard Schroeder suggested that the ECB could be 'more reasonable' when it came to the bank's interest rate policy. Schroeder was quick to emphasize that he respected the ECB's independence and that the bank's policies had been – until then – quite reasonable. But facing a stagnating German economy, with unemployment pushing up over 4 million, and a parliamentary election slated for September 2002, the chancellor was anxious to see more action taken by the ECB. Moreover, a preliminary draft of an EU summit statement had called for the ECB to take 'further decisive action' in easing monetary policy in order to boost the Euro-Zone's economy.[148] The statement was eventually watered down after objections were raised among ECB officials and some Euro-Zone finance ministers. But face-to-face meetings between EU leaders and the ECB indicated the level to which the disagreement on interest rate policy had risen. With the decision to keep rates steady on 25 October, the political cacophony calling for an immediate rate cut was nearly overwhelming.

Relief came two weeks later as the ECB lowered rates another half percentage point from 3.75 per cent to 3.25 per cent. The fourth rate cut of the year by the ECB was certainly welcome and more decisive than many had anticipated. The ECB justified the cut in terms of falling Euro-Zone inflation rates (still hovering around 2.4 per cent on an annual basis) and mounting evidence of economic disintegration in many Euro-Zone states and the United States. But did the ECB bow to political pressure? The answer is difficult to assess. From the ECB's perspective, the ECB did not bow to pressure. Its decision to lower rates was consistent with its medium- to long-term perspective on keeping inflation rates and monetary growth under control. Moreover, the decision by the ECB to consider adjusting interest rates only once a month so as to lower speculation in the markets and reduce volatility was also indicative of the ECB's authority over the monetary policy decision-making process. The bank would make its decisions based on its own time table.

But the ECB's move was a clear sign that it had to do something to stabilize public and political sentiment which had risen to a feverish pitch in the two months following the 11 September attack. In fact, the ECB's move could be interpreted as a new approach toward interest rate policy – an attitude more in tune with public and political attitudes. Given the imminent launch of euro notes and coins, the ECB was extremely sensitive to the public's level of acceptance of the changeover. Removing the spotlight away from the ECB's monetary policies and shifting the focus on 1 January 2002 would be seen as an important public relation's strategy for the successful implementation of the changeover. In addition, and fortunately from the ECB's perspective, focus had shifted away from its interest rate policy and toward the deteriorating financial situation in Germany, among other EU countries.

Following a very unsettled three months, the ECB and the EU could now focus on the full and final changeover to euro notes and coins. Concerns about counterfeiting and the supply of coins and notes preoccupied ECB officials (to say nothing of EU governments, banks, and businesses). With great fanfare and with some uncertainty, the launch of the euro was made on 1 January 2002. Long lines at cash machines and some crowding at banks marked the transition. But within days, transactions were preceding smoothly (outside of Italy) as most businesses and consumers were shifting to the euro. Despite some griping about price gouging, the euro launch was a success – boosting the euro's value to over .9 to the dollar. 'E' day had finally arrived and with it, the ECB was now more firmly in control of monetary policy than ever before.

Despite the relatively smooth transition of 'E' day, the European Central Bank and Euro-Zone members would quickly become immersed in serious debates over the future of enhanced economic co-ordination. By February 2002, Germany's budget deficit as a percent of GDP had risen from 1.3 per cent in 2000 to 2.7 per cent in 2001. As outlined in the Stability and Growth Pact, the European Commission had been given the responsibility to give early warnings to Euro-Zone members who were in danger of breaching the deficit ceilings. With Germany and Portugal both pushing to the upper limits of the deficit ceilings, Chancellor Schröder lobbied vigorously to prevent a vote within ECOFIN to accept a Commission's recommendation of a politically embarrassing formal warning of Germany. Ultimately, ECOFIN agreed unanimously not to issue the warning. In return, the German government promised to monitor national and state government budget figures and spending on social benefits more closely. Germany also promised to balance its budget by 2004. Similar promises on controlling government spending were made by Portugal. What was missing from the equation was the informal Eurogroup. Their role was largely inconsequential in the debates and indicated that ECOFIN remained, outside of the ECB, *primer inter pares* among EU-level institutions of economic governance.

The repercussions from the agreement were enormous; the differing interpretations of the agreement enlightening. German Finance Minister Hans Eichel suggested that the agreement not to issue a formal reprimand of Germany had actually 'strengthened the European Stability and Growth Pact'.[149] Eichel laid much of the blame on the heavily indebted German Land governments and not on the Schröder government. Trying to save some face, Commissioner Solbes suggested that the credibility of the Pact remained undamaged by the agreement – a suggestion not shared by most ECB analysts. Most German economists and industry and bank associations strongly condemned the agreement and its failure to protect the euro's credibility, suggesting the deal was characterized by 'political horse trading'.[150] Duisenberg issued a statement in support of the agreement, but grumbling could be heard throughout the halls of the eurotower and the Bundesbank in Frankfurt. Belgium's Finance Minister Didier Reynders contended that the agreement and ECOFIN had actually 'disciplined' the Germans for the first time – a suggestion accepted by neither the Germans nor the ECB.

The ability of Germany to withstand the Commissioner's pressure seemed to reflect the fact that great power politics remained alive and well within the Euro-Zone. Germany received political backing from the United Kingdom and France. Gordon Brown, the British Finance Minister, suggested that the European Commission had an overly narrow interpretation of the stability pact. Instead, Brown suggested a broader view – supported by the French – of the stability pact that took greater account of economic cycles, investment needs, and the sustainability of a country's debt. EU Commissioner of Economic and Monetary Affairs Pedro Solbes discounted the British interpretation but found himself on the losing end of some high level of intergovernmental politics. Germany's ability to produce a face-saving formula indicated the overall weakness of economic governance at the EU level. While a number of 'surveillance' mechanisms existed and with the ECB focused on combatting inflation, there was clearly no effective enforcement mechanism on Euro-Zone governments. Even though the ECB did put out constant reminders to the Euro-Zone governments to reign in spending, the credibility of the pact and the effect on the credibility of the euro would likely be long lasting. With the ECB's control over monetary policy now more sharply in focus following E-day, the lack of centralized economic co-ordination and governance clearly in evidence after the heated political debates of early February 2002 would provide a fertile ground for Euro-Zone battles to come.

The likelihood of future Euro-Zone battles over budget deficits and economic governance will be complicated by the announcement of Duisenberg that he would be stepping down as President of the ECB on 9 July 2003. The announcement brought an end to speculation as to when he would step down but renewed speculation over the likely successor. The 1998 débâcle over Duisenberg's initial selection as President of the ECB and the 'gentlemen's agreement' made on the length of tenure in office insured that renewed political infighting would soon return. Duisenberg had hoped that his early decision to retire would strengthen the ECB's credibility by allowing for an orderly succession. But he declined to endorse Jean-Claude Trichet, the likely French candidate for the presidency (Trichet was currently enmeshed in various investigations by the French magistrates). While the decision to step down in July 2003 gives the impression of political independence from French pressure to resign earlier, the politics that will inevitably surround the selection process will renew debate over the personal independence of the ECB. It would be wise to settle the issue of succession quietly without bumping into the deadline set by Duisenberg.

The debate over Duisenberg's succession opened up the door for speculation that other potential candidates were jockeying for position – including the ECB's Vice-President Christian Noyer (whose four-year term expired on 31 May, 2002) and the leading German insider on the ECB Governing Council Otmar Issing. In the months leading to April, debate resurfaced on the future of the position of ECB Vice-President. The highly qualified Greek Lucas Papademos was eventually selected by all member states except the Belgians who had insisted on the appointment of the noted monetary expert and Belgian Senator Daniel Gros. The Belgians abstained on the final vote and made it clear that they would seek to block the appointment of a Frenchmen as ECB President in 2003 (likely to be Jean-Claude Trichet) if the next appointment to the Executive Board was not a Belgian. Once again, the debate revealed a certain level of embarrassment regarding appointments to the board; more importantly, the appointment débâcle demonstrated the extent to which one member state will still go to push national prerogatives (and potentially undermine ECB independence and credibility).

Through the summer and early fall of 2002, the euro stabilized and even gathered strength as the US economy continued to slump and the ECB's interest rate policies found some footing. The euro even resurfaced to find parity with the dollar, although the euro would again slowly depreciate into the early autumn months – largely on the back of the continuing conflict over Euro-Zone member budget deficits (see below). For its part, the ECB maintained its Euro-Zone rate freeze. Interest rates remained unchanged at 3.25 per cent for the eleventh month in a row. In September the ECB cited general uncertainty over the strength of the limited economic recovery underway in the Euro-Zone and the fact that price stability had become more 'balanced' – precluding any immediate move up or down in rates. Despite the ECB's steady policies, the newly re-elected SPD/Green coalition government in Germany sought to increase pressure on the ECB to reduce rates. Shortly after the September election, the German government urged the ECB to adopt a more growth-oriented monetary policy. Memories of Lafontaine's failed 1999 attempt to pressure the ECB to cut rates should have been clear in Schröder's mind, but the government's limited room for manoeuvre in fiscal policy indicated that the government had to use whatever means necessary – including battling the ECB – to boost employment, growth and tax revenues. It was a battle that the German government would likely lose.

More problematic for the Germans – in addition to many other Euro-Zone member states – was the ongoing problem of budget deficits. In France, Jean-Claude Trichet targeted sharp criticism at the new centre-right government of Jean-Pierre Raffarin for not being more ambitious in its efforts to cut its budget. Specifically, Trichet called for the government to cuts its structural deficit by .5 per cent and to balance the budget by 2006 – both of which the government had so far rejected. During the 2002 French presidential campaign, President Chirac questioned the necessity of respecting the 2004 balanced budget target. In the lead up to the parliamentary elections, members of conservative Interim government questioned the need to respect the Stability Pact targets 'to the letter'. At the 21–22 June 2002 European summit in Seville, the French were permitted by their European partners to not balance their budget by 2004, except if France enjoyed 3 per cent economic growth or more over the 2002–3 period, an unlikelihood. They would try for 2006 instead. More importantly, on 8 October, Francis Mer, the new French finance minister, was outvoted 11–1 by the other Euro-Zone finance ministers after refusing to honour commitments to cut France's budget deficit. It was likely that the French would face the possibility of a formal rebuke from the EU Commission and increased demands to amend its immediate 2003 budget. Raffarin found himself trapped between the government's commitments to the Stability and Growth Pact on the one hand, and President Chirac's elections promises to cut taxes and increase defence spending – a sure recipe for budget imbalances.

The French debate was the latest in a series of increasingly difficult crises over the Stability and Growth Pact. The most intense crisis to date took place in mid-October when Germany admitted that it would breach the EU rules on deficits. In a television interview, Eichel stated that it would not be possible for Germany to 'stay under the 3 per cent deficit limit'.[151] What is noteworthy was that Eichel was trying to avoid earlier embarrassment during the election campaign by insisting that Germany's budget deficit would only rise to 2.9 per cent of GDP. Speculation in the German press prior to the September election that the finance minister was concealing accurate deficit figures in order to avoid any negative publicity for the campaign seemed to be accurate. The tactic may have worked as the SPD/Green coalition won a narrow victory, largely on the back of the success of the Greens. However, many German economists and bankers complained that the government's policies were only further damaging the euro's value at home and abroad.

Whatever the accuracy of the reports, the credibility of the Stability and Growth Pact and, by definition, the ECB's euro policies, would be severely damaged by the continued inability of Euro-Zone governments (in particular, Portugal, Italy, France and Germany) to curtail deficits. This view was strengthened by Commissioner Solbes' own comments indicating that he was prepared to be patient with countries that on the surface appeared to be willing to take tough measures to control deficits. While there was some indication that the Commission would launch a formal early warning to reprimand France and perhaps launch an official 'excessive deficit procedure' against Germany, Portugal's 4.1 per cent deficit indicated the problematic nature of the 3 per cent cut-off. It appeared that the Commission was taking the position of more 'flexibility' in the enforcement of the Pact – a move originally feared by conservative German governments and the Bundesbank in the 1990s. While Schröder has insisted that the Pact was untouchable, the battle lines were being drawn for a major fight over interpretation, enforcement and possible amendments to the Pact. The situation was compounded by the remarks of Commission President Prodi who suggested in a 17 October interview in *Le Monde* that the stability pact was 'imperfect' and 'stupid' and that adjusting the pact – albeit a move that required unanimity – was possible. While Prodi's comments were subsequently downplayed by the Commission, it did reflect a prevailing view among centre-left governments and policy-makers.

The ECB was vehemently against any revisions and demanded the strict interpretation and enforcement of the Pact. From day one (July 1998), the ECB had warned governments to maintain fiscal restraint and to avoid fiddling with government ledgers. Any slippage would undermine the ECB's stability-oriented policies and would further damage the euro's credibility both with the public and with the markets. Moreover, the lessons from February, when Germany avoided a formal rebuke for its deficit policies, were now being copied in France, Portugal and Italy. The historic summer floods that overwhelmed much of central Europe were now metaphorically threatening to overwhelm the Stability and Growth damn – and no amount of 'plugging' the financial leaks by Euro-Zone member governments would satisfy the ECB. Would the damn hold? Would the ECB wield its interest rate weapon? Or would the damn need serious reconstruction?

Conclusion

As noted earlier, credibility must be measured over time and must be evaluated in terms of the monetary policies of the bank. In addition, credibility must be earned. Given the relative infancy of the ECB and its record over the last four years, the conclusions drawn from this chapter must be read with some note of caution. In terms of fighting inflation, ensuring price stability, and keeping monetary growth under control and given the ECB's high level of independence (as noted in Chapter 5), it is not surprising then to argue that the ECB's anti-inflation credentials are as strong as ever. When the ECB proclaims its intent to combat inflation, it has established a credible record of achievement. No one doubts its commitment. The bank has also become – albeit haltingly – more open and transparent with its publishing of forecasts. Finally, with the successful changeover to euro notes and coins on 1 January 2002, the ECB can stand proudly in its position as defender of the euro.

More broadly speaking, however, the euro's depreciation over the last three years, the difficulty in communicating an overarching strategy for the euro, and the ongoing public misquotes by the ECB (and national governments) have damaged the public standing of the ECB and the euro project. Contrary to the statements of Otmar Issing in the introductory quote, the ECB did in fact exacerbate some of the euro uncertainty, especially among a fundamentally critical general public and market. Certainly, Duisenberg has been more careful in his public statements. As Duisenberg himself has noted, '[w]e are making quite an effort to sing with one voice, because the song we are singing is the same. But it sometimes takes us some time to sing in harmony' (Fairlamb, 1999: 64). Admittedly, many economists predicted the continuing decline of the euro – given interest rate differentials between the US and Europe, strong economic growth in general in the US and the inevitable shakiness of ECB policy as it tried to establish its footing in a markedly 'new world' of European monetary politics. But the ECB still needs to earn more credibility if the EMU project is going to succeed and expand through enlargement. 'The ECB faces … a "communication challenge". … There is certainly room for improvement in communicating the ECB's policy decisions and measures'.[152]

The concluding chapter highlights the immediate and long-term challenges confronting the ECB a stagnant Euro-Zone economy and the potential enlargement of the EU. More generally, we analyse the implications of our study on for European integration and the power of the ECB in relation to other EU institutions. Our concern is focused on the changing nature of EU economic governance – primarily over whether to further strengthen efforts at fiscal policy co-ordination – and the role of the ECB within this governance. Given 2002's ongoing crises over budget deficits and the difficulty of enforcing the Stability and Growth Pact, attention will increasingly focus on the need for either some revisions in the Pact or strengthened macroeconomic co-ordination either through the Eurogroup or through other existing or newly-created EU institutions.

7
Conclusion: the ECB and the Future of Europe

> … the unification of Europe has been, and continues to be, a 'work in progress'. The introduction of the euro and the establishment of the European Central Bank form an intrinsic part of this constant evolution. In fact, the dynamics inherent in Economic and Monetary Union suggest that the euro might become a powerful catalyst for further integration. Our job at the ECB is to contribute to making the euro a lasting success. In this way the euro will bring benefits to an enlarged EU and beyond.
>
> Wim Duisenberg, President of the ECB[153]

Introduction

The primary objective of this book was to provide a theoretically and historically rich study of the institutional structure and operation of the ECB. In doing so, we have highlighted the historical transformation toward EMU, the institutional set-up of the ECB, and the bank's independence. We have also evaluated the monetary interests and preferences of key EU member states – Germany, France and the United Kingdom – toward EMU and the ECB. Finally, we briefly analysed the short history of ECB policy-making with a focus on the overarching credibility of the ECB.

Our findings confirm that the ECB has emerged as one of the most powerful actors in European politics. It is well on its way to establishing its influential position within the institutional framework of EU governance – along with the Council of Ministers, the European Commission, the European Parliament, and the member states. While the bank has had problems in establishing its credibility in terms of an overarching communication strategy for the euro, it has also lived up to its mandate to ensure price stability. Also noteworthy in the ECB's early history is the relative success of the transition to the euro on 1 January 1999 and the ECB's ability to increase its capacity to analyse Euro-Zone data and maintain its Euro-Zone perspective given national variations in economic conditions. It also has emerged dominant in several clashes over its independence – most notably with Oskar Lafontaine in early 1999, but also in resisting pressure from the IMF and some members of the G-7 to lower interest rates in April of 2001. It also has adjusted to the enlargement of the Euro-Zone brought about by Greece's participation in the euro as of 1 January 2001. We concur with Duisenberg's note above and suggest that the ECB has become an integral actor in the larger framework of EU governance and will prove to be a powerful lever for further EU integration.

But the ECB also has been humbled on multiple fronts. The ECB, much like independent national central banks finds itself constrained – by the public, by member states, and by the markets, both within the Euro-Zone and global economy. In its relations with the US, the ECB has been left standing on commitments to exchange rate intervention. Despite unquestioned political independence, the ECB finds its policy autonomy shackled by market pressures that have relentlessly hounded the euro. Moreover, the ECB's image with the general public has been battered by the weak euro. Finally, Denmark's rejection of the euro, the continued foot-dragging by the British (and a likely rejection of the euro in any referendum), the consistent public unease in Germany over the euro project indicate the ongoing legitimacy crisis facing the ECB and the EMU project. The ECB will need to continue to wage an effective public relations campaign to convince all Europeans of the full merits of monetary union.

To be sure, the ECB takes its role as monetary sovereign seriously. And the record demonstrates the ECB operating in a world of monetary disorder, setting hedges that guide economic policy-makers within the Euro-Zone. In addition, there are those that criticize the ECB as being out of touch with the needs of the economies of the Euro-Zone and with the needs of the people. In other words, the ECB has shifted power toward the centre (the ECB) and away from the freedoms of individual states to regulate monetary policy. The notion of the unaccountable, undemocratic, secretive ECB still permeates monetary discussion among European politicians and the public.

Nonetheless, European monetary policy is not made in a vacuum – the creation of a monetary monster is far from reality. As noted above, the ECB is not omnipotent, its power not absolute. Indeed, the power of the ECB might thus be compared loosely with that of Thomas Hobbes' Leviathan as revealed through a more careful reading of the original texts: a supreme ruler that is nonetheless greatly constrained in its actions by natural law and constitutional structures. First, EU institutions have a limited say on aspects of European monetary policy and the ECB must use other institutions to forward its own policy goals. Second, a degree of loose co-ordination has been established (and is gradually being reinforced) between the ESCB and fiscal and macroeconomic policy-making authorities at the EU and national levels in order to achieve an appropriate policy mix and the kind of structural reforms that will ensure the maintenance of price stability in the medium to long term. Related, and more problematic, has been the weakening of the Stability and Growth Pact that makes ECB policy-making even more challenging and difficult. The ECB has most of the responsibility for managing the single currency. However, it can only make an economic success of the euro – and thus maintain public support for it – within the context of tight co-ordination with other EU institutions and national governments. In this way, the ECB has and must continue to balance the interests of the public, member states, and the markets with the ECB's inherent urge to control and order. In particular, the ability to control and order has been offset by national governments and respective national central bank governors articulating visions of the euro that have been at cross-purposes with the ECB Executive Board. While the ECB has tried to 'sing in harmony', the bank's chorus still needs some fine-tuning. Given the existing institutional structure within the ECB and in its relations with other EU- and national-level institutions, the bank will be hard pressed to reign in the discordant notes coming from the chorus.

The ECB is the first to recognize its limits; it would argue that while it does have firm control over the monetary levers of the Euro-Zone, there are multiple competing actors with control over various other macroeconomic levers that make any comparison of the more absolutist image of Hobbes' Leviathan meaningless. The first years of ECB policy have demonstrated the difficulty the bank has had with competing centres of power – from the national governments, the national central banks, the public, the markets, and the institutions of the EU. While the social contract that is the Maastricht Treaty and the Stability and Growth Pact continue to insure – at least for the moment – a good measure of discipline and order, *they are no guarantee* that individual Euro-Zone members will never again pursue self-interest or national objectives counter to the goals and objectives of the ECB. While the larger outlines of the 'social contract' are all but agreed upon by most players, the ongoing differing interpretations of the internal operation and workings of the Euro-Zone suggest a much more fluid political arena within which the ECB is but one player – albeit an important and powerful one.

It is in this still quite fluid political and institutional scenario that the book has identified a number of critical issues and challenges confronting the ECB in the near future. Certainly there are a number of short-term challenges confronting the ECB – especially the ongoing struggles with Euro-Zone data collection and weakening government fiscal balances. However, in this concluding chapter we analyse how significant longer-term challenges within the Euro-Zone will shape the future operation of the EMU and the ECB more profoundly. In particular we focus on the institutional challenges of economic governance, the impact of enlargement, and the ongoing issues of policy credibility and the euro.

Institutional challenges and the ECB

On 1 January 1999, the ECB became one of the most powerful EU institutions affecting the lives of all people living in the member states of the Euro-Zone. It is without doubt the most independent European institution, both from other EU bodies as well as national governments. As such, the transfer of European monetary policy to the ECB highlights the problematic legitimacy of the EU as a political system. The European Central Bank will have to manage with considerable technical skill and political sensitivity its role in monetary policy-making and the 'hard' and 'soft' co-ordination of fiscal and macroeconomic policies with other EU institutions and national governments. Efforts to strengthen the democratic legitimacy of European monetary policy-making have focused less on the role and powers of the ECB – given the desire to preserve the bank's independence and credibility – and more on the reinforcement of the co-ordination role and profile of the ECB's political interlocutor in the Eurogroup. It remains to be seen if the European Central Bank can cope with (and if European governments can manage) the political fall out created by economic recession and uneven internal shocks in the Euro-Zone without the support of a more interventionist 'economic government' at the EU level (McKay 1999a, 1999b, 2000).

The institutional challenges confronting the ECB are therefore quite enormous. Despite the apparent solid foundation of institutional independence and political support from member governments, the ECB has become a focal point for concern about the lack of direct accountability and transparency in its policy-making process and institutional structure. Modifications in the current institutional structure of the ECB are likely needed. Furthermore, the lack of clarity over exchange rate policy (see more below), the lack of a centralized EU budgetary or political authority, and the looming enlargement of possibly five new members into the EU in the next five years will put further pressure on the institutional weaknesses of current EU monetary policy-making processes and institutions.

The ongoing problems with accountability, transparency, and 'democratic deficits' that plague the EU's credibility in the eyes of the people will focus intently on the ECB. While the EU already regulates the European public in many policy arenas across Europe, the ECB has had and will continue to have the most direct and profound impact on all Europeans. The ECB has and will continue to face the searing heat of the political spotlight like no central bank has ever faced before. Will the ECB melt under such pressure? If the ECB is able to withstand such pressure, what EU institution will become the focal point for the public's demand for accountability? The Eurogroup has not been of any real significance, at least initially. Neither the European Commission nor the European Parliament will likely fulfill this role – at least not in the near term.

From the earlier discussion on the merits of central bank independence, accountability in an open, democratic society is an important element of an effectively functioning political system. In Germany, at least the government served this function. If the ECB and the EU institutions fail in this function, the future of EMU and the EU may very well rest on shaky political foundations. Both the German government and the Bundesbank recognized this fact when they pushed for European political union to operate in conjunction with EMU. The Bundesbank explicitly noted the importance of political union prior to Maastricht. Specifically, the Bundesbank argued that '… a Monetary Union is … an irrevocable sworn cofraternity – "all for one and one for all" – which, if it is to prove durable, requires, judging from past experience, even closer links in the form of a comprehensive political union'.[154] Judging from the past experiences of German monetary politics, it will prove critical for the EU to develop political union – a strengthened EP and revised Council – in order to reassure the public and provide a stable political foundation for the future operation of the EMU. Ultimately, political institutions must provide a vehicle in which the people of Europe can express their concerns, worries, fears, hopes and anger.

One way of dealing with the democratic deficit is to think in terms of principal agent theory. In an innovative analysis, Elgie (2001) applies principal–agent theory (see Calvert, McCubbins and Weingast 1989 and Pollack 1997) – which can be classified as an application of rational choice institutionalism – to understand better the nature of the democratic deficit created by the ECB's control over European monetary policy. He also applies the theory to demonstrate ways to diminish the deficit in the event that this is deemed to be unacceptable. Elgie argues that the theory illustrates that both ECB critics and supporters have 'intrinsically sound positions'. First, the theory demonstrates that the agent (the ECB) is 'shirking' from the delegation of power as set up by the principal (the member states collectively) in the TEU and, thus acting in an undemocratic manner. It can be argued that the ECB has insufficiently taken into consideration its secondary objective to support the general economic policies in the Community and promote 'balanced and sustainable economic growth and social progress, and strengthening economic and social cohesion'. The TEU does state that price stability is the 'primary' responsibility of the Bank. However, the lack of a precise definition of this goal worried many observers that the Bank would become overly zealous in maintaining low inflation thus menacing deflation.[155] By largely ignoring its secondary goal the Bank could be accused of shirking and acting in an undemocratic manner.

A second way in which the principal–agent theory can be applied to explain the underlying logic of criticism of the ECB is that the preferences of the principal have changed since the Maastricht Summit resulting in a divergence with the preferences of the ECB. This is demonstrated principally in the French government's efforts to establish an 'economic government', a political counterweight to check the ECB. The institutional and political difficulties of amending the terms of delegation effectively prevents the synchronization of the principal's and agent's preferences. Elgie argues that principal–agent theory can be used by ECB critics 'to imply that whatever the initial preferences of the principal may have been the ECB is now acting in an undemocratic manner'. It could be argued that this use of the principal–agent theory is problematic in that only a part of the principal has changed its preferences. The perception of democratic deficit is thus likely to be stronger in some EU countries and in particular constituencies than in others. The problem here lies with the principal itself – not the agent *per se* – which, if in agreement on this matter could seek to modify the treaty (however institutionally problematic). Principal–agent theory can also be used to justify arguments presented by those who support the ECB against accusations of democratic deficit. The argument is made that 'the ECB has been faithful to the clearly expressed preferences of the principal at the moment of delegation': central bank autonomy and price stability, regarding which the Bank was allowed 'to decide for itself exactly what was meant' (Elgie 2001).

Principal–agent theory also proposes standard and non-standard solutions to the principal–agent problem (the risk of growing divergence between the preferences of the principal and the agent) including ex ante and ex post controls, police-patrol, fire alarm oversight and sanctions. The aim here is to enable other institutions to survey the agent's (ECB's) shirking and to discourage further shirking. Ex ante controls, including a renegotiation of the terms of the delegation, sanctions and fire alarms are all considered too potentially damaging to the ECB's credibility and thus unlikely to be introduced. Elgie argues that there are several possible ways for increasing the police-patrol oversight without treaty reform and in ways that weaken neither the statutory responsibility nor the credibility of the ECB, including the commissioning of scientific studies and the holding of hearings to question officials. Indeed, the EP has already begun to play an important role in this regard. Duisenberg agreed that he or an Executive Board member would appear before the EP's Economic and Monetary Affairs Committee four times per year. Elgie also points to Duisenberg's statements and ECB reports to show that there is 'some evidence that the EP has managed to encourage the Bank to pay greater attention to its secondary objective regarding growth and employment'. The ECB shows some willingness to accept publicly that there is a floor to its definition of price stability to prevent deflation. An example of this is found in the Bank's annual report for 1998 in which it is noted that 'deflation, i.e., prolonged decline in the level of the HICP index, would also not be deemed consistent with price stability' (ECB 1999, p. 49). Furthermore, Duisenberg justified the Bank's decision to cut interest rates on 8 April 1999 on similar grounds, stating that 'price stability and social stability are not conflicting, but supplementary and mutually reinforcing policy objectives. As economic policy-makers, we should keep this in mind when we formulate strategies to promote employment and social stability' (Duisenberg 1999, p. 3). Elgie argues that the European Parliament can do a lot more on its own accord to demonstrate publicly its own preoccupations concerning the conduct of monetary policy, including the more frequent organisation of EP debates, even in the absence of ECB officials, and the passing of resolutions on ECB affairs.

Elgie also presents non-standard solutions to the principal–agent problem. The Eurogroup is statutorily forbidden from seeking to influence ECB members (and to pressurize the ECB in any formal sense). However, this does not prevent it from establishing 'a more discrete and subtle dialogue with the ECB' with the aim of creating a 'favourable and mutually respectful environment with which the [Bank] may be encouraged to give greater importance to popular sentiment when making its decisions'. Elgie gives the example of the ECB's first cut in interest rates in April 1999, which could be interpreted as demonstrating the Bank's political sensitivities – meeting halfway the widespread political demands for an interest rate cut – while also rewarding EU governments for the departure of the trouble maker, Lafontaine.

Closely related, the prestige of the euro among the public will depend on how effective the EMU can deal with various crises – from external shocks from dollar instability, internal shocks within certain regions, and the ongoing political question of high unemployment in some parts of the Euro-Zone. The ability to deal with crises that are certain to come will depend on the institutional and legal foundations of EMU. Will the Stability Pact operate as designed? Will there be a political forum to address or counter ECB policy? Will political union develop? Will the ECB in fact be able to withstand pressure on exchange rate policy and how will such policy be developed? How will the ECB integrate new members – whether the three remaining EU members not part of EMU or the possible new members from the east (see more below)? All of these issues demand further clarity of EU institutions – clarity that can only come through institutional modification.

For the ECB itself, the future of the ECB's independence and credibility will depend on the ability of EMU to function effectively in the post-2002 period. Most national central bank officials believe that in order to ensure a frictionless transition from national currencies to the euro, it is especially important that the euro and EMU enjoy the same prestige on international financial markets as that attained by the DM over the past decades. The early record – the euro's depreciation against the dollar by over 20 per cent – is not quite so convincing. More problematic is the institutional relationship between the ECB and Eurogroup over exchange rate policy. As noted earlier, states sought to retain control over exchange rate policy and constrain the supranational competence of the ECB in this arena. With the increasing complexity and integration of the global economy, a single external voice on exchange rate policy would appear to be crucial. While the ECB thinks it is the 'voice' on exchange rate policy,[156] we would contend that this 'voice', is still lacking, thus damaging the euro's and EMU's successful implementation as well as the EU's external monetary influence. Therefore, in order for EMU to function effectively, exchange rate policy-making must be more clearly articulated from one institutional body – not left unclear in the institutional grey-area between the ECB, the Eurogroup, and ECOFIN.

Finally, the legitimacy problem has placed increased focus on the matters of accountability and transparency. Monetary policy decisions will affect member states differently due to different national economic cycles (despite some convergence) and differently structured economies. Given the lack of financial transfer payments to compensate those parts of the Euro-Zone suffering from asymmetrical shocks, limited labour mobility and the strong constraints placed on the use of national fiscal instruments, the ECB's response to these shocks will be of considerable importance. The risk remains strong that some member states may come to feel disadvantaged by ECB monetary policy, that the legitimacy of the bank will then be called into question, and the pressure will increase on governments to speak out. Doubts about the ECB's legitimacy increase the need for Executive Board members to give frequent interviews, press conferences and speeches about goals and instruments. NCB governors need to do the same at the national level. Likewise, the decision to hold two Governing Council meetings a year in other Member States was designed to improve the visibility of the ECB. The ECB must also be careful in its public criticism of member state economic policies, leaving this to the Commission and the Eurogroup – as in February 2001 with regard to Ireland. More generally, the maintenance of an effective and positive working relationship with the Eurogroup is vital to the ECB's public image.

In fact, the ECB recognizes these problems and suggests the need for a political body at the EU level that it can engage in a dialogue over the future direction of the Euro-Zone. Many – including within the ECB – call for strengthened links between the ECB and the EP to improve the democratic legitimacy/accountability of the ECB. Favero *et al.* (2000) argue that the European Parliament should have a greater say over the appointment of the members of the Executive Board *and* the weight of the Board versus NCB governors could be increased (see also Taylor (2000)). However, this is inherently problematic given that the EP, despite being directly elected, is neither well understood nor well liked by many Europeans. Moreover, the strong opposition of several Euro-Zone member state governments to increased EP involvement in European monetary affairs makes this unlikely. This is concern that increased EP meddling would damage the appearance of independence and the credibility of ECB monetary policy. Other observers, led by the French government, argue that the democratic legitimacy problem can be partially resolved by creating a stronger and more visible political counterweight to the independent ECB – the European equivalent of the American Treasury Secretary (Boyer 2000). This could come through the reinforcement of the Eurogroup – a priority of the French Council Presidency in 2000 – through, for example, the eventual creation of a high profile permanent representative to help manage economic policy co-ordination and act as the ECB's leading political interlocutor (Howarth 2001).

All of these issues center around the possible need for improved EU-level economic governance. While there is no consensus between national governments on the larger design of such a model of EU economic governance, we suggest the need for a more effective way to conduct policies through a collective European institution (or set of institutions). This institution (or set of institutions) would need to reflect the desires of European citizens and have a stabilization function while leaving the implementation of suggested policies to national governments. This new institutional set-up would need to fill the existing policy gap between the ECB, ECOFIN, the Eurogroup, and the Commission. Currently, economic and political decisions made by these institutions often are not integrated into the national policies of Euro-Zone states and are clearly not yet grounded in public support. This especially evident given the latest crises over the Stability and Growth Pact. In times of economic slowdown and growing pressures on budgets, are governments and publics absolutely committed to ECB independence and the 3 per cent deficit cut-off all in the spirit of supporting the euro? Increased democratic cooperation will be necessary in order to implement common macroeconomic policies and fiscal policies. Neither the Nice Summit of 2000 nor proposals for a new form of EU governance advanced by the Germans in April of 2001 to make the EU more democratic are likely to substantially address the need for more collective economic governance. While a long-term challenge for the EU in general, the short-term complications of the lack of economic governance will greatly constrain the ECB in the next year or two.

Enlargement and the future of the ECB

Neither the 1996/97 Amsterdam Treaty nor the 2000 IGC (Nice Summit) focused much attention on the impact of enlargement upon the operation of the ECB and the Euro-Zone. The lack of urgency is in part due to the two-step process by which the applicant countries will join the Euro-Zone. While they must respect the convergence criteria and make the necessary institutional preparations to accede to the EU, they will initially join the Single Market and the ERM II and only accede to the Euro-Zone at a later stage. The European Commission has argued that candidate countries should take their time based on the fact that existing EU law requires at least a two-year gap after a country joins the EU before it can enter the monetary union. The Commission also interprets the Maastricht criteria to include the mandate that candidate countries maintain national currencies stable against the euro. Moreover, the Commission suggests that candidate countries not rush into EMU in that such attempts 'could be highly damaging'.[157] In that respect, the Commission's concerns are echoed by the ECB which sees the need for candidate countries to retain a measure of monetary autonomy and flexibility given the transitioning of those economies toward a market oriented system.

Nonetheless, the impact of enlargement looms large principally because it highlights existing problems with the operation of the Governing Council. As a result, we would contend that the question of enlargement and its impact on ECB decision-making will likely be the most divisive issue confronting the ECB and national governments in the next 5–10 years as some or all of the new EU member states enter the Euro-Zone. As it stands now, many observers question if the Eurosystem's structure – notably a Governing Council of 18 – is conducive to efficient or optimal policy-making or policy co-ordination especially when the matters discussed are technical (Favero *et al.*, 2000). Any enlargement poses considerable problems. Willem Buiter, a member of the Monetary Policy Committee of the Bank of England, writes:

> A group of 17 is already too large for the serious and productive exchange of views, discussion and group decision making. … A squad of 21 will be quite unwieldy. Thirty would be a mob. … Based on my own limited experience, a policy-making body with seven members would probably be optimal (1999: 200).

The Governing Council can change its own practices if it finds problems in decision making. There is much scope for its procedures to evolve – such as the creation of more working groups – and the work of the Governing Council can involve more activity at the ECB or through the NCBs. However, the size problem still does matter.

Favero *et al*. (2000) amongst others suggest that the problem could be resolved by emulating the American Federal Reserve Board, by increasing the power of the Executive Board in relation to the NCB governors and rotating Governing Council places among the member states. However, such a recommendation ignores both the unique character of both the Eurosystem as a 'federal' banking system and the EU as a political entity. First, the centre (the ECB) is considerably less dominant in the Eurosystem than in the American system. The NCBs retain considerably more power than American state banks and the governors have final say – thanks to their majority in the Governing Council – over the allocation of functions. Any reform to strengthen the Executive Board at the expense of the Governing Council would be challenged on grounds of legitimacy. The arrangements of the American Federal Reserve Board were developed just over 60 years ago, around 160 years after the creation of the United States as a country and long after the conclusion of the Civil War successfully asserted federal government authority. There is obviously no parallel situation in the EU.

Buiter (1999) recommends – even without enlargement – restricting the size of the Governing Council to nine members and the Executive Board to four. However, it could be argued that the EU lacks the legitimacy as a political system to deny member states a permanent seat on the ECB Governing Council. No other EU institution currently denies member states representation. It is unlikely that the existing members or their governments will be willing to remove the right to a permanent seat. Officially, each NCB Governor is there in a personal capacity as an experienced expert on central banking not as a national representative *per se*. In theory, therefore, a rotation of governors (either all or only the less populated member states) would be adequate: a particular group of them should be as representative of informed opinion as all of them. However, the Governors are de facto national representatives because they each come from one of the member states and are most familiar with their own national systems. It would be difficult for Governors to present the perspective of other member states as effectively as their own, making a simple rotation of seats for all or even just the smaller member states problematic. One possibility might be to group the smaller member states together so that they share one seat on the Governing Council, or three member states (for example, the Netherlands, Belgium and Luxembourg) could share two seats. The governors would be required to maintain close links with the governors and central banks of their partner states. The decision at the Nice Summit to move to the future rotation of Commission places – yet to be devised but 'based on the principle of equality' and reflecting demography and geography – once the number of EU member states reaches 27 sets a precedent which might be followed for the ECB Governing Council.

Lastly, there is the issue of timing. Candidate countries could adopt the euro unilaterally – as Estonia threatened to do in 2002. Estonia in particular is in a good position already given its peg of the kroon to the D-mark since 1992. In that sense, Estonia is already fixed into the euro system. However, Estonia would likely not receive support from the ECB in times of monetary or financial difficulty. And the ECB does not (and cannot) take these candidate countries' economic conditions into account. Still, high-level policy dialogue between the ECB and central bank governors from the accession countries is ongoing and intense. Professional working relationships have developed and the ECB offers continuing technical assistance to the possible new members. In this respect, a foundation has been created for the accession countries to align their policies to the euro and seek ECB assistance, where appropriate.

However, it should be clear that the ECB tends to be very cautious about enlargement – reflecting the Bundesbank's own views on candidate countries to EMU back in the late 1980s and 1990s. Our own interviews with ECB officials confirm the general unease with this topic. The ECB sees the eastern European countries as largely still out of convergence with the Euro-Zone in terms of inflation rates, growth rates, budget deficits and debt. These states still need to transition and converge on the Euro-Zone (again, Slovenia and Estonia might be closer than other candidate countries). The ECB suggests a more realistic approach for future member states and sees the euro's role as easing the economic divisions of Europe – but only over the very long-term. Finally, given the existing problems of differential growth rates and inflation rates within the Euro-Zone (and the difficulties in data collection), one would suspect even deeper problems in terms of developing EU level co-ordination and cooperation. To be blunt, the ECB would prefer to see this issue not dealt with any time soon.

Conclusion: credibility and creating a 'vision' for the euro

All of these issues – from concerns about the legitimacy and transparency of the ECB and its policies to the institutional weakness of the EU and the ECB in terms of co-ordinating EU macroeconomic governance and decision-making in the Governing Board – have weighed heavily on the ECB's credibility and the value of the euro. This has been painfully evident with the euro's depreciation – one critical measure of the bank's credibility in the eyes of the public and the markets. The ECB's inability to articulate an effective or convincing overarching vision on the euro and the bank's policies has proven the achilles heel of ECB monetary governance. Chapter 6 demonstrated the particular acute problems of the ECB in this arena. One might suspect that any further bending of the rules on the convergence criteria for accession countries or increased 'flexibility' in enforcing or interpreting the Stability and Growth Pack might put increased downward pressure on the euro.

In short, a credibility gap has emerged in the minds of many Europeans. The gap exists between the expectations of a strong euro upon which the EMU was sold to Europeans (especially the Germans and French) and the reality of the euro's value. The ECB would counter the notion of a credibility gap by stating its view that the euro's value is driven by factors beyond its control: strong economic growth in the US and weak economic growth in Europe, structural problems in several Euro-Zone member state economies and the failure of several governments to make the kinds of reforms that would enable sustainably low public deficits. Moreover, the ECB would argue that it has fulfilled its strict mandate of maintaining price stability despite brief bursts of inflation over the past two years. While the ECB's vision may seem too narrow to some – HICP inflation in the euro area at or below 2 per cent – few seem to question this vision any more. The ECB has done its job (for now), but what is still lacking is this larger vision for the ECB and the euro. Perhaps demanding a new vision for the euro may be asking too much of the ECB, although the notion of the ECB acting as in important agent of integration and economic success – as noted by Duisenberg in the introductory quote – is a step in the right direction.

The future of the ECB provides a rich ground for academics and policy-makers to test their theories and their practical policy recommendations. We hope that we have contributed to this debate and that we have provided a strong foundation for future analysis.

Appendix 1

Protocol on the Statute of the European System of Central Banks and of the European Central Bank

THE HIGH CONTRACTING PARTIES
DESIRING to lay down the Statute of the European System of Central Banks and of the European Central Bank provided for in Article 4a of the Treaty establishing the European Community,
HAVE AGREED UPON the following provisions, which shall be annexed to the Treaty establishing the European Community:

CHAPTER 1

CONSTITUTION OF THE ESCB

ARTICLE 1

The European System of Central Banks

1.1. The European System of Central Banks (ESCB) and the European Central Bank (ECB) shall be established in accordance with Article 4a of this Treaty; they perform their tasks and carry on their activities in accordance with the provision of this Treaty and of this Statute.

1.2. In accordance with Article 106(1) of the Treaty, the ESCB shall be composed of the ECB and of the central banks of the member states ('national central banks'). The Institut monétaire luxembourgeois will be the central bank of Luxembourg.

CHAPTER II

OBJECTIVES AND TASKS OF THE ESCB

ARTICLE 2

Objectives

In accordance with Article 105(1) of this Treaty, the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2 of this Treaty. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 3a of the Treaty.

ARTICLE 3

Tasks

3.1. In accordance with Article 105(2) of this Treaty, the basic tasks to be carried out through the ESCB shall be:
- to define and implement the monetary policy of the Community
- to conduct foreign exchange operations consistent with the provisions of Article 109 of this Treaty;
- to hold and manage the official foreign reserves of the member states;
- to promote the smooth operation of payment systems.

3.2. In accordance with Article 105(3) of this Treaty, the third indent of Article 3.1 shall be without prejudice to the holding and management by the governments of Member States of foreign exchange working balances.

3.3. In accordance with Article 105(5) of this Treaty, the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

ARTICLE 4

Advisory functions

In accordance with Article 105(4) of this Treaty:

(a) the ECB shall be consulted:
- on any proposed Community act in its fields of competence;
- by national authorities regarding any draft legislative provision in its fields of competence, but within the limits and under the conditions set out by the Council in accordance with the procedure laid down in Article 42;

(b) the ECB may submit opinions to the appropriate Community institutions or bodies or to national authorities on matters in its fields of competence.

ARTICLE 5

Collection of statistical information

5.1. In order to undertake the tasks of the ESCB, the ECB, assisted by the national central banks, shall collect the necessary statistical information either from the competent national authorities or directly from economic agents. For these purposes it shall cooperate with the Community institutions or bodies and with the competent authorities of the member states or third countries and with international organizations.

5.2. The national central banks shall carry out, to the extent possible, the tasks described in Article 5.1.

5.3. The ECB shall contribute to the harmonization, where necessary, of the rules and practices governing the collection, compilation and distribution of statistics in the areas within its fields of competence.

5.4. The Council, in accordance with the procedure laid down in Articles 42, shall define the natural and legal persons subject to reporting requirements, the confidentiality regime and the appropriate provisions for enforcement.

ARTICLE 6

International co-operation

6.1. In the field of international co-operation involving the tasks entrusted to the ESCB, the ECB shall decide how the ESCB shall be represented.

6.2. The ECB and, subject to its approval, the national central banks may participate in international monetary institutions.

6.3. Articles 6.1 and 6.2 shall be without prejudice to Article 109(4) of this Treaty.

CHAPTER III

ORGANIZATION OF THE ESCB

ARTICLE 7

Independence

In accordance with Article 107 of this Treaty, when exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and this Statute, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a member state or from any other body. The Community institutions and bodies and the governments of the member states undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks.

ARTICLE 8

General principle

The ESCB shall be governed by the decision-making bodies of the ECB.

ARTICLE 9

The European Central Bank

9.1. The ECB which, in accordance with Article 106(2) of this Treaty, shall have legal personality, shall enjoy in each of the member states the most extensive legal capacity accorded to legal persons under its law; it may, in particular, acquire or dispose of movable and immovable property and may be a party to legal proceedings.

9.2. The ECB shall ensure that the tasks conferred upon the ESCB under Article 105(2), (3) and (5) of this Treaty are implemented either by its own activities pursuant to this Statute or through the national central banks pursuant to Articles 122.1 and 14.

9.3. In accordance with Article 106(3) of this Treaty, the decision-makingg bodies of the ECB shall be the Governing Council and the Executive Board.

ARTICLE 10

The Governing Council

10.1. In accordance with Article 109a(1) of the Treaty, the Governing Council shall comprise the members of the Executive Board of the ECB and the Governors of the national central banks.

10.2. Subject to Article 10.3, only members of the Governing Council present in person shall have the right to vote. By way of derogation from this rule, the Rules of Procedure referred to in Article 12.3 may lay down that members of the Governing Council may cast their vote by means of teleconferencing. These rules shall also provide that a member of the Governing Council who is prevented from voting for a prolonged period may appoint an alternate as a member of the Governing Council.

Subject to Articles 10.3 and 11.3, each member of the Governing Council shall have one vote. Save as otherwise provided for in this Statute, the Governing Council shall act by a simple majority. In the event of a tie, the President shall have the casting vote.

In order for the Governing Council to vote, there shall be a quorum of two-thirds of the members. If the quorum is not met, the President may convene an extraordinary meeting at which decisions may be taken without regard to the quorum.

10.3. For any decisions to be taken under Articles 28, 29, 30, 32, 33 and 51, the votes in the Governing Council shall be weighted according to the national central banks' shares in the subscribed capital of the ECB. The weights of the votes of the members of the Executive Board shall be zero. A decision requiring a qualified majority shall be adopted if the votes cast in favour represent at least two-thirds of the subscribed capital of the ECB and represent at least half of the shareholders. If a Governor is unable to be present, he may nominate an alternate to cast his weighted vote.

10.4. The proceedings of the meetings shall be confidential. The Governing Council may decide to make the outcome of its deliberations public.

10.5. The Governing Council shall meet at least ten times a year.

ARTICLE 11

11.1. In accordance with Article 109a(2)(a) of this Treaty, the Executive Board shall comprise the President, the Vice-President and four other members.

The members shall perform their duties on a full-time basis. No member shall engage in any occupation, whether gainful or not, unless exemption is exceptionally granted by the Governing Council.

11.2. In accordance with Article 109a(2)(a) of this Treaty, the President, the Vice-President and the other Members of the Executive Board shall be appointed from among persons of recognized standing and professional experience in monetary or banking matters by common accord of the governments of the member states at the level of the Heads of State or of Government, on a recommendation from the Council after it has consulted the European Parliament and the Governing Council.

Their term of office shall be 8 years and shall not be renewable.

Only nationals of member states may be members of the Executive Board.

11.3. The terms and conditions of employment of the members of the Executive Board, in particular their salaries, pensions and other social security benefits shall be the subject of contracts with the ECB and shall be fixed by the Governing Council on a proposal from a Committee compromising three members appointed by the Governing Council and three members appointed by the Council. The members of the Executive Board shall not have the right to vote on matters referred to in this paragraph.

11.4. If a member of the Executive Board no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct, the Court of Justice may, on application by the Governing Council or the Executive Boards, compulsorily retire him.

11.5. Each member of the Executive Board present in person shall have the right to vote and shall have, for that purpose, one vote. Save as otherwise provided, the Executive Board shall act by a simple majority of the votes cast. In the event of a tie, the President shall have the casting vote. The voting arrangements shall be specified in the Rules of Procedure referred to in Article 12.3.

11.6. The Executive Board shall be responsible for the current business of the ECB.
11.7. Any vacancy on the Executive Board shall be filled by the appointment of a new member in accordance with Article 11.2.

ARTICLE 12

Responsibilities of the decision-making bodies

12.1. The Governing Council shall adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the ESCB under this Treaty and this Statute. The Governing Council shall formulate the monetary policy of the Community including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the ESCB, and shall establish the necessary guidelines for their implementation.

The Executive Board shall implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council. In doing so the Executive Board shall give the necessary instructions to national central banks. In addition the Executive Board may have certain powers delegated to it where the Governing Council so decides.

To the extent deemed possible and appropriate and without prejudice to the provisions of this Article, the ECB shall have recourse to the national central banks to carry out operations which form part of the tasks of the ESCB.
12.2. The Executive Board shall have responsibility for the preparation of meetings of the Governing Council.
12.3. The Governing Council shall adopt Rules of Procedure which determine the internal organization of the ECB and its decision-making bodies.
12.4. The Governing Council shall exercise the advisory functions referred to in Article 4.
12.5. The Governing Council shall take the decisions referred to in Article 6.

ARTICLE 13

The President

13.1. The President or, in his absence, the Vice-President shall chair the Governing Council and the Executive Board of the ECB.
13.2. Without prejudice to Article 39, the President or his nominee shall represent the ECB externally.

ARTICLE 14

National central banks

14.1. In accordance with Article 108 of this Treaty, each member state shall ensure, at the latest at the date of the establishment of the ESCB, that its national legislation, including the statutes of its national central bank, is compatible with this Treaty and this Statute.

14.2. The statutes of the national central banks shall, in particular, provide that the term of office of a Governor of a national central bank shall be no less than 5 years.

A Governor may be relieved from office only if he no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct. A decision to this effect may be referred to the Court of Justice by the Governor concerned or the Governor Council on grounds of infringement of this Treaty or of any rule of law relating to its application. Such proceedings shall be instituted within two months of the publication of the decision or of its notification to the plaintiff or, in the absence thereof, of the day on which it came to the knowledge of the latter, as the case may be.

14.3. The national central banks are an integral part of the ESCB and shall act in accordance with guidelines and instructions of the ECB. The Governing Council shall take the necessary steps to ensure compliance with the guidelines and instructions of the ECB, and shall require that any necessary information be given to it.

14.4. National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a majority of two-thirds of the votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions shall be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB.

ARTICLE 15

Reporting commitments

15.1. The ECB shall draw up and publish reports on the activities of the ESCB at least quarterly.

15.2. A consolidated financial statement of the ESCB shall be published each week.

15.3. In accordance with Article 109b(3) of this Treaty, the ECB shall address an annual report on the activities of the ESCB and on the monetary policy of both the previous and the current year to the European Parliament, the Council and the Commission, and also to the European Council.

15.4. The reports and statements referred to in this Article shall be made available to interested parties free of charge.

ARTICLE 16

Bank Notes

In accordance with Article 105a(1) of this Treaty, the Governing Council shall have the exclusive right to authorize the issue of bank notes within the

Community. The ECB and the national central banks may issue such notes. The bank notes issued by the ECB and the national central banks shall be the only such notes to have the status of legal tender within the Community.

The ECB shall respect as far as possible existing practices regarding the issue and design of bank notes.

CHAPTER IV

MONETARY FUNCTIONS AND OPERATIONS OF THE ESCB

ARTICLE 17

Accounts with the ECB and the national central banks

In order to conduct their operations, the ECB and the national central banks may open accounts for credit institutions, public entities and other market participants and accept assets, including book-entry securities, as collateral.

ARTICLE 18

Open market and credit operations

18.1. In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may:
- operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments, whether in Community or in non-Community currencies, as well as precious metals;
- conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral.

18.2. The ECB shall establish general principles for open market and credit operations carried out by itself or the national central banks, including for the announcement of conditions under which they stand ready to enter into such transactions.

ARTICLE 19

Minimum reserves

19.1. Subject to Article 2, the ECB may require credit institutions established in Member States to hold minimum reserves on accounts with the ECB and national central banks in pursuance of monetary policy objectives. Regulations concerning the calculation and determination of the required minimum reserves may be established by the Governing Council. In cases of non-compliance the ECB shall be entitled to levy penalty interest and to impose other sanctions with comparable effect.

19.2. For the application of the Article, the Council shall, in accordance with the procedure laid down in Article 42, define the basis for minimum reserves and the maximum permissible ratios between those reserves and their basis, as well as the appropriate sanctions in cases of non-compliance.

ARTICLE 20

Other instruments of monetary control

The Governing Council may, by a majority of two-thirds of the votes cast, decide upon the use of such other operational methods of monetary control as its sees its, respecting Article 2.

The Council shall, in accordance with the procedure laid down in Article 42, define the scope of such methods if they impose obligations on third parties.

ARTICLE 21

Operations with public entities

21.1. In accordance with Article 104 of this Treaty, overdrafts or any other type of credit facility with the ECB or with the national central banks in favour of the Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of member states shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments.

21.2. The ECB and national central banks may act as fiscal agents for the entities referred to in Article 21.1.

21.3. The provisions of this Article shall not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the ECB as private credit institutions.

ARTICLE 22

Clearing and payment systems

The ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries.

ARTICLE 23

External operations

The ECB and national central banks may:
– establish relations with central banks and financial institutions in other countries and, where appropriate, with international organizations;
– acquire and sell spot and forward all types of foreign exchange assets and precious metals; the term 'foreign exchange asset' shall include securities and all other assets in the currency of any country or units of account and in whatever for held;
– hold and manage the assets referred to in the Article;
– conduct all types of banking transactions in relations with third countries and international organizations, including borrowing and lending operations.

ARTICLE 24

Other operations

In addition to operations arising from their tasks, the ECB and national central banks may enter into operations for their administrative purposes or for their staff.

CHAPTER V

PRUDENTIAL SUPERVISION

ARTICLE 25

Prudential supervision

25.1. The ECB may offer advice to and be consulted by the Council, the Commission and the competent authorities of the member states on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system.
25.2. In accordance with any decision of the Council under Article 105(6) of this Treaty, the ECB may perform specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

CHAPTER VI

FINANCIAL PROVISIONS OF THE ESCB

ARTICLE 26

Financial accounts

26.1. The financial year of the ECB and national central banks shall begin on the first day of January and end on the last day of December.

26.2. The annual accounts of the ECB shall be drawn up by the Executive Board, in accordance with the principles established by the Governing Council. The accounts shall be approved by the Governing Council and shall thereafter be published.

26.3. For analytical and operation purposes, the Executive Board shall draw up a consolidated balance sheet of the ESCB, comprising those assets and liabilities of the national central banks that fall within the ESCB.

26.4. For the application of this Article, the Governing Council shall establish the necessary rules for standardizing the accounting and reporting of operation undertaken by the national central banks.

ARTICLE 27

Auditing

27.1. The accounts of the ECB and national central banks shall be audited by independent external auditors recommended by the Governing Council and approved by the Council. The auditors shall have full power to examine all books and accounts of the ECB and national central banks and obtain full information about their transactions.

27.2. The provisions of Article 188c of this Treaty shall only apply to an examination of the operation efficiency of the management of the ECB.

ARTICLE 28

Capital of the ECB

28.1. The capital of the ECB, which shall become operational upon its establishment, shall be ECU 5000 million. The capital may be increased by such amounts as may be decided by the Governing Council acting by the qualified majority provided for in Article 10.3, within the limits and under the conditions set by the Council under the procedure laid down in Article 42.

28.2. The national central banks shall be the sole subscribers to and holders of the capital of the ECB. The subscription of capital shall be according to the key established in accordance with Article 29.

28.3. The Governing Council, acting by the qualified majority provided for in Article 10.3, shall determine the extent to which and the form in which the capital shall be paid up.

28.4. Subject to Article 28.5, the shares of the national central banks in the subscribed capital of the ECB may not be transferred, pledged or attached.

28.5. If the key referred to in Article 29 is adjusted, the national central banks shall transfer among themselves capital shares to the extent necessary to ensure that the distribution of capital shares corresponds to the adjusted key. The Governing Council shall determined the terms and conditions of such transfers.

ARTICLE 29

Key for capital subscription

29.1. When in accordance with the procedure referred to in Article 109/(1) of this Treaty the ESCB and the ECB have been established, the key for subscription of the ECB's capital shall be established. Each national central bank shall be assigned a weighting in this key which shall be equal to the sum of:

- 50% of the share of its respective Member State in the population of the Community in the penultimate year preceding the establishment of the ESCB;
- 50% of the share of its respective member state in the gross domestic product at market prices of the Community as recorded in the last five years preceding the penultimate year before the establishment of the ESCB;

The percentages shall be rounded up to the nearest multiple of 0.05 percentage points.

29.2. The statistic data to be used for the application of this Article shall be provided by the Commission in accordance with the rules adopted by the Council under the procedure provided for in Article 42.

29.3. The weightings assigned to the national central banks shall be adjusted every five years after the establishment of the ESCB by analogy with the provisions laid down in Article 29.1. The adjusted key shall apply with effect from the first day of the following year.

29.4. The Governing Council shall take all other measures necessary for the application of this Article.

ARTICLE 30

Transfer of foreign reserve assets to the ECB

30.1. Without prejudice to Article 28, the ECB shall be provided by the national central banks with foreign reserve assets, other than Member States' currencies, ECUs, IMF reserve positions and SDRs, up to an amount equivalent to ECU 50 000 million. The Governing Council shall decide upon the proportion to be called up by the ECB following its establishment and the amounts called up at later dates. The ECB shall have the full right to hold and manage the foreign reserves that are transferred to it and to use them for the purposes set out in this Statute.

30.2. The contributions of each national central bank shall be fixed in proportion to its share in the subscribed capital of the ECB.

30.3. Each national central bank shall be credited by the ECB with a claim equivalent to its contribution. The Governing Council shall determine the denomination and remuneration of such claims.

30.4. Further calls of foreign reserve assets beyond the limit set in Article 30.1 may be effected by the ECB, in accordance with Article 30.2, within the limits and under the conditions set by the Council in accordance with the procedure laid down in Article 42.

30.5. The ECB may hold and manage IMF reserve positions and SDRs and provide for the pooling of such assets.

30.6. The Governing Council shall take all other measures necessary for the application of this Article.

ARTICLE 31

Foreign reserve assets held by national central banks

31.1. The national central banks shall be allowed to perform transactions in fulfilment of their obligations towards international organizations in accordance with Article 23.

31.2. All other operations in foreign reserve assets remaining with the national central banks after the transfers referred to in Article 30, and member states' transactions with their foreign exchange working balances shall, above a certain limit to be established within the framework of Article 31.3, be subject to approval by the ECB in order to ensure consistency with the exchange rate and monetary policies of the Community.

31.3. The Governing Council shall issue guidelines with a view to facilitating such operations.

ARTICLE 32

Allocation of monetary income of national central banks

32.1. The income accruing to the national central banks in the performance of the ESCB's monetary policy function (hereinafter referred to as 'monetary income') shall be allocated at the end of each financial year in accordance with the provisions of this Article.

32.2. Subject to Article 32.3, the amount of each national central bank's monetary income shall be equal to its annual income derived from its assets held against notes in circulation and deposit liabilities to credit institutions. These assets shall be earmarked by national central banks in accordance with guidelines to be established by the Governing Council.

32.3. If, after the start of the third stage, the balance sheet structures of the national central banks do not, in the judgement of the Governing Council, permit the application of Article 32.2, the Governing Council, acting by a qualified majority, may decide that, by way of derogation from Article 32.2, monetary income shall be measured according to an alternative method for a period of not more than five years.

32.4. The amount of each national central bank's monetary income shall be reduced by an amount equivalent to any interest paid by that central bank on its deposit liabilities to credit institutions in accordance with Article 19.

The Governing Council may decide that national central banks shall be indemnified against costs incurred in connection with the issue of bank notes or in exceptional circumstances for specific losses arising from monetary policy operations undertaken for the ESCB. Indemnification shall be in a form deemed appropriate in the judgement of the Governing Council; these amounts may be offset against the national central banks' monetary income.

32.5. The sum of the national central banks' income shall be allocated to the national central banks in proportion to their paid-up shares in the capital of the ECB, subject of any decision taken by the Governing Council pursuant to Article 33.2.

32.6. The clearing and settlement of the balances arising from the allocation of monetary income shall be carried out by the ECB in accordance with guidelines established by the Governing Council.

32.7. The Governing Council shall take all other measures necessary for the application of this Article.

ARTICLE 33

Allocation of net profits and losses of the ECB

33.1. The net profit of the ECB shall be transferred in the following order:

(a) an amount to be determined by the Governing Council, which may not exceed 20% of the net profit, shall be transferred to the general reserve fund subject to a limit equal to 100% of the capital;

(b) the remaining net profit shall be distributed to the shareholders of the ECB in proportion to their paid-up shares.

33.2. In the event of a loss incurred by the ECB, the shortfall may be offset against the general reserve fund of the ECB and, if necessary, following a decision by the Governing Council, against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the national central banks in accordance with Article 32.5.

CHAPTER VII

GENERAL PROVISIONS

ARTICLE 34

Legal acts

34.1. In accordance with Article 108a of this Treaty, the ECB shall:
- make regulations to the extent necessary to implement the tasks defined in Article 3.1, first indent, Articles 19.1, 22 or 25.2 and in cases which shall be laid down in the acts of the Council referred to in Article 42;
- take decisions necessary for carrying out the tasks entrusted to the ESCB under this Treaty and this Statute;
- make recommendations and deliver opinions.

34.2. A regulation shall have general application. It shall be binding in its entirety and directly applicable in all member states.

Recommendations and opinions shall have no binding force.

A decision shall be binding in its entirety upon those to whom it is addressed.

Articles 190 to 192 of this Treaty shall apply to regulations and decisions adopted by the ECB.

The ECB may decide to publish its decisions, recommendations and opinions.

34.3. Within the limits and under the conditions adopted by the Council under the procedure laid down in Article 42, the ECB shall be entitled to impose fines or periodic penalty payments on undertakings for failure to comply with obligations under its regulations and decisions.

ARTICLE 35

Judicial control and related matters

35.1. The acts or omissions of the ECB shall be open to review or interpretation by the Court of Justice in the cases and under the conditions laid down in this Treaty. The ECB may institute proceedings in the cases and under the conditions laid down in this Treaty.

35.2. Disputes between the ECB, on the one hand, and its creditors, debtors or any other person, on the other, shall be decided by the competent national courts, save where jurisdiction has been conferred upon the Court of Justice.

35.3. The ECB shall be subject to the liability regime provided for in Article 215 of this Treaty. The national central banks shall be liable according to their respective national laws.

35.4. The Court of Justice shall have jurisdiction to give judgement pursuant to any arbitration clause contained in a contract concluded by or on behalf of the ECB, whether that contract be governed by public or private law.

35.5. A decision of the ECB to bring an action before the Court of Justice shall be taken by the Governing Council.

35.6. The Court of Justice shall have jurisdiction in disputes concerning the fulfilment by a national central bank of obligations under this Statute. If the ECB considers that a national central bank has failed to fulfil an obligation under this Statute, it shall deliver a reasoned opinion on the matter after giving the national central bank concerned the opportunity to submit its observations. If the national central bank concerned does not comply with the opinion within the period laid down by the ECB, the latter may bring the matter before the Court of Justice.

ARTICLE 36

Staff

36.1. The Governing Council, on a proposal from the Executive Board, shall lay down the conditions of employment of the staff of the ECB.

36.2. The Court of Justice shall have jurisdiction in any dispute between the ECB and its servants within the limits and under the conditions laid down in the conditions of employment.

ARTICLE 37

Seat

Before the end of 1992, the decision as to where the seat of the ECB will be established shall be taken be common accord of the governments of the member states at the level of Heads of State or of Government.

ARTICLE 38

Professional secrecy

38.1. Members of the governing bodies and the staff of the ECB and the national central banks shall be required, even after their duties have ceased, not to disclose information of the kind covered by the obligation of professional secrecy.

38.2. Persons having access to data covered by Community legislation imposing an obligation of secrecy shall be subject to such legislation.

ARTICLE 39

Signatories

The ECB shall be legally committed to third parties by the President or by two members of the Executive Board or by the signatures of two members of the staff of the ECB who have been duly authorized by the President to sign on behalf of the ECB.

ARTICLE 40

Privileges and immunities

The ECB shall enjoy in the territories of the member states such privileges and immunities as are necessary for the performance of its tasks, under the conditions laid down in the Protocol on the Privileges and Immunities of the European Communities annexed to the Treaty establishing a Single Council and a Single Commission of the European Communities.

CHAPTER VIII

AMENDMENT OF THE STATUTE AND COMPLEMENTARY LEGISLATION

ARTICLE 41

Simplified amendment procedure

41.1. In accordance with Article 106(5) of this Treaty, Articles 5.1, 5.2, 5.3, 17, 18, 19.1, 22, 23, 24, 26, 32.2, 32.3, 32.4, 32.6, 33.1(a) and 36 of this Statute may be amended by the Council, acting either by a qualified majority on a recommendation from the ECB and after consulting the Commission, or unanimously on a proposal from the Commission and after consulting the ECB. In either case the assent of the European Parliament shall be required.

41.2. A recommendation made by the ECB under this Article shall require a unanimous decision by the Governing Council.

ARTICLE 42

Complementary legislation

In accordance with Article 106(6) of this Treaty, immediately after the decision on the date for the beginning of the third stage, the Council, acting by a qualified majority either on a proposal from the Commission and after consulting the European Parliament and the ECB or on a recommendation from the ECB and after consultation the European Parliament and the Commission, shall adopt the provisions referred to in Articles 4, 5.4, 19.2, 20, 28.1, 29.2, 30.4 and 34.3 of this Statute.

CHAPTER IX

TRANSITIONAL AND OTHER PROVISIONS FOR THE ESCB

ARTICLE 43

General provisions

43.1. A derogation as referred to in Article 109k(l) of this Treaty shall entail that the following Articles of the Statute shall not confer any rights or impose any obligations on the member state concerned: 3, 6, 9.2, 12.1, 14.3, 16, 18, 19, 20, 22, 23, 26.2, 27, 30, 31, 32, 33, 34, 50, 52.

43.2. The central banks of member states with a derogation as specified in Article 109k(l) of this Treaty shall retain their powers in the field of monetary policy according to national law.

43.3. In accordance with Article 109k(4) of this Treaty, 'member states' shall be read as 'member states without a derogation' in the following Articles of this Statute: 3, 11.2, 19, 34.2 and 50.

43.4. 'National central banks' shall be read as 'central banks of member states without a derogation' in the following Articles of this Statute: 9.2, 10.1, 10.3, 12.1, 16, 17, 18, 22, 23, 27, 30, 31, 32, 33.2, 52.

43.5. 'Shareholders' shall be read as 'central banks of member states without a derogation' in Articles 10.3 and 33.1.

43.6. 'Subscribed capital of the ECB' shall be read as 'capital of the ECB subscribed by the central banks of member states without a derogation' in Articles 10.3 and 30.2.

ARTICLE 44

Transitional tasks of the ECB

The ECB shall take over those tasks of the EMI which, because of the derogations of one or more member states, still have to be performed in the third stage.

The ECB shall give advice in the preparations for the abrogation of the derogations specified in Article 109k of this Treaty.

ARTICLE 45

The General Council of the ECB

45.1. Without prejudice to Article 106(3) of this Treaty, the General Council shall be constituted as a third decision-making body of the ECB.

45.2. The General Council shall comprise the President and Vice-President of the ECB and the Governors of the national central banks. The other members of the Executive Board may participate, without having the right to vote, in meetings of the General Council.

45.3. The responsibilities of the General Council are listed in full in Article 47 of this Statute.

ARTICLE 46

Rules of procedure of the General Council

46.1. The President or, in his absence, the Vice-President of the ECB shall chair the General Council of the ECB.

46.2. The President of the Council and a member of the Commission may participate, without having the right to vote, in meetings of the General Council.

46.3. The President shall prepare the meetings of the General Council.

46.4. By way of derogation from Article 12.3, the General Council shall adopt its Rules of Procedure.

46.5. The Secretariat of the General Council shall be provided by the ECB.

ARTICLE 47

Responsibilities of the General Council

47.1. The General Council shall:
- perform the tasks referred to in Article 44;
- contribute to the advisory functions referred to in Articles 4 and 25.1.

47.2. The General Council shall contribute to:
- the collection of statistical information as referred to in Article 5;
- the reporting activities of the ECB as referred to in Article 15;
- the establishment of the necessary rules for the application of Article 26 as referred to in Article 26.4;
- the taking of all other measures necessary for the application of Article 29 as referred to in Article 29.4;
- the laying down of the conditions of employment of the staff of the ECB as referred to in Article 36.

47.3. The General Council shall contribute to the necessary preparations for irrevocably fixing the exchange rates of the currencies of member states with a derogation against the currencies, or the single currency, of the member states without a derogation, as referred to in Article 109/(5) of this Treaty.

47.4. The General Council shall be informed by the President of the ECB of decisions of the Governing Council.

ARTICLE 48

Transitional provisions for the capital of the ECB

In accordance with Article 29.1 each national central bank shall be assigned a weighting in the key for subscription of the ECB's capital. By way of derogation from Article 28.3, central banks of member states with a derogation shall not pay up their subscribed capital unless the General Council, acting by a majority representing at least two-thirds of the subscribed capital of the ECB and at least half of the shareholders, decides that a minimal percentage has to be paid up as a contribution to the operational costs of the ECB.

ARTICLE 49

Deferred payment of capital, reserves and provisions of the ECB

49.1. The central bank of a member state whose derogation has been abrogated shall pay up its subscribed share of the capital of the ECB to the same extent as the central banks of other member states without a derogation, and shall transfer to the ECB foreign reserve assets in accordance with Article 30.1. The sum to be transferred shall be determined by multiplying the ECU value at current exchange rates of the foreign reserve assets which have already been transferred to the ECB in accordance with Article 30.1, by the ratio between the number of shares subscribed by the national central banks concerned and the number of shares already paid up by the other national central banks.

49.2. In addition to the payment to be made in accordance with Article 49.1, the central bank concerned shall contribute to the reserve of the ECB, to those provisions equivalent to reserves, and to the amount still to be appropriated to the reserves and provisions corresponding to the balance of the profit and loss account as at 31 December of the year prior to the abrogation of the derogation. The sum to be contributed shall be determined by multiplying the amount of the reserves, as defined above and as stated in the approved balance sheet of the ECB, by the ratio between the number of the shares subscribed by the central bank concerned and the number shares already paid up by the other central banks.

ARTICLE 50

Initial appointment of the members of the Executive Board

When the Executive Board of the ECB is being established, the President, the Vice-President and the other members of the Executive Board shall be appointed by common accord of the governments of the member states at the level of Heads of State or of Government, on a recommendation from the Council and after consulting the European Parliament and the Council of the EMI. The President of the Executive Board shall be appointed for eight years. By way of derogation from Article 11.2, the Vice-President shall be appointed for four years and the other members of the Executive Board for terms of office of between five and eight years. No term of office shall be renewable. The number of members of the Executive Board may be smaller than provided for in Article 11.1, but in no circumstance shall it be less than four.

ARTICLE 51

Derogation from Article 32

51.1. If, after the start of the third stage, the Governing Council decides that the application of Article 32 results in significant changes in national central banks' relative income positions, the amount of income to be allocated pursuant to Article 32 shall be reduced by a uniform percentage which shall not exceed 60% in the first financial year after the start of the third stage and which shall decrease by at least 12 percentage points in each subsequent financial year.

51.2. Article 51.1 shall be applicable for not more than five financial years after the start of the third stage.

ARTICLE 52

Exchange of bank notes in Community currencies

Following the irrevocable fixing of exchange rates, the Governing Council shall take the necessary measures to ensure that bank notes denominated in currencies with irrevocably fixed exchange rates are exchanged by the national central banks at their respective par values.

ARTICLE 53

Applicability of the transitional provisions

If and as long as there are Member States with a derogation Articles 43 to 48 shall be applicable.

Appendix 2

Resolution of the European Council on the Stability and Growth Pact

I. Meeting in Madrid in December 1995, the European Council confirmed the crucial importance of securing budgetary discipline in stage three of Economic and Monetary Union (EMU). In Florence, six months later, the European Council reiterated this view and in Dublin, in December 1996, it reached an agreement on the main elements of the Stability and Growth pact. In stage three of EMU, member states shall avoid excessive general government deficits: this is a clear Treaty obligation.[†]

The European Council underlines the importance of safeguarding sound government finances as a means to strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. It is also necessary to ensure that national budgetary policies support stability oriented monetary policies. Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all member states to deal with normal cyclical fluctuations while keeping the government deficit within the 3 percent GDP reference value.

II. Meeting in Dublin in December 1996, the European Council requested the preparation of a Stability and Growth pact to be achieved in accordance with the principles and procedures of the Treaty. This Stability and Growth pact in no way changes the requirements for participation in stage three of EMU, either in the first group or at a later date. Member states remain responsible for their national budgetary policies, subject to the provisions of the Treaty; they will take the necessary measures in order to meet their responsibilities in accordance with those provisions.

III. The Stability and Growth pact, which provides both for prevention and deterrence, consists of this resolution and two Council Regulations, one on the strengthening of the surveillance of budgetary positions and the surveil-

[†] Under Article 5 of Protocol 25, the obligation does not apply to the United Kingdom unless it moves to the third stage; the obligation under Article 116(4) to endeavour to avoid excessive deficits shall continue to apply to the United Kingdom.

lance and coordination of economic policies and another on speeding up and clarifying the implementation of the excessive deficit procedure.

IV. The European Council solemnly invites all parties, namely the member states, the Council and the Commission, to implement the Treaty and the Stability and Growth pact in a strict and timely manner. This resolution provides firm political guidance to the parties who will implement the Stability and Growth Pact. To this end, the European Council has agreed upon the following guidelines:

The Member States

1. commit themselves to respect the medium-term budgetary objective of close to balance or in surplus set out in their stability or convergence programmes and to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives;
2. are invited to make public, on their initiative, the Council recommendations made to them in accordance with article 99(4);
3. commit themselves to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes once they receive an early warning in the form of a Council recommendation issued under Article 99(4);
4. will launch the corrective budgetary adjustments they deem necessary without delay on receiving information indicating the risk of an excessive deficit;
5. will correct excessive deficits as quickly as possible after their emergence; this correction should be completed no later than the year following the identification of the excessive deficit, unless there are special circumstances;
6. are invited to make public, on their own initiative, recommendations made in accordance with Article 104(7);
7. commit themselves not to invoke the benefit of Article 2 paragraph 3 of the Council Regulation on speeding up and clarifying the excessive deficit procedure unless they are in severe recession; in evaluating whether the economic downturn is severe, the Member States will, as a rule, take as a reference point an annual fall in real GDP of at least 0.75%.

The Commission

1. will exercise its right of initiative under the Treaty in a manner that facilitates the strict, timely and effective functioning of the Stability and Growth pact;
2. will present, without delay, the necessary reports, opinions and recommendations to enable the adoption of Council decisions under Article 99 and Article 104; this will facilitate the effective functioning of the early warning system and the rapid launch and strict application of the excessive deficit procedure;
3. commits itself to prepare a report under Article 104(3) whenever there is the risk of an excessive deficit or whenever the planned or actual government

deficit exceeds the 3 per cent of GDP reference value, thereby triggering the procedure under Article 104(3).

4. commits itself, in the event that the Commission considers that a deficit exceeding 3% of GDP is not excessive and this opinion differs from that of the Economic and Financial Committee, to present in writing to the Council the reasons for its position;

The Council

1. is committed to a rigorous and timely implementation of all elements of the stability and growth pact in its competence; it will take the necessary decisions under Article 99 and Article 104 as quickly as is practicable;
2. is urged to regard the deadlines for the application of the excessive deficit procedure as upper limits; in particular, the Council, acting under Article 104(7), shall recommend that excessive deficits will be corrected as quickly as possible after their emergence, no later than the year following their identification, unless there are special circumstances;
3. is invited always to impose sanctions if a participating member state fails to take the necessary steps to bring the excessive deficit situation to an end as recommended by the Council;
4. is urged always to require a non-interest bearing deposit, whenever the council decides to impose sanctions on a participating Member State in accordance with Article 104(11);
5. is urged always to convert a deposit into a fine after two years of the decision to impose sanctions in accordance with Article 104(11), unless the excessive deficit has in the view of the Council been corrected;
6. is invited to always state in writing the reasons which justify a decision not to act, if at any stage of the excessive deficit or surveillance of budgetary positions procedures the Council did not act on a Commission recommendation, and, in such a case, to make public the votes cast by each member state.

Notes

1. All notes of Thomas Hobbes' *Leviathan* are from the edition by Michael Oakeshott (Oxford: Basil Blackwell, 1957).
2. This naturally begs the question: Do not individual rights also need to be protected against a government powerful enough to oppress them?
3. Verdun (1996 and 2000c) outlines how the CNPF membership was split on the question of EMU.
4. The 'inconsistent quartet' includes free trade, while the 'triangle' includes only monetary policy autonomy, free capital flows and fixed exchange rates. Following the Maastricht Summit, this 'quartet' was presented as the official technocratic justification in favour of EMU in several EU member states.
5. There are, of course, powerful arguments against the usefulness of neofunctionalism more generally. Despite the detail of its analysis, neofunctionalism's predictions about automatic, gradual and incremental progression into deeper European integration and greater supranational influence have not always been accurate. Community building has come in fits and starts, fraught with sustained periods of 'euro-pessimism' and 'euro-sclerosis'. Spill-over, while occurring in certain sectors or policy-arenas, has not necessarily occurred in any and all other sectors or areas. In fact, some policy areas have strongly resisted spill-over as states have jealously guarded sovereignty. Moreover, the autonomous influence of supranational authorities has increased only slowly and unevenly, if at all.
6. Haas (1990: 55) defines epistemic community as:

   > a professional group that believes in the same cause-and-effect relationship, truth tests to assess theory and shares common values. As well as sharing an acceptance of a common body of facts, its members share a common interpretative framework, or 'consensual knowledge', from which they convert such facts, or observations, to policy-relevant conclusions. … An epistemic community's power resource, domestically and internationally, is its authoritative claim to knowledge. To the extent that its members can penetrate the walls of government and maintain their authority, new orders of behavior are possible.

   He also notes (1992: 3) that:

   > an epistemic community is a network of professionals from a variety of disciplines and backgrounds, they have 1) a shared set of normative and principled beliefs, which provide a value-based rationale for the social action of community members; 2) shared causal beliefs, which are derived from their analysis of practices leading or contributing to a central set of problems in their domain and which then serve as the basis for elucidating the multiple linkages between possible policy actions and desired outcomes; 3) shared notions of validity – that is, intersubjective, internally defined criteria for weighing and validating

knowledge in the domain of their expertise; and 4) a common policy enterprise – that is, a set of common practices associated with a set of problems to which their professional competence is directed, presumably out of the conviction that human welfare will be enhanced as a consequence.

7. With regard to France see Howarth (2001).
8. Central bankers, themselves, have frequently made such claims. See Blessing (1966) and Emminger (1966).
9. The 'garbage can' model corresponds neither to the views of the policy-makers themselves as to their principal motivations nor to any apparent hidden motives. In the French case (Howarth 2001) at no time have policy-makers stated that they sought to share policy-making at the European level because it was excessively controversial to deal with it at home. This approach ignores the very strong republican tradition in France of political control over all elements of policy-making. Moreover, during the three year period prior to the Maastricht Treaty, there were no speculative attacks against the franc, no franc realignments – after January 1987 – and the French economy was performing well, in spite of high interest rates, at least until 1990, long after the solidification of French policy on EMU. Furthermore, the Socialists blamed the attacks of the 1986–88 period on the economic policies of the previous government.
10. The concept 'epistemic community' is defined in Chapter 1; see n.6 above.
11. Several years later, during the discussions on EMU by the Delors Committee, the Bundesbank President Pöhl noted that 'the EMCF, which is tied to directives issued by the EC Council of Ministers and hence is subject to political instructions, is not suitable as a monetary authority for the Community' (Pohl 1989, 149; cited in Gros and Thygesen 1992, 21).
12. The first co-ordinated change of interest rates by the Bank of France and the Bundesbank, took place on 5 November 1987.
13. For example, Edouard Balladur, 'The EMS: advance or face retreat', *Financial Times*, 17.6.87.
14. Philippe Lagayette (1988) 'Les perspectives monétaires à l'horizon 1992', *Banque de France-Info*, no. 88–06, 14 March. Lagayette was a deputy governor of the Bank at the time.
15. Jean-Victor Louis, *et al.* (1989), 'Vers un système Européen de banques centrales', collection Etudes Européennes, Editions de l'Université de Bruxelles.
16. The governors of the central banks presented their final project of a statute of the ESCB and ECB on 9 April 1991 (*Agence Europe*, 10.4.91, 5468).
17. Karl-Otto Pohl (1989), 'The further development of the European Monetary System', in collection of papers annexed to Delors Report, Office of Publications of the European Communities, Luxembourg, 131–55.
18. Following the 1995 enlargement, this meant 11 out of 16 members.
19. The president was appointed to a three-year term by the 'common accord' of the heads of state or government, on a recommendation from the Committee of Governors/new EMI Council. Murray Doyle, the gover-

nor of the Bank of Ireland, was chosen as vice-president by the EMI Council.

20. As another compromise to assuage the wary Germans, at the Madrid December 1995 European Council the name of the European currency was changed from ECU – which the Germans thought sounded too French – to the more linguistically neutral euro.
21. The EMI's reports were decidedly more negative than those of the Commission, emphasizing the additional effort required in most member states to meet the convergence criteria. The publication of annual convergence reports was a treaty requirement (article 109j).
22. Of the countries that wanted to participate only Greece was deemed to have failed to have satisfied the convergence criteria. The EMI report ended years of speculation on Italian participation.
23. Dinan 2000, 477. Duisenberg subsequently announced on 31 December 1998 that he did not recognize, or intend to abide by, this compromise (ibid.).
24. Noyer, with no previous experience working in a central bank and not trained as a monetary economist, was a unique appointment to the ECB. Rather his background was typical of heads of the French Treasury: general training in public administration at the *Ecole Nationale d'Administration* and then in financial management in the Financial Inspectorate.
25. Hans Tietmeyer (1997) 'Der Euro: ein entnationalisiertes Geld', *Auszuege aus Pressartikeln*, 12 December (Frankfurt/Main: Deutsche Bundesbank). Author's translation.
26. 'Tietmeyer describes euro's slide as not good news', *Financial Times*, 6.5.01.
27. ibid.
28. Interviews with French Treasury officials and Michel Aglietta, a leading French monetary economist and consultant to the Bank of France (13 and 18.6.1994).
29. Reforms throughout the late 1970s, the financial deregulation of 1984 and European Competition rules substantially diminished this dependence. Aglietta (1988) claims that the relationship between the state and the central bank is not the real problem.

    > Monetary systems each have their own particular history. It is only in federal countries that central banks need to be independent of government. To create such a relationship in a highly centralized nation would be totally artificial and would not at any rate provide a real guarantee of anti-inflationary monetary policies, which is economic not juridical. What is essential is that the central bank is not the prisoner of a financial structure that requires it, under pain of destabilising this structure, to monetise public or private debts. It is the financial structure which must be transformed so that the central bank is not required to finance financial institutions. The policy must define the general conditions of the liquidity for all of the national economy. To achieve this judicial change is insufficient: what is needed is financial deregulation. This has been achieved in France. … The dependence that existed was not vis-à-vis government but rather a structural dependence which

limited the Bank of France's margin of manoeuvre. … The aim was to organize an open financial market in which the banks could lend without perturbing excessively the interest rates. … Internal deregulation and the raising of the external controls on capital movements go together (p. 19, author's translation).

30. It should be stressed that this favourable disposition ignored the potential economic policy implications of central bank independence. For a detailed description of the development of French public opinion in the pre-Maastricht period see the annual surveys in Sofres, *L'Etat de l'opinion*, Paris: Editions du Seuil, 1990–91; see also Corinne Balleix-Banerjee (1997) pp. 146ff.
31. For a copy of the French Draft Treaty see *Revue Financière Internationale: aujourd'hui l'écu, numéro spécial*, June 1991; and *Agence Europe*, 28/29.1.91, 5419. Much of the following information was also outlined by Treasury and Bérégovoy's support staff officials in interviews. See also Paul Fabra, *Le Monde*, 4.7.89. This also demonstrated the control exercised by Bérégovoy as leader of the French negotiating team during the IGC and the control of Treasury officials over the preparation of the Draft Treaty. Previously, Bérégovoy had struggled with Roland Dumas, the Minister of Foreign Affairs, in shaping the project (Dyson 1997, pp. 57–77; Aeschimann and Riché 1996; and Balleix-Banerjee 1997, pp. 332–54 and 372–7).
32. *Communiqué du Conseil des Ministres*, 5.12.90 and the French proposal for an EMU treaty, *Agence Europe*, 28/29.1.91, 5419.
33. *Agence Europe*, ibid., 5419.
34. The Dutch presidency presented a couple of texts (*Agence Europe*, 9.5.90, 5250) as did the Commission (*Agence Europe*, 18.5.90, 5257).
35. This involved the creation, at the start of Stage Two, of an ECB which would immediately begin emitting ECU (K. Dyson *et al*., 1994, p. 77). Support for this approach appears to have been based upon limited economic analysis and the French definitely underplayed its potential inflationary effects. Bérégovoy – who approached European affairs differently than Mitterrand – also wanted to continue British participation in monetary integration in order to further diminish German monetary power in Europe (Bauchard 1994).
36. *Agence Europe*, 13.4.91.
37. *Agence Europe*, 26.10.89, 5119.
38. In 1993, the Treasury fought a determined and public battle with Prime Minister Balladur, Minister of Finance Alphandéry and the Bank of France – which it lost – to assume direct control over banking supervision rather than allow the independent central bank to retain control. However, the Treasury made clear that its opposition to the Bank of France retaining this power did not indicate its hostility to the independence required in the context of the EMU project. See, for example, 'Banque de France: une liberté très surveillée', *Le Quotidien de Paris*, 6.4.1993.
39. Interview, 26.8.94.
40. This decision-making style is commented upon in great detail by Favier and Martin-Roland (1991) and Attali (1993, 1994, 1995).
41. However, at the same time, Mitterrand did not prevent de Larosière from publicly, and repeatedly, expressing his support for independence. See,

for example, de Larosière's speeches reprinted in *Banque de France-Info*, 89–24, 1.11.89, p. 8; and 90–12, 27.3.90, p. 7.

42. *Libération*, 4.9.92. Other leading Socialist politicians made similar claims.
43. Interviews with leading members of the Rocard and Cresson Governments and members of Bérégovoy's support staff.
44. For an analysis of Genscher's proposal from a French perspective see Aglietta (1988, pp. 14–19).
45. 'On n'est plus très loin du gouvernement économique', interview with Jean Lemierre in *Libération*, 13 January 1999. Jean Lemierre, former head of the French Treasury and the first president of the Economic and Financial Committee made such announcements to the French press upon the creation of the council at the start of 1999. The powers of the new Economic and Financial Committee do not reinforce those of the Euro-XI. Like the former Monetary Committee, this new body includes leading central bank officials and the Heads of national Treasuries. It incorporates the principal responsibilities of the former Monetary Committee, placing emphasis upon economic policy co-ordination (which explains the change in name). In June 1998, the Commission's proposals to strengthen economic policy co-ordination in the context of the new Committee and the Euro-XI, were rejected by the member states. Like its predecessor, the new Economics and Financial Committee is the principal body in which detailed negotiations and decisions take place, leaving ECOFIN to ratify the decisions or to negotiate and make decisions in those situations in which the treasury officials and bank governors are not able to reach agreement.
46. The Employment Chapter itself involved no additional spending or obligatory measures and emphasized a vision of job creation closer to that advocated by Tony Blair's New Labour – with an emphasis placed on training and the adaptability of the work force as contributing to a 'flexible and competitive Europe' – than the Plural Left vision of EU-level spending and intervention. The Luxembourg and Cardiff 'job summits' of November 1997 and March 1998, and the Cologne and Lisbon summits of June 1999 and March 2000 established and reinforced a programme of employment policy co-ordination: best practice information sharing, pilot projects and non-binding job creation targets. This co-ordination fell far short of the Jospin Government's initial proposals for the Luxembourg summit that included the establishment of specific binding national plans for the creation of 12 million jobs throughout the EU over the next five years, the co-ordination and regulation of employment policy at the EU-level and even the necessary Commission approval on industrial redundancies and closures ('Le Sommet de Tony Blair', *Le Monde*, 23–24 November, 1997).
47. See Martine Aubry's comments in 'Le Sommet de Tony Blair', *Le Monde*, (1997).
48. It should be noted that Finance Minister Fabius did not officially endorse this report.
49. Fabius, L., 'Donner plus de visibilité à l'euro 11 sera un axe fort de la présidence française'; Zecchini, L. and Lemaitre, P. H., 'La France veut renforcer le pouvoir du club de l'euro', *Le Monde*, 4 July (2001).

50. During the period between 1965 and 1988, the UK had an average inflation rate of 8.9 per cent and was ranked fifteenth out of the 18 OECD (Western industrialized) countries (Busch 1994: 59).
51. The pamphlet almost certainly had the blessing of Prime Minister Jospin, with an eye to the upcoming French presidential and National Assembly elections. Lamy and Pisani-Ferry likewise challenged the logic behind the continued application of the Stability Pact's 3 per cent budget deficit criterion.
52. Article 11.1 of the Statute of the European System of Central Banks (ESCB) allows the European Council to appoint as few as four Executive Board members.
53. Article 109l of the TEU, articles 44 to 47 of the ESCB Statute.
54. On payment systems, it can be noted that the EMI and the ECB have fought a hard battle to make these operational. The Target system was largely put in place by the EMI. However, well into Stage Three, there remained difficulties on retail cross border payment systems. A September 1999 ECB report ('Improving retail cross border payment systems – the Eurosystem's view') called on the banking to provide substantially improved services in this area by 2002 in order to create a 'single payment area in which people [were] able to transfer money as rapidly, reliably and cheaply from one part of the [Euro-Zone] to another as they can within each Member State'. Since the publication of the report the private banking sector has subscribed to the Eurosystem's objectives in principle and has cooperated with Eurosystem to identify the practical impediments to the achievement of these objectives and in order to investigate and where possible agree on effective solutions. However, by the summer of 2000, limited progress had been made which encouraged the ECB to prepare a progress report by autumn 2000 (ECB, 'Improving Cross-Border Retail Payment Services, Progress Report', September 2000). The ECB accepted that it would be unrealistic to expect the service level for cross-border payments to reach that of domestic payments in all respects by 2002 and that at present the Eurosystem would not become 'operationally active' on the matter. However, the ECB announced that, if sufficient progress had not been made by the time of the early 2002 progress report, the Eurosystem would step up the pressure on the banking sector to provide improve services.
55. The General Council has clarified the imposition of fines for failure to comply with obligations contained in ECB regulations and decisions in September 1999 and February 2000.
56. Since the transfer of power to the ECB, monetary aggregates have assumed greater significance in monetary policy-making than was previously the case with most EC central bank with the exception of the Bundesbank (Kenen 1995; 44). Their increased significance in part reflects the greater control the ECB possesses over the total money supply of Eurosystem countries than most EC central banks previously had over their own national money supplies.
57. These are: reserve transactions (applicable on the basis of repurchase agreements or collateralised loans); outright transactions; the issuance of

debt certificates; foreign exchange swaps and the collection of fixed-term deposits.

58. See also the speech by Wim Duisenberg at the conference organized by the De Nederlandsche Bank on the occasion of the 50th anniversary of Dutch bank supervisory legislation, Amsterdam, 24 April 2002 (http://www.ecb.int/).
59. Kenen (1995) cites in footnote 28 a central banker's optimistic comments on this matter:

    > I doubt that what has been agreed really excludes the ECB from involvement in supervision … and in the closing or restructuring of major institutions in difficulty. If there are systemic implications, the ECB is bound to be involved; it is surely inconceivable that the Governing Council will not discuss such operational questions if and when they arise; and although the Council does not have specific powers to instruct individual governors on such occasions, its general powers and responsibilities … will surely give it the necessary authority to exercise behind the scenes influence.

60. IMF, 'Report on Capital Markets', September 1998. The IMF report argues that the uncertainty generated by the present arrangements would entail new risks, including the possibility of investors requiring an additional risk premium at times of financial market volatility and, ultimately, of the credibility of EMU being damaged.
61. Padoa-Schioppa (1999) – among others including Kenen (1995; 34–5) – criticizes this criticism, arguing that it reflects an outdated notion of lender of last resort operations, underestimates the Eurosystem's capacity to act, and finally 'represents too mechanistic a view of how a crisis is, and should be, managed in practice'.
62. *Business Week* (2000), for example, pointed out one difference in opinion between two members of the Executive Board, Noyer and Issing. However, it was unclear whether in fact there was a substantive difference of opinion expressed or whether the difference was principally in the manner in which they summarized the position of the Governing Council.
63. However, there is a judicial mechanism for dismissing an individual member of the Executive Board in Article 11.4 of the protocol on the Statute of the ESCB: 'if a member of the Executive Board no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct, the Court of Justice may … compulsorily retire him'. Nonetheless, the onus rests with the Governing Council or the Executive Board of the ECB to apply to the ECJ on such matters.
64. These three types/modes of governance have been described by several authors. See Wessels and Linsenmann (2001).
65. There were efforts to clarify the contents of Article 109 in the Amsterdam Treaty. However, these efforts did not end the debate on the respective roles of the ECB and the Council in external monetary policy.
66. Dyson (2000, 197) and Padoan and Henning (2000) explore this point. The ECB's 'message is that states should be encouraged to put their own houses in order before seeking to engage in international economic coordination' (see Tietmeyer 1999b).

67. Kenen (1995; 190–1) argues that these arrangements should give the ECB 'some influence on the exchange rate policies of the nonparticipants' which, in turn, could gain some form of support from the ECB.
68. The respective roles of the EU institutions would also likely have ramifications in third countries with regard to the role of different institutions in relations with the EU and the Euro-Zone. Padoan and Henning (2000) argue that an increased future role of the ECB in international discussions and negotiations would have an impact upon the balance of power between the US Federal Reserve and Treasury Secretary. To the extent that the EU creates a full partner for the US Treasury in the form of a Council that is able to act, the present balance between the Treasury and Fed on external monetary policy can be preserved. If the Council cedes authority over external monetary policy to the ECB by default, the balance would probably shift toward the Fed.
69. The Euro-Zone, like the Eurosystem, has no legal personality and thus cannot negotiate and conclude public international law agreements or become a member of international organizations. The Euro-Zone must be represented externally by Community institutions or bodies which have a legal personality: ECOFIN, the ECB and, in accordance with an ECB decision, one or more NCB. Article 6.2 of the ESCB statute provides that the participation of Eurosystem's NCBs in international monetary institutions is subject to the approval of the ECB.
70. On 8 February 1999, Robert Raymond, former DG of the EMI, was appointed as the first ECB permanent representative in Washington DC with observer status at the IMF. On 9 September 1999, he was replaced by Gerald Grisse.
71. The difficulty of obtaining a unified position is due in part to the structure of representation of members of the IMF within the Executive Board constituency system, which separate Euro-Zone member states.
72. Protocol no. 1 to the OECD Convention was used as the legal basis for the decision on this matter.
73. See for example, Otmar Issing's speech on crisis prevention, 'IMF surveillance, need for new teeth', statement at the IMF conference on the role of the IMF in the world economy, 2 July 1998, Frankfurt.
74. Duisenberg (2000) defines coordination as the agreement between separate policy-makers to take and implement joint decisions.
75. Duisenberg quoted in 'Hard Money for a Softer Europe', *The New York Times*, 5 November 1998.
76. 'Europhoria fizzles out', *Financial Times*, 5 March 1999.
77. There exists considerable debate over the usefulness of using monetary aggregates such as M3. Alan Greenspan, the current chairman of the Federal Reserve admits that monetary aggregates are no longer a reliable guide for policy. The Bundesbank was one of last central banks to focus exclusively on the M3 money target. Some economists prefer to target nominal GDP (broadly speaking, the sum of inflation and real growth in output).
78. 'OECD report warns on ECB risks', *Financial Times*, 8 March 1999.
79. 'From the EMI to the ECB', Speech delivered by Wim Duisenberg, 30 May 2000. Published on the ECB's website (http://www.ecb.int/).

80. Through his comparison of the ECB to two other main paradigms of central banking independence, the US Federal Reserve System and the 'New Zealand model', Taylor (2000) offers proposals for strengthening the democratic and cooperative elements in the Maastricht model, while respecting the treaty constraints and the objectives of the key players.
81. Interviews were conducted at the ECB headquarters, Frankfurt/Main in June of 2000 and June of 2001.
82. Typically, no actor controls all of the instruments relevant to achieving particular goals. Thus, any actor's ability to reach his or her objectives depends to some degree on the actions of others – even if the actor's own choice of action is completely free. The effects of monetary policy actions are dependent in part on fiscal policy, bank regulatory policy, and events in the private sector, among other factors.
83. The ECB's first 'independence' casualty is Lafontaine who retired after only five months on the job. While internal SPD politics and the government's tax policies contributed to his decision, Lafontaine's ongoing battle with the ECB's President Wim Duisenberg certainly contributed to Lafontaine's decision to retire. See Chapter 6 for more on the Lafontaine–Duisenberg confrontation.
84. See the analysis, 'Hard Money for a Softer Europe', *The New York Times*, 5 November 1998.
85. ibid.
86. See, for example, Duisenberg's testimony in front of the European Parliament's Sub-Committee on Monetary Affairs, 18 January, 1999 (www.ecb.int).
87. See also Tony Barber, 'Inside the ECB: Consensus and Europeanism rule', *Financial Times*, 22 October 1999.
88. See the analysis in 'Euro-Towers or Faulty Towers', the *Economist*, 31 October 1998.
89. One can argue that budgetary independence (i.e. freedom from the need to get legislative approval of the central bank's operating budget) should also be considered. Although it may be important in some countries, the issue of operating budgets has not emerged a source of contention.
90. Although not codified in treaty, in the last analysis the ECB, through the national central banks, must cover the financial requirements of a government that cannot be met from other sources. For further discussion, see Buiter (1999: 201–2).
91. See the comments of Treasury Assistant Secretary for International Affairs Edwin Truman, 'US Official in attack on Euro-Zone policy', *Financial Times*, 8 April 1999.
92. We do not include a detailed separate analysis of the Bundesbank here, but use the Bundesbank as a baseline model of a historically independent central bank. See Loedel (1999a) for a more detailed analysis.
93. See the analysis of the *Economist*, 'Ready or not, here comes EMU', 11 October 1997.
94. See the comments of Wim Duisenberg, 'Monetary Policy in the EMU', *Auszüge aus Presseartikeln*, December 2 1997.
95. 'Euro-Wechselkurspolitik lässt Fragen offen', *Finanz-und Wirtschaftsspiegel*, 15 December 1997.

96. 'The problem of credibility of the European Central Bank', Deutsche Bundesbank, *Auszüge aus Pressartikeln*, January 5, 1998.
97. 'Banker with Euro vision', the *Observer*, 1.23.00
98. 'ECB to try to avoid shocks', *Financial Times*, 29 June 1998. The inaugural meeting of the ECB was held on 9 June, 1998 in Frankfurt Germany.
99. 'Rates in the Euro-Zone will be "higher than expected"' *Financial Times*, 22 July 1998. The ECB set its target rate for M3 growth at 4.5 per cent on an annual basis.
100. Wolfgang Münchau, 'Europe's fragile recovery', *Financial Times*, 29 July 1998.
101. 'ECB cracks the whip', *Financial Times*, 10 July 1998.
102. It should be noted that the ECB was also involved in controversy over its selection of the two-pillar monetary strategy as well as its decision to impose higher than expected reserve requirements. While more of technical debate among economists and bankers, the ECB was well within its power and discretion to make these decisions. These issues are detailed in Chapter 4.
103. 'Interest Rates cut in Europe', *Washington Post*, 4 December 1998.
104. 'European Rate Cuts Explained and Applauded', *This Week in Germany*, 11 December 1998.
105. 'Hard Money for a Softer Europe: Leftist Politics Complicates the Job of the Euro's Banker', *The New York Times*, 5 May 1998.
106. Quote from a member of the ECB Governing Council. Interview with the author, June 2000, Frankfurt/Main.
107. 'Clear skies viewed from the euro tower', *Financial Times*, 5 January 1999.
108. 'Wir reagieren nicht auf politischen Druck', *Frankfurter Allgemeine Zeitung*, 2 January 1999.
109. 'Mehr Transparenz in der Geldpolitik', *Handelsblatt*, 20 January 1999.
110. Interview with a German banker, June 2000, Munich, Germany.
111. Such a view was confirmed in interviews with the ECB. Frankfurt/Main, June 2000.
112. 'Euro-Zone may win credibility back under Prodi regime', *Financial Times*, 6 April 1999.
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References

Address: European Central Bank, Kaiserstrasse 29, D-60311, Frankfurt am Main, Germany.
Telephone: 49 69 13440; Fax 49 69 1344 6000
Postal Address: Postfach 16 03 19, D-60066 Frankfurt am Main, Germany.
Email address: info@ecb.int
Web address: http://www.ecb.int/

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