The European Central Bank and the Economic Government of Europe

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Introduction

Although the drive to build a new Europe after the Second World War was largely political, there were also sound economic reasons for driving European integration forward. Deepening economic ties meant that Europe's economies were becoming increasingly interdependent. European integration is the means to structure and manage this interdependence within a broader context.

Our pamphlet explores one aspect of this process, namely macroeconomic policy, more precisely monetary policy – the power to set interest rates and influence exchange rates – and fiscal policy – the power of the purse. It will look at how macro-economic policy is made at the European level and how the two policies, monetary and fiscal, interact. This interaction can be growth-boosting, but it can also strangle the Euro area economy. Economists refer to this as the search for an optimal policy mix. We will assess the institutions in charge of Europe's macroeconomic policy according to two criteria: their effectiveness is obviously crucial, but so is their integration into a broader democratic context.

A federal economic government?

Economic sovereignty is an integral part of the nation state. In the EU, the member-states have decided to voluntarily transfer some of this sovereignty to the supranational level to support and complement the deep economic integration that has underpinned Europe's economic success over the last 50-odd years. The EU's economic sovereignty has three main elements: the European Central Bank (ECB), which draws up and implements Europe's monetary policy; the stability and growth pact (SGP), a mechanism for supervising the fiscal policies of the member-states; and the European Commission's directorate-general for competition policy (DG Competition), which oversees industrial policy. In

economic terms, the EU has therefore adopted some of the characteristics of a federal government. It has a monetary authority, a ministry of industry and a secretary of state to oversee budgets[1]. In other areas of policy, however, the EU still functions as a confederation of nation states, most importantly in foreign policy, defence and security. The EU is thus a federation in some respects and a confederation in others. Nevertheless, the EU's economic institutions are rarely perceived as a federal government, probably because they are independent rather than run by political decision-makers.

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

[1] A finance minister would have the power to draw up budgets – a power the EU does not have at present. The EU itself has a budget. This, however, is tiny compared with the national budgets of the member-states and its use is determined by the member-states rather than the EU's supranational elements, such as the European Commission.

Europe's economic 'constitution' was devised and approved through democratic processes involving the governments and parliaments of all 15 member-states. But this does not mean that Europe's economic government is set in stone. The EU is in a state of flux, which leaves it opened to criticism since its institutions and processes are necessarily incomplete. The current set-up is in many ways unsatisfactory and the relatively new institutions have yet to get into their stride. Some of the EU's flaws derive directly from the fact that it is still evolving. This means that any assessment of the EU, this one included, is somewhat artificial. Is it fair to reproach a child making its first tentative steps for not striding boldly ahead? How can we criticise a building that is still under construction? Europe's integration process is uneven. Every step forward can either lead to another step or block progress elsewhere. Any snapshot of the EU would be distorted unless it took into account this underlying dynamic.

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

Any assessment of the EU's economic institutions depends on which position one adopts in this debate. Those who believe that macroeconomic and competition policies are complementary tend to have a broad vision of the European policy mix, whose instruments -- monetary policy, budgetary policy and structural reforms -- are seen as highly interdependent. This interdependence requires close co-operation and co-ordination, perhaps even centralisation under the aegis of a European government. The view that the two policy areas are substitutes, more liberal in outlook, fits in more neatly with the current structure of European economic government. The constraints of the SGP and the existence of an independent monetary authority with the sole objective of price stability are bound to weaken the EU's executive powers, which are concentrated in the Council. Competition policy, and its impact on society and the public sector through deregulation, will thus become the tool of choice in the construction of an integrated Europe.

Irrespective of whether one agrees with either of the two positions, it is clear that the first one suggests a degree of continuity in the way the EU member-states organise and govern themselves while the second one implies radical change. While many governments have been moving towards more liberal economic policies, they are rarely (if ever) prepared to give sovereignty over their macroeconomic policies. It is the dynamic of European integration that has underpinned the transfer of economic sovereignty to European institutions. But it is also this dynamic aspect that is probably at the heart of the debate about Europe's 'democratic deficit', the fear that the EU's growing powers and competences are not fettered by any democratic checks and balances. There is nothing wrong per se when nation states subordinate their policies to the EU, just as the emergence of nation states placed limits on regional autonomy. This is an inherent part of any process of unification. However, the fact that the EU does not itself provide any real policy choices and that its policies are essentially

determined in a democratic vacuum does not only go against Europe's political tradition but may also pose a threat to its economies. The EU is a strange political animal: First governments agree on rules designed to restrict the way in which they exercise national sovereignty. But then they oppose the emergence of sovereignty on a higher, federal level in the name of national sovereignty. The gap that is created here harbours Europe's 'democratic deficit'.

The EU's impending enlargement further highlights its institutional weaknesses and malfunctions. The EU is unwieldy enough as it is, although its current 15 member-states are a fairly homogenous group, both economically and politically. With up to 27 members it may well be ungovernable, unless it restricts itself to being a free trade area in which federal authority is limited to ensuring free trade and competition between businesses and public policies, as well as monetary stability (for a more detailed analysis, see Fitoussi and Le Cacheux, 2002). Unless radical reform takes place, the Europe of the future will thus resemble the vision of its liberal supporters but denounced by those who, in the name of economic autonomy, social security and equity, seek to return to a Europe of nation states. Unless credible and effective institutions are created, monetary union will add to this trend by reinforcing economic and financial integration and thus competitive pressures, which will increasingly restrict national policies.

In an international monetary system that is not subject to control by national political authorities, the traditional tools of macroeconomic policy become blunt. Adjustment to economic shocks takes place only through the adjustment of relative costs and prices, which can only happen, says the theory, if markets for goods and labour are fully liberalised. Hence the insistence of both the ECB and the Commission on removing obstacles to competition and implementing structural reforms, in particularly in the field of labour law and social legislation, even at the risk of widening income gaps and eroding public services and social security. The logic of Europe's economic 'constitution' is thus to push the region

towards an increasingly liberal economy through EU institutions that do not have a choice in this matter. They have the power to increase the intensity of competition within the single market but not to reduce it. Is that what most citizens of Europe’s democracies really want? And even if it is, can we be sure that if they change their minds in the future there will be room for alternative visions?

The criterion of democratic legitimacy

Democratic legitimacy should be at the heart of any evaluation of public policies. There is an inherent tension between the two principles underlying the system of western liberal democracy: individualism and inequality – the principle of the market – on the one hand and the public sphere and equality – the principle of democracy -- on the other. The system is therefore characterised by a continual struggle for compromise. This struggle is productive. It enables the system to evolve steadily, quite unlike systems organised by a single organisational principle, such as the Soviet system, which tend to strain until they finally break down. Only those forms of government that continually adapt can survive; all others will stagnate and die.

A hierarchy of values normally ensures that economic criteria are subordinated to democratic concerns and not the other way round. Yet it is generally economic criteria that are used to assess economic policies and reforms. Dan Usher (1981) has proposed an alternative criterion: Is a policy more likely to reinforce democratic support or to weaken it? Will it bind a population more closely to the prevailing political regime or alienate it? If ever there were doubts about the validity about these democratic criteria, the recent rise of the far Right in Europe should have eliminated them. How can reform policies work if the people are not committed to them? Can people be made to live and act contrary to their wishes in the name of a however-defined principle of economic efficiency? Democracy

implies a hierarchy in the relations between political and economic systems: Societies choose the economic system they want and not the other way round.

And yet, the relationship between democracy and the market is more complicated than that. As Usher remarks: "In one way or another all societies should decide who will be rich and who will be poor, who will command and who will obey, who will do those jobs generally considered desirable, and who will do those considered undesirable." Yet entrusting the distribution of wealth and jobs to democratic coalitions can result in instability, which risks undermining the very foundations of democracy. Political scientists refer to this dilemma as the 'faction problem': Any given coalition can undo the work of another coalition, since a minority faction can achieve a majority by offering certain members of the current majority a better position if they switch sides. This potentially endless cycle can only be broken by a change in political regime.

Non-political channels of change and decision-making – referred to as 'equity' systems by Usher – are therefore crucial for the survival of a market democracy. The free market is such a channel. Generally, an 'equity' mechanism must fulfil two conditions: it must be feasible and universally acceptable. Feasability is a question of degree. If the market fully determines the distribution of income and wealth, then there is no place for political intervention and thus for democracy. At the other extreme, if the distribution of, say, 80% of national income depends on the outcome of the next election, individuals will have such strong incentives to get involved in politics that the democratic system will become grind to a halt. An equitable system is feasible if the distribution of a significant part of national income depends on non-political channels. And an equitable system is acceptable as long as a majority of citizens does not feel excluded from the system and works towards a regime change. Here too the advent of populism in a number of European countries ought to make us pause for thought.

In our society, the ‘equity’ mechanisms are being modified by a return to ‘pure’ economics and a gradual erosion of the scope for democratic decision-making. Behind this trend lie the predominance of market forces and growing competition between fiscal and social systems, which restrict state intervention and reduce governments’ scope for redistributing wealth. If the process of European integration stops half-way, its ‘equity’ mechanisms will push back democracy in the name of market efficiency and a set of values that override democratic concerns. Thus changes to ‘equity’ mechanisms will not be the result of a political decision – in which instance they would represent the popular will – but rather of external factors constraining the political regime.

Democracies have the big advantage of being flexible. This does not mean that they are prone to radical change, since their constitutions usually ensure gradual evolution. But it does allow them to adapt to new circumstances. Reducing this flexibility by handing over decision-making to a set of fixed rules, drawn up in accordance with the doctrines of the day, cannot be considered as progress. Europe’s main challenge today is to move from a rule-based system of government to a system founded on freedom of choice. In other words, Europe must become more pragmatic.

The European Central Bank and the Stability and Growth Pact

In line with the above discussion, we attempt to evaluate the EU’s institutions responsible for macroeconomic policy -- the European Central Bank and the Stability and Growth Pact – according to two criteria: effectiveness and democratic legitimacy. We focus mainly on the ECB but also discuss the SGP, not only for the sake of being comprehensive, but also because monetary and fiscal policy are so closely interlinked. Perhaps one of the driving forces behind the SGP was the desire to restrict the strategic interaction between them to facilitate the ECB’s task. In the first part of the pamphlet, we discuss the institutional

framework for monetary and budgetary policies within the Euro area, as well as their co-ordination. Co-ordination has been rendered problematic by a major institutional imbalance between an independent and unaccountable central bank and a plurality of budgetary authorities constrained by the SGP.

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

Current economic thinking assigns monetary policy, rather than fiscal policy, the most active (and reactive) role in the stabilisation of economic activity and thus in the pursuit of employment, growth and inflation targets. The ECB therefore bears a heavy responsibility. The second section of this pamphlet will try to assess the ECB's performance to date, using the standard criteria of efficiency, credibility and transparency. We will put our findings into context by comparing the ECB's performance with that of the Federal Reserve, the Bank of England and the Bundesbank. We arrive at positive conclusions -- the ECB's monetary policy appears less restrictive than the Bundesbank's had it faced the same macroeconomic situation as the Euro area since 1999.

In terms of credibility and transparency, there appears much room for improvement. However, the debate surrounding these issues is still in its infancy and our suggestions here are of a tentative nature. Where we do feel secure, is in our view that the ECB's (self-imposed) 2 per cent limit for medium-term inflation is too restrictive. By the end of this year, the ECB will probably have missed its

target for the third year out of the four it has been in operation. This clearly undermines the Bank's credibility and should be rectified.

Our reform proposals in part three reflect the concerns expressed in the first two sections of the pamphlet. They seek to address the ECB's own democratic deficit and system of governances. We also discuss ways how to improve the Stability Pact. We suggest that the ECB's political accountability should be strengthened by giving the European parliament the right to define the objective of 'price stability'. The ECB's management structure – the Governing Council and the Executive Board – will have to be reformed after the EU's eastward enlargement, when another 12 countries will join. There are two reform proposals that we consider feasible. The first one, for which we have a slight preference, would put the European Council in a position to nominate only a certain number of national central bank governors to sit on the ECB's Governing Council. The second one would rely on a principle of rotation, albeit with some permanent seats reserved for the large member-states. As for the SGP, we believe that its theoretical foundations are dubious and its political implications deeply troubling. Nevertheless, it cannot be scrapped altogether as ECB fears about the inflationary consequences of fiscal profligacy could lead to a sub-optimal European policy mix. We suggest a thorough overhaul of the Pact that takes into account both cyclical factors and public investment spending in the definition of public deficits. Since it would fall upon the European Council to determine which kind of spending can be classified as investment, the new rule would actually give the EU another way of directing national spending towards European priority areas.

I. The institutions of macroeconomic policy in the Euro area

Most of Europe's economic institutions are set out in the 1991 Treaty of the European Union (TEU), known also as the Maastricht treaty. The Stability and Growth Pact was added later, by the Amsterdam summit in June 1997 and clarified by the Luxembourg summit in December the same year. All permanent arrangements came into force on 1st January 1999.

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

Despite the reference to employment, article 3A indicates that the signatories regarded combating inflation as their priority: "(the action of member-states) shall include the irrevocable fixing of exchange rates leading to the introduction of a single currency (...) and the definition and conduct of a single monetary policy and exchange rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the community, in accordance with the principle of an open market economy with free competition."

Moreover, the treaty set out the preconditions for entry into economic and monetary union (EMU), the so-called Maastricht criteria. Any country applying to join EMU had to demonstrate that it satisfies five conditions of which four were convergence criteria (article 109 J). The underlying philosophy was that in order to join the club, each country had to demonstrate its ability to respect certain

criteria of sound financial management. The alternative would have been to introduce a single currency straight away and rely on the mechanisms of EMU to bring about convergence.

I.1. Budgetary policy

Fiscal policy remains under the authority of the individual member-states, but they are constrained by common rules. The Maastricht criteria already set strict limits on fiscal deficits and public debt[2] for those countries wanting to join the euro. The SGP added procedures for controlling budgetary policies after the introduction of the euro. These are laid out in Council regulations (1466/97 and 1467/97) and a Council resolution of 17 June 1997.

The first regulation requires each member-state to publish annually a medium-term 'stability programme', which lays out projections for macroeconomic performance and the concomitant fiscal targets. While the level of revenue and expenditure is at the government's discretion, the programmes must enshrine the medium-term objective of either a balanced budget or a budget surplus. The Council scrutinises the programmes and it can subsequently make recommendations to any country that deviates from its targets. This is intended to improve the transparency of the budgetary process and reinforce the supervision of economic policy established by the Maastricht treaty.

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[2] The limits are defined as follows: "*Member-states shall avoid excessive governmental deficits*" (article 104C of the treaty), defined in the following terms : the ratio of the government deficit to GDP exceeds 3% "*unless the ratio has declined substantially and continuously and reached a level that comes close to the reference value or the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value*"; the ratio of the gross public debt to GDP "*unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace*".

The second regulation deals with ‘excessive’ deficits. It extends the provisions of article 104C of the Maastricht treaty, which refers to national budget deficits that exceed the reference value of 3% of GDP. It sets out the procedure by which a deficit may be judged ‘excessive’ and defines the sanctions that may be imposed. If a national budget deficit exceeds 3% of GDP, the Commission draws up a report about the public finances of the country in question. On the basis of this report the Council decides whether the deficit is deemed excessive. A deficit of more than 3% of GDP is considered excessive unless it results « from an unusual event outside the control of the member-state concerned”. In this case, “the excess over the reference value shall be considered temporary if budgetary forecasts provided by the Commission indicate that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn.” A downturn is considered severe if the annual fall in GDP is 2% or more.

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

This procedure is not automatic, however. The Council’s decisions in this respect require a qualified majority (including those countries that are not Euro area members). For example, the Council can accept that a country is suffering a severe downturn even if GDP contracts by less than 2%. Although member-states are ‘in principle’ committed to no resorting to this clause if their GDP contracts by less than 0.75%, this commitment is not legally binding since it is based on a Council resolution not a regulation. If the Council decides that a deficit is indeed excessive, it can make economic policy recommendations to the member-state in question and, if these recommendations are not followed, impose the sanctions

described above. However, the Council has complete discretion in this matter, with any decision requiring a two-thirds majority (this time among Euro area members only and excluding the member-state in question).

I.2. Monetary policy

Monetary policy is the responsibility of the European System of Central Banks (ESCB), which is made up of the European Central Bank (ECB) and the 12 national central banks (NCB).

The ESCB is run by three separate bodies:

- The *Governing Council* formulates monetary policy. It consists of the governors of the 12 national central banks and the six members of the Executive Board of the ECB. Decisions are taken by a simple majority, with the president having the casting vote. The president is chosen for eight years by the national governments of the member-states.
- The *Executive Board* is responsible for implementing the decisions taken by the Governing Council. The president, the vice-president and the four other board members are all appointed by the Council of the European Union after consultation with the European Parliament and the Governing Council.
- The *General Council* comprises the president and the vice-president of the ECB and the governors of all the national central banks of the EU member-states, including those not in the Euro area. It supervises stage 2 of the European Monetary System (EMS), which co-ordinates monetary co-operation between the Euro area and the other member-states of the EU.

The principal objective of the ESCB is “to maintain price stability” (article 105 of the treaty). The ECB and the national central banks are independent from both national governments and the European Commission and cannot receive

instructions from either side (article 107 of the treaty). Neither national central banks nor the ECB can lend money to governments ("grant overdraft facilities or any other type of credit facility in favour of public authorities") or buy government debt (article 104 of the treaty).

The ECB presents an annual report to the European Parliament, the Council of the European Union and the Commission. The president of the ECB appears before the European Parliament four times a year. However, unlike in the US for example, where Congress has the power to alter the statutes of the Federal Reserve, the European Parliament has no legal or political clout over the ECB. Furthermore, the ECB is subject to only minimal requirements of transparency. The Governing Council discusses and votes in camera. This means that only the ECB itself can initiate a move towards more transparency. The only body that allows for a regular dialogue between the ECB and the other EU institutions is the Economic and Financial Committee, which consists of two delegates from each member-state, as well as the Commission and the ECB.

I.3. Economic policy co-ordination

The EU has two bodies for economic policy co-ordination. The member-states co-ordinate their policies through the Ecofin Council, which consists of the national economics and finance ministers and which may issue economic policy recommendations to individual member-states (article 103 of the treaty). Furthermore, the Maastricht treaty established the Economic and Financial Affairs Committee, consisting of representatives of the member-states, the Commission and the ECB. The Committee's brief was to monitor the economic and financial situation in the member-states and take decisions with regard to economic and financial relations between the EU and third countries, as well as other international institutions (article 109C). This Committee was subsequently

replaced by the Monetary Committee, before it was superseded by the Euro Council, which has since been renamed the Eurogroup.

Although the Eurogroup, set up in 1997 in response to Franco-German pressure, is an informal, consultative body, it has been crucial for enhancing economic policy co-ordination within the Euro area. The Eurogroup's main tasks are to promote the exchange of information about economic trends and political decisions that may affect other member-states; to monitor macroeconomic trends and budgetary developments; and to explain national labour-market policies. The Eurogroup thus contributes to the development of a long-term macroeconomic strategy, which is decided upon by the Ecofin Council.

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

I.4. An unchanging framework?

Economic policy in the Euro area has been characterised by a stark imbalance between fiscal and monetary policy. The goal of the single monetary policy is clear: price stability. But fiscal policy remains under the responsibility of the individual member-states – fiscal federalism is making little headway – and its goal are not defined in the EU treaties. The only 'positive' instrument of co-ordination is the broad economic policy guidelines -- non-binding recommendations drawn up each year by the Commission and adopted by the

Ecofin Council. We consider that the Stability and Growth Pact is way of co-ordination ‘from below’ since it restricts governments’ margins of operation: it is thus a ‘negative’ instrument of coordination.

The warning issued to Ireland over its budget is a good illustration of the deficiencies of the EU’s fiscal policy co-ordination. In February 2001 the EU finance ministers (excluding their Irish colleague) publicly counselled the Irish government to “redress the inconsistency of the 2001 budget with the broad economic policy guidelines” adopted by the Council in June 2000. Although this warning has no legal force, it shows that the EU member-states attach great importance to economic policy co-ordination. But it also shows that their way of co-ordination is very much a retrospective rather than a pre-emptive one. Furthermore, it involves no collaboration with the ECB.

It also revealed a very narrow reading of the SGP. Although strong growth had allowed Ireland to run a sizeable budget surplus, the EU finance ministers were worried that expansionary fiscal plans for 2001 could lead to economic overheating. Irish inflation averaged 5.3% in 2000, exceeding both the ECB’s medium-term target of 2% and the European average in 2000 of 2.1%. However, the dangers emanating from Ireland’s inflation to the Euro area were small as the Irish economy accounted for a mere 1.5% of the total GDP (at current prices) of the euro-11 area in 2000. In addition, Ireland’s large trade surplus (1.4 billion US dollars in 2000) may have undermined the argument that the country’s strong economic performance has benefited the whole Euro area. On the other hand, the economic downturn in the larger member-states, such as Germany and France, in 2001 was likely to help reduce inflationary pressures in the Irish economy, which

is heavily reliant on demand from the Euro area[3]. Indeed, inflation fell to an average of 4% in 2001 and the discussion about potential economic overheating dried up.

By reprimanding Ireland themselves, the Euro area governments had stolen a march on the ECB, which is usually quick to condemn lax fiscal spending. The Euro area governments may have been motivated by a desire to divert attention away from their own brewing budgetary problems as a result of poor revenue performance. The public reproach proved very controversial in Ireland and some commentators claimed that it contributed to the Irish "no" on the Nice treaty in a referendum later that year.

The example of Ireland also shows the complex interaction between the EU's monetary policy and the national fiscal policies. Signals are being sent back and forth between the different political centres in an ongoing game of chicken: "I shall raise interest rates because you are not doing enough to tighten your budget." "That is not true. Look, I am reprimanding another government to convince you of the contrary." "Sorry, not credible. Your adjustment efforts are clearly slipping." "But the economy of which I am in charge will go into recession!" "Had you listened to me in the first place, you would now have enough room for manoeuvre to counter the slowdown." "Had you cut rates more forcefully when inflation was still low, I would not have this problem now." And on it goes. This fictitious dialogue illustrates the difficulties experienced by the 14 partners responsible for economic policies (the ECB, national governments, the Commission) in their search for an optimal policy mix.

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[3] In 2000, 35.5% of Irish exports were destined to the Euro area, according to the OECD. Some 57% were directed towards the Euro area and the UK together. Germany and France alone accounted for 17.4% of Irish exports.

II. The European Central Bank in action

Assessing the ECB's performance is unusually difficult because both the Bank and the context within which it operates - the integration of 12 national foreign exchange markets - are so radically new. There is no historical precedent. Nor are there any criteria against which to judge monetary policy designed for a group of states, which are closely integrated but fall short of a federal structure. One does not need to be an economic expert to appreciate that monetary policy is much more complicated in this novel situation than it is for in a nation state or a federation which can resort to historical precedents. There are technical difficulties – Euro area statistics are far less reliable as a basis of policy decisions than national ones – and political ones, in particular the preponderance of national interests over any sense of a common destiny. European governments still tend to europeanise their problems and nationalise their successes. Since European integration is still very much a work in progress, it is all too easy to criticise the work of the ECB, not least because it is build on various, perhaps even conflicting ulterior motives.

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

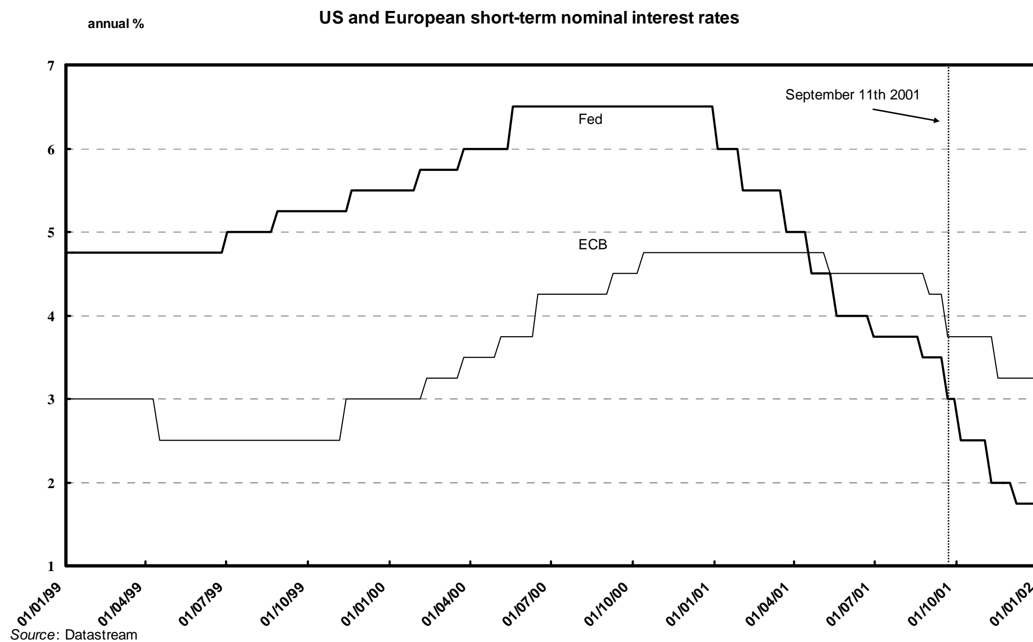
policy and evaluate the scope of credibility of its actions. Doing this, we owe extensively to the works of Creel and Fayolle (2002a, b), especially from section II.1 to section II.3.

II.1. ECB policy in 1999-2002

In the course of 1999 the ECB skilfully steered the European economy through the global economic turbulences created by the Asian crisis. It proved vigilant to the dangers of deflation and appeared to clear up the ambiguity created by its inflation target for the Euro area. The ECB's chief economist, Otmar Issing, said at the time that aiming for average CPI inflation of less than 2% also ruled out the possibility of negative inflation.

However, despite the ECB's efforts to clarify and adjust its position, traders and commentators did not give it the benefit of the doubt. Its hesitant decision-making has not necessarily worked in its favour. Despite recession fears in 2001, following the sharp slowdown in the US in late 2000, it took the Bank nearly six months, until May, to reduce its main rate by a quarter of a percentage point. The next cut, by another quarter of a percentage point, had to wait until the end of August. Interest rate cuts that small and far between did not provide a clear sense of the ECB's strategy. Faced with intermittent bursts of inflationary pressure, the ECB decided to err on the side of caution. But this made it follow an overly rigid interest rate policy, which failed to prevent the deceleration in the European economy in 2001. In mid-September 2001 the Bank finally decided on a more decisive rate cut of half a percentage point, but this was interpreted as a reaction to the possible economic shock delivered by the terrorist attacks on the US. And then it took until November for another rate cut to follow. Compare this to much more straightforward and consistent approach of the Federal Reserve, which lowered its main rate twice, each time by a full percentage point, following the September 11th attacks and continued to pursue this policy thereafter (figure 1).

Figure 1



Source: Datastream

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

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

– Monetary policy was then progressively tightened for a year, bringing the refinancing rate up to 4.75% by the autumn of 2000. This had an only modest impact on long-term borrowing rates, which began to stabilise in early 2001—indicating that markets were little concerned about inflation. In the autumn of 2001 the curve of various fixed-term interest rates flattened out significantly. (Figure 2).

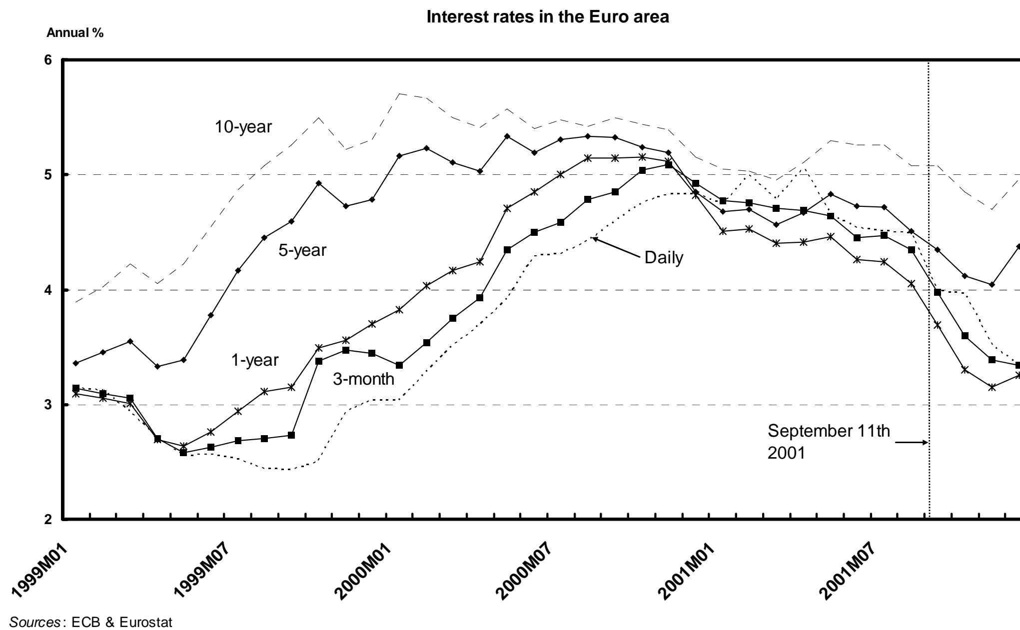
– The ECB then moved into a steadier period, leaving the refinancing rate untouched at 4.75% between the autumn of 2000 and May 2001. But this apparent stability was accompanied by a partial inversion of the yield curve. In the course of 2001, one-year rates fell below three-month rates, which, in turn fell towards and even below daily rates. In other word, financial markets were betting on a long overdue easing of monetary policy.

– The refinancing rate was cut slightly, to 4.5 per cent in May 2001, and to 4.25 per cent in August. A more substantial cut followed in September, in response to the heightened recessionary threats created by the terrorist attacks on the US. By the end of 2001 the refinancing rate was down to 3.25% and it has since remained there (at least until the time of writing in July 2002). The yield curve is on its way back to normal although one-year rates have remained a record low levels since late 2001. Markets are apparently still waiting for a further easing in interest rates.

The vagaries of the ECB refinancing rate appear to mirror the movements of the Fed's federal fund rate, albeit with a significant time lag and to a less extreme degree. This can be attributed to two factors: (i) changes in the Euro area's underlying economic fundamentals and (ii) the impact of US monetary policy on international financial markets.

Figure 3 shows the monthly progression of the ECB's refinancing rate and Euro area inflation as measured by the year-on-year change in the standardised consumer price index. Data are also provided for underlying or core inflation, which strips out the more volatile movements of prices for energy, foodstuffs, tobacco and alcohol. To provide an overview of developments in the real economy, figure 4 shows quarterly GDP growth rates in the Euro area and the contribution made by internal Euro area demand and export demand.

Figure 2



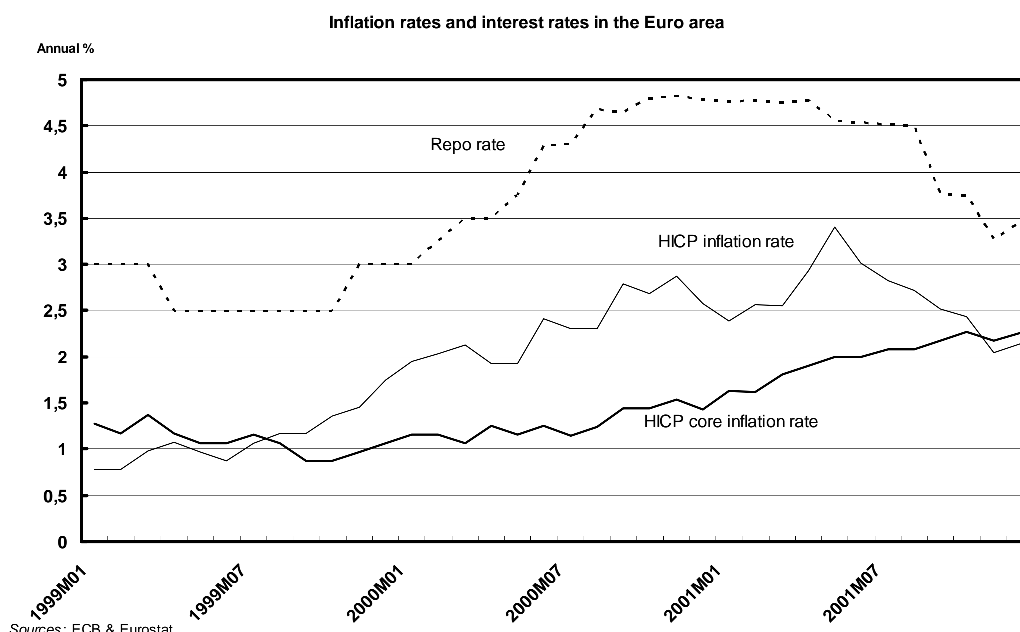
The figures show that the ECB reacted swiftly to any acceleration of inflation. The ECB's first rate hike in November 1999 came after annual consumer price inflation had climbed from 1 per cent in the summer to 1.5 per cent in the autumn. However, there was no accompanying rise in core inflation. During the following months, consumer price inflation continued to accelerate, pushed up by soaring petrol and food prices. It peaked at almost 3.5 per cent in mid-2001 before descending again towards the ECB's medium-term target of 2 per cent. During the same period the rise in core inflation was much less marked and it lagged movements in headline inflation by several months, staying below the 2 per cent mark until the summer of 2001. Until late 2000, the ECB reacted to rising inflation with even sharper hikes in interest rates, which resulted in a gradual rise in short-term real interest rates.

Drawing firm conclusions on the basis of these data is difficult. Did the ECB correctly anticipate the risk of rising core inflation? Core inflation did indeed take off in 2000-2001, but it may have risen even more sharply had it not been for the ECB's pre-emptive action. Or do the actual inflationary trends indicate that the

ECB is actually quite powerless in the face of reviving inflation? For example, monetary tightening, if it threatens to dampen growth, puts downward pressure on the euro, which, in turn, creates imported inflationary pressures. Figure 4 may help to clarify the issue. Following the Asian crisis, Euro area GDP growth peaked at the start of 2000 but then decelerated throughout the year, with the slowdown in domestic demand being the main drag on the economy in the second half of 2000.

Nevertheless, the ECB continued to tighten monetary policy until the autumn of 2000. Not only was the slowdown clearly visible, the expansion that had preceded it had been neither strong nor long enough for Europe to close its output gap[4]. The risk of a pronounced rise in inflation was hard to discern in 2000 and the ECB's behaviour fuelled suspicion that its monetary policy acted pro-cyclically, accentuating the unforeseen slowdown in growth.

Figure 3



Sources: ECB & Eurostat

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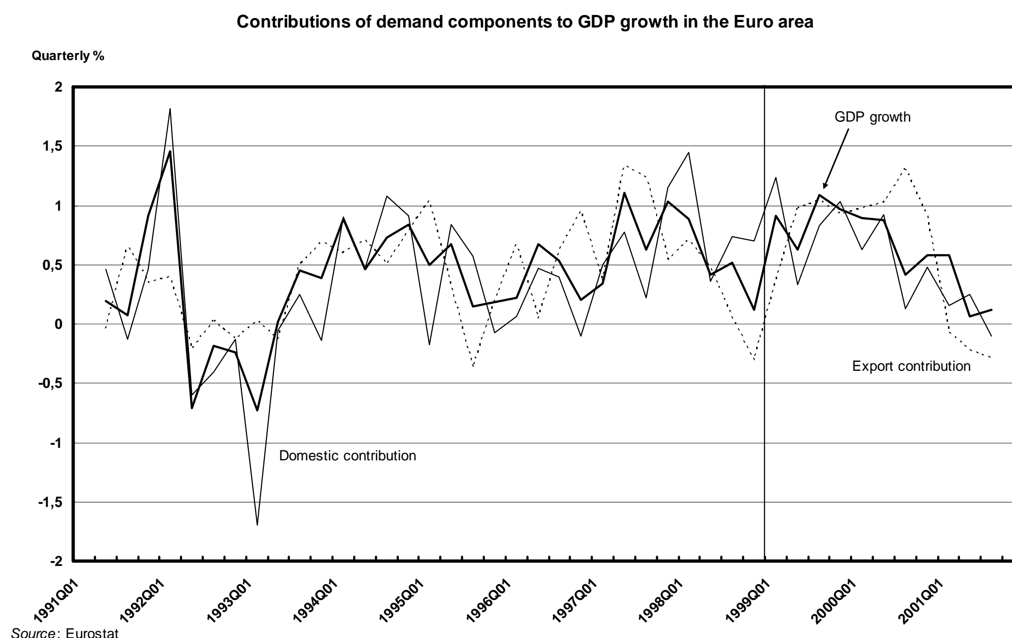
[4] See Heyer and Timbeau (2002).

Figure 4



Source: Eurostat

II.2. The ECB and the Federal Reserve

We have already highlighted the fact that ECB interest rate decisions tend to follow those of the Federal Reserve with a lag of up to six months and tend to be less pronounced (figure 1). Figure 5 adds more detail on the development of short and long-term interest rates in the US and the Euro area in 1999-2001. At least partly the discrepancies reflect the different growth trajectories of the US and the Euro area economies. Up to and including 2000 the US economy went through an extraordinarily dynamic phase of fast growth and high employment and up to the present day it has preserved a positive growth differential vis-à-vis the Euro area.

It was therefore perfectly normal for US short-term rates to exceed those in the Euro area and for the euro to be weak against the dollar, be it as a result of interest rate or growth differentials. It is not clear, however, whether it was wise for the ECB to follow the US rate hikes (however imperfectly), despite Europe's much weaker growth performance. The ECB may have taken into account the

inflationary risks that emanated from a strong world economy, powered by American growth. The ECB was certainly, if perhaps only implicitly, guided by the fear of imported inflation – through real channels, such as a growing imbalance between global supply and demand, for example in international oil markets, and through monetary channels, in particular the fall of the euro as a result of the greater attractiveness of the US economy for international, in particular European, investors. However, there were no internal inflationary pressures that could have exacerbated the rise in imported inflation through a wage-price spiral.

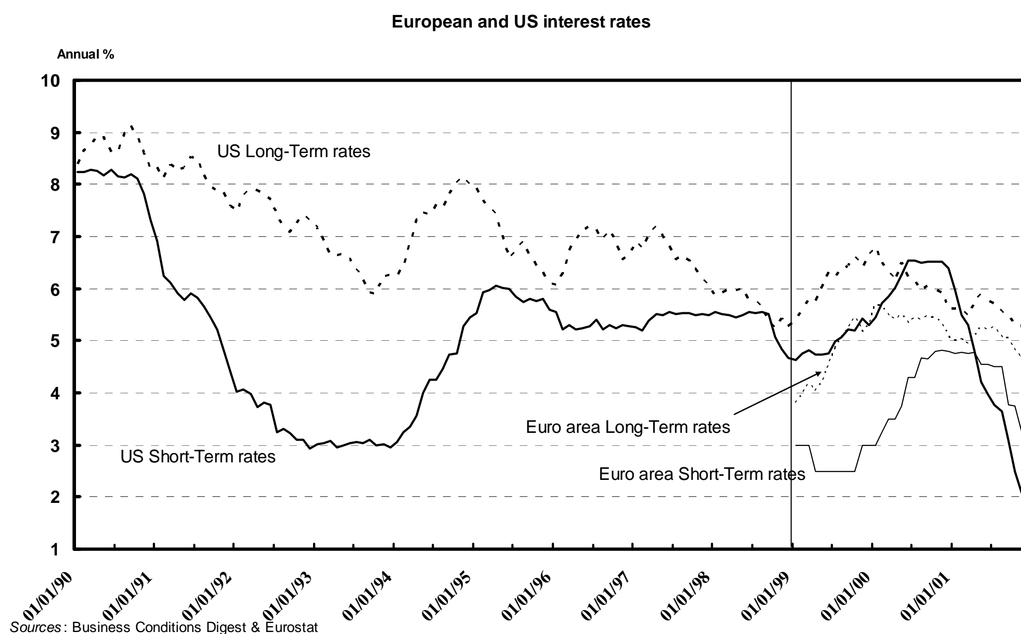
While short-term interest rates in the Euro area were much lower than in the US, long-term rates followed more closely the trends in international markets as represented by US long-term rates. The tightening of US monetary policy between mid-1999 and mid-2000 was justified by an appreciable rise in inflation[5]. The determined action of the Federal Reserve helped to dampen inflationary expectations and reversed the upward trend in long-term interest rates. Between late 2000 and the spring of 2001 it also caused an inversion of the yield curve, which contributed in classic fashion to the turn in the economic cycle. Long-term European rates, which tend to be weak indicators of growth and inflation expectations, followed US rates. Although they remained consistently below US levels, the Euro area thus saw a flattening of the yield curve, which may have been premature given the immaturity of its expansion.

Euro area interest rates, both at the short and the long end, thus appear more strongly influenced by international trends than by home-made factors. The impact of this lack of autonomy should not be exaggerated, however. On the whole, monetary policy in the Euro area has been more relaxed than it was in the

[5] US inflation was much higher than in the Euro area: headline inflation was at 3-4 per cent in 2000 while core inflation rose from 2 per cent in 1999 to 2.5 per cent in 2000.

years before EMU, with regard to both the level of interest rates and the depreciation of the euro. The looseness of monetary policy has helped to revive the Euro area economy. But the *timing* of interest rate adjustments was unsuited for consolidating the economic recovery.

Figure 5



There are major differences between the US and the Euro area, which may help to explain and perhaps even justify the seeming inertia of the ECB, as illustrated by its failure to react to economic shocks, such as the projected falls in inflation and employment. A comparison of the *changes* in inflation and employment rates has generally lead commentators to highlight the rapid and vigorous response of the Fed. But this fails to take into account that the *levels* of inflation and employment in the two economies were very different. Between 1999 and 2001 inflation, in particular core inflation, remained much lower in the Euro area than in the US. Unemployment, on the other hand, was much higher. It is definitely more difficult for monetary policy to be pre-emptive if unemployment is falling from a high level and inflation is accelerating from a very low base than if the opposite is the case.

Any conclusions about the effectiveness of the ECB therefore have to take into account Europe's economic conditions at the time when the Bank was set up. Broadly speaking, in 1998-1999 unemployment was above and inflation below their long-term equilibrium levels. The ECB's reaction to rising inflation and falling unemployment was therefore naturally limited. A similar situation can arise at the other end of the economic cycle, should the authorities determine that actual levels of unemployment were close to their 'natural' rate. The lack of action on the part of the ECB may thus have been based on a high estimate for Europe's natural unemployment--itself the result of the hesitancy of European governments when it comes to implementing structural reforms.

Europe may be more tolerant of high unemployment, as shown by the co-existence of high interest rates and low employment levels. But this tolerance limits the room for manoeuvre of the ECB, which will find only limited room for rate rises even if there are dangers for macro-economic stability. To create room for an more assertive monetary policy will require the action of various players, not just the central bank. There is much to be said for a pre-emptive monetary policy when the economy nears a state of full employment. But it cannot be the sole responsibility of the central bank.

II.3. The ECB and the Bundesbank?

The ECB's monetary strategy rests on two pillars. The first is a money supply target, namely growth in broad money (M3) should not exceed 4.5 per cent per annum in the medium-term[6]. The other is close monitoring of actual inflationary developments. Although the ECB insists that it does not follow an explicit

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[6] The money-supply target, set in 1998, reflects ECB assumptions about inflation (a maximum of 2 per cent), GDP growth (2-2.5 per cent) and the rate of currency circulation. The ECB's growth projection is significantly lower than what the Council regards as both desirable and feasible (3 per cent), which may be another obstacle to finding an optimal policy mix.

inflation target, it interprets its main objective of 'price stability' of keeping consumer price growth below 2 per cent per year over the medium term. For this, the ECB engages in ongoing analysis of all factors that may contribute to price developments.

The two-pillar system highlights the unresolved tension between the ECB's strong historical ties to the Bundesbank (which followed a broad money supply target) and the best practice followed by an increasing number of central banks including the Bank of England, namely explicit inflation targeting. There is no doubt that the second pillar requires the ECB to engage in policies that are very close to actual inflation targeting. This draws attention to the conflicting inflation forecasts released by private-sector analysts and the ECB itself. Not only is the ECB accountable for meeting its implicit inflation target, it is also required to explain every policy action in the light of its judgement whether actual inflation is deviating from its target. Some commentators (Bofinger, 2000) do not regard the ECB's approach as a break with the spirit (though with the letter) of German monetary policy in the "golden age of the Deutschmark". Others (Reither, 2000; Solans, 2000) fear that the ECB's credibility could be undermined if the public doubts the accuracy and reliability of the Bank's inflation forecasts, which serve as intermediate targets for Euro area monetary policy. E. D. Solans, a member of the ECB Council, argues that the disadvantages of a rigorous inflation target, which could tie the hands of the ECB, will quickly outweigh the benefits in terms of predictability and transparency.

Their main argument against linking monetary policy exclusively to inflation targeting is that the central bank's forecasts may be both biased and inaccurate. The credibility of the ECB will crucially depend on the gap between the level and foundations of its own inflation forecasts and those of the private sector. In this context it is helpful to recall the monetary policy pursued by the US Fed in the 1990s, described by Mankiw (2001) as "covert inflation targeting": the target, set

at around 3 per cent remained implicit, allowing discretion to be deployed where too strict a rule would have blocked it.

Moreover, the UK's eventual accession to the Euro area, if and when it happens, will certainly highlight further the practical differences in monetary policy. British monetary policy is based on an official strategy of inflation targeting. How can these two strategies be reconciled if not by reciprocal concessions? The UK could perhaps reduce its annual target rate from 2.5 per cent to 2 per cent while the ECB could adopt a more explicit inflation target. Another possibility would be for the ECB to raise its target for inflation without altering its strategy for achieving it.

Nevertheless, the ECB's two-pillar strategy appears increasingly artificial. The ECB appears to largely disregard the first pillar. This may be justified since changes in Euro area M3 are poor indicators of future inflation. The main purpose of the first pillar appears to be to allow the ECB to dispense with a precise definition of the second pillar, although this is the one that really matters. This, however, comes at the expense of transparency and the ECB's statements have remained opaque and highly confusing for the markets (Begg et al, 2002).

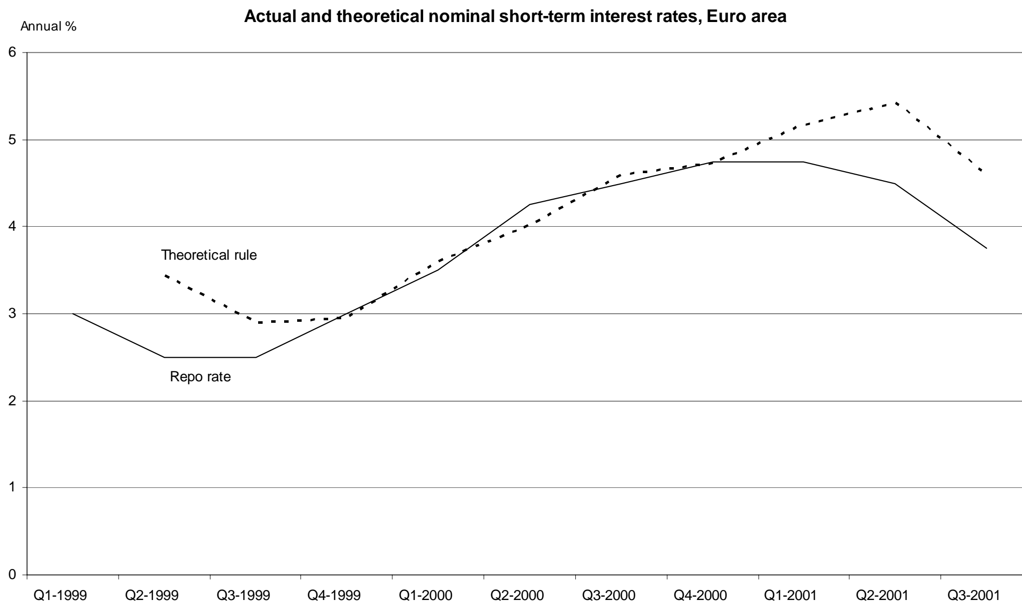
The debate about the ECB's monetary policy thus centres on the Bank's policy targets. Officially, the ECB sets its key rates in line with changes to the two pillars, with price stability as its primary objective. This was also the official strategy of the Bundesbank. In retrospect, however, it is clear that the Bundesbank's interest rate policy had two objectives, namely inflation and the output gap (the difference between actual output and its medium-term potential) with its implications for inflation.

Empirical studies show that the Bundesbank's monetary policy rule did not lead to overreactions in response to changes in inflation (see Appendix). This was

crucial for finding an optimal mix between monetary and fiscal policies. Take a situation in which a negative supply shock pushes up inflation while at the same time increasing the output gap (such as a temporary fall in productivity or a rise in oil prices). In this case, the Bundesbank would raise nominal interest rate, but not enough for the real rate, which determines investment and credit growth, to go up as well. This means that real public borrowing costs were contained, giving the government sufficient room to stimulate the economy, for example through tax cuts. Had the Bundesbank simply reacted to the rise in inflation, this would have left the government little choice but to tighten fiscal policy in order to compensate for higher costs of servicing public debt. In the first case, monetary policy helped to stabilise output, albeit at a higher level of inflation than before the shock. In the second case, inflation would have returned to its pre-shock level, but at the expense of a lasting loss in economic output.

Applying the Bundesbank's monetary policy rule to the ECB (using ECB price and output data)[7], produces some interesting results. It appears that the ECB's monetary policy after January 1999 was actually less restrictive than would have been the case for the Bundesbank faced with the same economic realities (figure 6). Until the first quarter of 2000 ECB interest rates were below the levels that would have been consistent with the Bundesbank's rule. Until the end of 2000, ECB rates are in line with the hypothetical rates estimated according to Bundesbank rules. And from the first quarter of 2001 onwards the fall in Euro area rates was much more pronounced than one would have expected had German rules applies. The results of this comparison, however cursory, imply that ECB reactions to changes in inflation may be more severe if it took into account changes in the output gap in so far as these act as an early warning sign for inflationary pressures. The findings put the general assumption that the ECB tends to err on the side of caution into perspective.

Figure 6



Source: Creel & Fayolle (2002a)'s estimations.

Our analysis of the ECB's first three years therefore paints a varied picture. Although most commentators would agree that the Bank has not done badly, some criticise it for not having formulated a convincing set of policy rules. After riding the storm of the first half of 1999 relatively well, the ECB went into apathy. It appears to take its time to collect and analyse economic evidence before it makes its rate decisions. Such inertia is not unusual in central banks, Germany pre-1999 being a case in point. However, financial markets tend to get impatient with the ECB, especially since its approach appears overly cautious if compared with the decisiveness of Alan Greenspan's Federal Reserve. Whereas the Fed adjusts its rates by small amounts, which gives the markets time and opportunity to adjust their expectations, the decisions taken by the ECB appear much more as a 'once-and-for-all' shot. If the markets misjudge the strategy implemented by the ECB

[7] For more details, see Creel and Fayolle (2002,a).

the consequences can be serious, far more so than if it took a more gradual approach.

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

II.4. Credibility and transparency

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

pre-determined rules and contractual incentives[8]. Let us look at each of these in turn.

Inflation expectations are formed by the tension between the authorities' 'inflationary bias' – how much they want economic growth to exceed its long-term, non-inflationary equilibrium rate -- and their aversion to inflation. In general, if the authorities are seen to have a strong aversion to inflation, inflation tends to be lower and the central bank's credibility is stronger. Another way to ensure credibility is to stick to pre-determined rules rather tan leaving monetary policy free to respond pragmatically. If the private sector knows in advance how the central bank will react to any changes in underlying fundamentals, it will adjust expectations accordingly. This makes it much harder for governments to disguise their intentions and engineer 'surprise' inflation in an attempt to boost growth. Tying the central bank's hands through pre-determined rules therefore helps to achieve an optimal policy mix. A third way to enhance credibility is the use of contractual incentives. By providing central bankers with disincentives to go back on their words, such contracts can make policy statements sound more credible in the ears of the public. One way of doing this is to set fines for central bankers, which increase in relation with the difference between actual inflation and the pre-determined inflation target. However, the difficulties involved in projecting inflation correctly (which may depend on a plethora of 'external factors' such as international commodities prices, supply side shocks or exchange rate movements) make these contracts very difficult to use in practice.

Perhaps the most effective way to demonstrate determination to meet a set goal, such as price stability, is to actually meet it. Blinder (2000) points out that the Bundesbank – although it repeatedly missed its money supply targets – was

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[8] For a summary of the debate about rules vs. discretion, credibility and commitment. see chapter 8 of Walsh (1998).

always seen as credible simply because it managed to control inflation. In this case, credibility is synonymous with reputation and hence it is hardly surprising that an institution as young as the ECB is not yet entirely 'credible'. It takes time to build a reputation.

Generally, a central bank becomes credible if it manages to create the conditions for low inflation *in the long-term* so that a convergence of inflation expectations with the inflation target allows for a durable fall in long-term interest rates. The persistence of the ECB to push inflation below an annual average of 2 per cent can be explained in these terms. As long as it is still in the process of building up its reputation, the ECB must undermine all suspicions that it may be tempted to move towards an 'inflation bias' and it must adhere to a very strict rule to rule out policy reversals that could destroy its hard-won reputation. Thus between November 1999 and October 2000, the ECB raised its repo rate seven times, before maintaining it at the same level for the following seven months. However, although short-term Euro area rates rose above US ones, this did no prevent the euro from continuing its slide against the dollar. It became clear that an overly strict monetary policy, especially if it is poorly understood by the markets, can be detrimental to the external value of a currency. Corsetti (2000) explains the euro's fall against the dollar in 1999-2000 by the US more favourable growth outlook compared with the Euro area. The ECB put the brakes on European growth too early and thus encouraged a further fall in the currency. The weak euro, in turn, created additional inflationary pressures (through pushing up the prices of imported goods). In other words, the ECB went against its own objectives by helping to keep down economic growth rates in Europe.

Central bank credibility also requires a certain amount of transparency (Cukierman, 2000). According to Winkler (2000), transparency has three elements: effective communication with the public; internal consistency and integrity (the central bank has to be seen to base its decisions on its own statistics,

for example); and accuracy. If all these conditions are met, the credibility of the central bank will rise.

In an ideal world, with a central bank that is clear, open and efficient, transparency serves to remove all ambiguities that may exist between the bank and the public be it over economic information, monetary policy objectives and strategy. In this case, transparency enhances the central bank's credibility. However, it can also have the opposite effect. In a not-so-ideal world transparency can reveal the flaws in the central bank's past decision-making and thus undermine its credibility in the future.

Generally, a central bank that is following an explicit rule in its interest-rate policy may as well reveal it. Available evidence suggests that by observing the application of the rule, economic agents can figure out the underlying model anyway (Faust and Svensson, 2001). In this sense, the strategy followed by the Bank of England appears fully coherent: transparency and inflation-targeting go hand in hand. But what about central banks that follow a more discretionary approach? Academic economists have little to say about this because for them the rule-versus-discretion debate has long been settled in favour of a rules-based monetary policy. In practice, however, this is not at all the case. US monetary policy, for example, is entirely discretionary, even though the governor of the Federal Reserve has to subsequently account for it in front of the nation and the government[9]. Although the 'Taylor rule' explains rather well the Fed's past policy actions, no-one knows whether it is relevant it to the Fed's future decisions. In today's uncertain economic environment with multiple risks, monetary policy will always have to fly by sight. Central banks need data that allow it to make sound predictions about the most likely course of the economy (so-called leading

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[9] Another possible constraint is that exchange-rate policy is determined jointly by the Federal Reserve and the Treasury Department (see Davanne and Jacquet, 2000).

indicators), but it also needs room for manoeuvre rather than following a rigid course. This means that at least some secrecy may be necessary for monetary policy to be effective.

Faced with the conflicting demands of credibility and transparency, the ECB appears to have opted for minimal transparency. Although the ECB's objectives are well-established and clear[10], its strategy is anything but. As shown above, the two-pillar system is not exactly a model of simplicity. And its communication with the public is more style than substance. In May 2001, for example, the ECB governor justified its decision to cut interest not in terms of gloomy growth predictions, which were at the time the focus of media attention and one of the public's main worries, but in terms of the past overestimation of broad money supply M3. Preceding the long-awaited rate cut, the ECB had justified its seven-month inertia by pointing to the risks of a revival in inflation. The ECB's chief economist, Otmar Issing, however, had announced that inflation would peak in the second quarter of 2001. Given that the impact of monetary policy is always delayed, the reasons for the ECB's inertia were therefore hard to understand, unless, that is, the Bank does not trust its own in-house inflation forecasts. (Solans, 2000)[11].

Meanwhile, the debate continues over whether the ECB should follow the Federal Reserve and the Bank of England in publishing the minutes of its policy meeting. Those against (such as Issing, 1999) argue that any subsequent publication of details would constrain policy makers during the meeting and would therefore damage the freedom and the quality of the policy debate. If this is the case, the minutes may not reveal much more than the fact that a debate took place, which is

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[10] The ECB has put much effort into defining its objective of 'price stability'(see Issing,, 2000).
[11] On page 4, Solans declares that "not to be conscious of the limited usefulness of the forecasts made by the staff of the ECB in the process of formulating monetary policy (in Europe) would be

what the public knows already. Those in favour (such as Buiter, 1999) think that the publication of minutes would help the general public, and private-sector economists in particular, to better understand the way in which the ECB reaches its decisions. This would allow the private sector to make more accurate predictions about future ECB behaviour, helping to clear up questions such as who carries the most weight in the debate, what role is played by national sensitivities and on which factors the ECB Council bases its decisions (economic data, forecasts, political events or others). Once again, the ECB's lack of transparency would be thrown into stark relief if the UK – whose central bank is at the opposite side of the transparency scale – decided to join the Euro area. The Bank of England does not only publish the minutes of its meetings but also the individual voting records of the members of the Monetary Policy Committee.

The discrepancy should be cleared up as soon as possible, not only if and when the UK joins the euro. Recent academic studies have in any case reinforced doubts about the need for secrecy and have advocated the impact of good communication with the public -- 'open mouth operations' – over the direct intervention of central banks in financial markets – called 'open market operations' (Guther and Wright, 2000; Thornton, 2000). Action is no longer enough. An effective monetary policy also requires continuous communication between the central bank and the public. Transparency has therefore become a key ingredient of an effective monetary policy.

Nevertheless, it would be extremely difficult to draw up a clear set of recommendations on the basis of this discussion. While credibility is crucial, there is no clearly prescribed way of attaining it. Transparency may add to it or diminish it. The publication of minutes works well in the US and the UK but

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paradoxically to reduce, rather than to increase, the level of transparency of its policy, which should always be its principal objective."

would it have the same effect in the Euro area, where the minutes would be subject to conflicting interpretations by various national authorities? For the time being, it appears that the best thing the ECB can do is to continue with current practices while paying close attention to constructive criticism with a view to future improvements.

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

III. Reforming Europe's Economic Policy Framework

The Euro area is made up of 12 highly diverse countries – the common obligation to meet the Maastricht convergence criteria and observe the fiscal rules of the SGP notwithstanding. The member states show large differences in terms of their economic competitiveness, degree of openness to foreign trade, the structure of industrial production and, perhaps most importantly, levels of employment and unemployment. This diversity calls strongly for differentiated national economic policies -- something that the current Euro area framework does not permit. Monetary policy is fully centralised and while fiscal policy remains decentralised, it is inhibited by the terms of the Stability and Growth Pact.

The co-existence of a single, independent and politically unaccountable central bank and a plurality of fiscal authorities all constrained by the same rule creates a major institutional imbalance. Until 2000, strong economic growth, and the boost to budget revenue it delivered, helped to disguise this imbalance by weakening the constraints of the SGP. The subsequent downturn, however, has fully revealed the problem. Why European governments had to tighten their budgets, on behalf of the SGP, at a time when their economies were already slowing down and when a loosening of monetary policy was also out of the question? There may be two underlying reasons for this dilemma: an overly orthodox and single-minded conception of monetary policy; and/or overly cautious assumptions about Europe's medium-term growth potential. The combination of the two first strangled Europe's recovery and then exacerbated the resulting slowdown. The Euro area's institutional set-up therefore prevents the implementation of an optimal policy mix. Reforms are necessary, not least because ten more countries are preparing to join the EU and Euro area institutions in the near future. However, it is important to measure all reform proposals by the standards of feasibility. Radical changes to the EU's institutional status quo may be desirable, but they are hardly realistic.

III.1. Monetary Policy after Enlargement

III.1.1. The ECB and democracy in Europe

Our review of the ECB's first three years in operations comes to broadly positive conclusions. If it ain't broken, don't fix it, some might argue. However, the ECB's monetary policy could have been much tighter during these years had the Bank followed a strict interpretation of its monetary targets. In this case, economic growth would have been much weaker; perhaps even pushing the Euro area into recession, unemployment would have risen further and public deficits

would have spiralled. As outlined above, the ECB is in a strong position to resist all political pressures. Its primary objective is price stability. Supporting the economic policies of the member states is a secondary objective, as the terms of the Maastricht treaty make clear (article 3A).

Europe's current set-up does not foresee the political accountability of the ECB. Political accountability in this context means that the central bank has to account for its actions in front of an institution that possesses the right to modify the central bank's statutes, however carefully circumscribed that right may be. This is the case for most national central banks. So why not for the ECB? The fact that national parliaments rarely make use of their powers in this respect does not prove that they serve no purpose. Their very existence forces central banks to take into account the preoccupations of a country's elected representatives and make better use of the information available. Democratic institutions work better than non-democratic ones precisely because they make better use of information disseminated and discussed in the process of legislation (Rodrik, 2000). Thus democracy can be seen as a 'meta-institution', which ensures that the decision-making process is based on the best information available.

The EU's democratic deficit is so worrying because, in theory, it could lead to a crisis of democracy by subjugating the powers of elected representatives to those of independent, unaccountable agents. The ECB has a very clear idea of what European governments should do in the name of 'sound' economic management: reduce the role of the state in the economy by cutting public expenditure; and increase the flexibility of labour markets by shrinking the welfare state (see for example the ECB's Monthly Bulletin April 2002). The ECB's vision would matter little if it did not have the power to 'punish' European governments' reluctance to follow it by keeping interest rates at very high levels. This is a very effective way of sanctioning national governments. The governments, on the other hand, have no power whatsoever to sanction the ECB. The Council of Ministers

may well disagree with the ECB's monetary policy, but it has no way of forcing the ECB to change its behaviour. The ECB, on the other hand, can raise the economic and social costs for non-adherence of 'its' policy ideas. What is at stake here is nothing less than to redress the imbalance in Europe's economic governance.

Although the ECB's institutional legacy comes from the German Bundesbank, at least as far as its strategy is concerned, it lacks the kind of democratic foundations that gave the Bundesbank its legendary authority. The ECB is not embedded in an identifiable and unified social system, as was the case for the Bundesbank until the re-unification of Germany. This creates the danger that Europe's citizens regard the ECB as aloof and remote from their concerns. For the average European in the street, the defence of price stability simply does not have the kind of significance and unifying force that it had to Germans who had gone through economic turmoil and hyperinflation as a nation (Creel and Fayolle, 2002b).

The question of ECB accountability should obviously be approached with great caution. The issue at hand is not to rescind the ECB's institutional independence, but to acknowledge that in a democracy independence is a relative concept. We have already pointed out that it is not so frequent for a central bank to have the right to set its policy targets *and* chose the means to achieve them. The governments that signed the Treaty on European Union assigned the ECB responsibility for price stability, without elaborating further. It fell to the ECB to freely interpret this objective, without any formal procedure for this process being included in the treaty. The ECB came up with an interpretation – the two-pillar system discussed above -- but it may equally well have come up with a totally different one, without any political authority having the powers to intervene. It then took a relatively pragmatic approach in implementing its choice. But again, it could have gone the other way. This is not a very satisfactory state of affairs, neither from the point of view of the Bank's credibility, nor its legitimacy.

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

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

Alternatively, the Council of Heads of State or Government could be tasked with setting the ECB's monetary policy targets, again by a qualified majority and after consultation with the ECB Council. Although this would be an improvement on the current situation, it would not bring the same gains in terms of legitimacy and transparency that we would expect from a Parliament vote on monetary policy. The European Parliament's debates are characterised by real debate. They are also public. The published records of its sessions and hearings would allow the public

to better understand the rationale behind the ECB's policy targets. Furthermore, having the targets set by the European Parliament would be rich in democratic symbolism. The most important issue is not that the monetary policy target be changed, but that it be changed by a politically legitimate body, be it the Parliament or the Council. Would this require a revision of the Maastricht treaty? Since the treaty is silent on the definition of price stability, the answer is probably no. But it will probably require a new treaty, and/or a unanimous decision by the Council. The next intergovernmental conference and its predecessor, the European Convention under the presidency of M. Valéry Giscard d'Estaing, provide an excellent opportunity to have a fresh look at Europe's economic governance and the roles that the Parliament, the Council and the Commission should play in this respect.

III.1.2. Monetary policy after enlargement

The Laeken summit of December 2001 instructed the Convention to reconsider the EU's institutions with a view to the upcoming eastward enlargement. It would be most unfortunate if the Convention failed to also have a thorough look at monetary policy. Enlargement may not only require a revision of the institutional set-up of European economic policy making. It will also require a revision of the ECB's inflation target. Enlargement will bring into the EU a number of countries whose *equilibrium* rates of growth and inflation are considerably higher than those of the current member-states. Per capita GDP in the central and eastern European candidates is much lower than that of the current EU-15. To catch up, the new members require both higher growth and higher inflation as the price levels in the East non-tradable sector adjusts to western levels (economists refer to this process as the Balassa-Samuelson effect). Higher inflation in Eastern Europe is thus a structural phenomenon, not necessarily a monetary one.

If the European Parliament set a target range for inflation that was strictly positive (ruling out the possibility of deflation) and allowed inflation to exceed

the current ECB limit of 2 per cent over the medium term, it would give European monetary policy additional room for manoeuvre. The target range could, for example, aim for inflation between 1 and 3 per cent or, better, between 1.5 and 3.5 per cent. Too low a target can be harmful because it needlessly limits the ECB's ability to push real interest rates into negative territory in the short term to stimulate economic activity. Too high a target, on the other hand, can undermine the central bank's credibility and may encourage fiscal laxity in some member-states.

EU enlargement will also require a revamp of the ECB governance. At the moment, the Bank's Governing Council, the main decision-making body for monetary policy, has 18 members: the six members of the Executive Board and the 12 governors of the national central banks. Each member of the Governing Council has one vote in setting interest rates. Once the current round of enlargement is over and all 12 candidates have joined the Euro area[12], the ECB Council will have 30 members. This will create two kinds of problems: first, decision-making would become unwieldy and slow; and second, the Council would be heavily dominated by small countries. A coalition of the smaller countries representing only 20 per cent of European GDP[13] could control a majority of the votes. Some commentators (for example Baldwin et al., 2001) argue that a more complex decision-making process will favour the status quo. The ECB is already being criticised (probably unfairly) for its slow decision-making process with regard to interest-rate adjustment. And that although at present the ECB Council has only 18 members and the Board – presuming it

[12] Ten countries are assumed to join the EU as early as 2004, another two, Bulgaria and Romania, a number of years after that. Turkey's accession is assumed to take longer. All new members will probably be required to fulfil the Maastricht convergence criteria before they can join the Euro area.

[13] On the problems posed by enlargement see JP. Fitoussi and J. Le Cacheux, *Rapport sur l'état de l'union européenne 2000*, Fayard, 2000.

agrees among itself – only has to persuade three governors to reach a decision. With enlargement there are good reasons to fear that the ECB could become paralysed and that its monetary policy would be unable to adjust quickly enough to steer Europe's giant economy through the tricky waters of international shocks.

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

A smaller ECB Council would avoid both these problems. This, however, implies that not all the national central bank governors would be part of the Council at all times. There are various ways among which a selection could be made:

Rotation: The Nice summit considered the idea of a rotating membership for the European Commission, without, however, adopting it. Member-states may oppose rotation for fear of being excluded from decision making for too long. A fast rotation among a large number of governors obviously does not make sense. But the lower the number of governors and the longer the rotation period, the longer the other governors have to wait for their turn in the ECB Council (Baldwin et al., 2001). Suppose that only eight out of 24 governors have the right to vote and that their mandate is five years. Each governor would then have to wait ten years for his next turn. Even if all the governors were allowed to attend Council meetings, this would probably be considered politically unacceptable.

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

Representation: Representation, the most widely discussed option, would involve the establishment of regional groups, each of which would send one representative to the ECB Council. There are number of drawbacks, however. Like rotation, it would exclude a number of governors from the decision-making process, only that in this case the exclusion would be permanent. Moreover, it involves the difficulties of forming regional groupings, which may as such be seen as politically undesirable. It may well add another layer to Europe's complex political geography (regions, nation-states, the EU as a whole, and now regional sub-groups).

Delegation: What about basing the selection process on personal competence and merits, rather than political considerations? Baldwin et al. (2001) argue that national central bank governors should only have a consultative role. Instead, the Council should include five external figures, chosen by the governments of Europe from among "the finest experts in the world". They do not specify the criteria according to which these 'experts' should be selected, except that they

have not to be European. They furthermore suggest that ECB reform should be placed under the responsibility of the Commission since the ECB itself cannot be relied upon to generate sufficient ideas, not only because of its inherently conservative nature but also because the Nice treaty requires it to back any proposals by a unanimous vote in the ECB Council.

It goes without saying that a 'technocratic' solution like this is not the way forward to plug the EU's 'democratic deficit'. Although the idea of a government of appointed 'experts' is appealing to many, in a functioning democracy governments derive their legitimacy from being backed by the popular vote. Moreover, experts do disagree about the right course of action, just as much as elected politicians. This is even truer in economic policy-making, where there is usually more than one 'right' answer to each socio-economic problem. The national central bank governors may well be 'experts' in the sense that they have a firm grounding in economics, but they have the added advantage of being accountable in their individual countries, which gives them an added incentive to make the 'right' decision. It is simply an illusion to believe that monetary policy is a purely technical affair. It is also, perhaps even primarily, a political affair (take the Bundesbank as a classic example). Here again we see how a disregard for democratic principles in the EU reform debate threatens to widen the gap between the European integration process and Europe's citizens and thus undermine the legitimacy of the former in the eyes of the latter.

Direct nomination: Direct political involvement is therefore preferable if reform is supposed to result in enhanced efficiency, credibility *and* accountability – as we have argued all along. From our point of view, a more accountable central bank is also a more credible one. Politics should play a more prominent, but also better informed, role in the appointment of the ECB leadership. We would propose that the heads of state and governments in the European Council directly decide who sits on the ECB Council. The ECB Board would remain unchanged, with six

members, and the European Council select from the 18 national central bank governors a number it deems optimal to the ECB Council.

The appointment of Wim Duisenberg, the current ECB governor, and his possible successor, may be instructive in this context. Many commentators considered the way in which Mr Duisenberg was nominated as very damaging to the ECB's credibility. This may imply that the direct nominations to the ECB Board – based on the same horse-trading between large and small members-states, North and South etc – could be equally damaging. We disagree. The search for compromise is part and parcel of any democratic process. The idea behind democracy is that decisions are legitimate if they are supported by the largest possible share of eligible voters. However, since unanimity is the exception, any democratic assembly will have to reach decisions by way of compromise. The European Council is not an exception. It is not a fact-finding mission or jury that somehow uncovers the 'right' decisions based on 'objective' criteria. And of course, even juries rely heavily on compromises in their verdict.

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

Let us assume that the membership of the Governing Council is reduced to 15: six members of the Executive Board and nine national central bank governors. A pre-selection would be made under the aegis of two committees: The first -- composed in equal numbers of members of the Council of Ministers (ideally deputy prime ministers responsible for European affairs) and MEPs – would present a shortlist for the six members of the Executive Board to the EU Council. This 'search committee' would liase extensively with other European institutions before putting forward two or three potential candidates for each position in the

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

To conclude, we think that there are two possible solutions to the potential gridlock in the ECB's management. Our first choice would be the direct nomination of the Governing Board members in a political process. Alternatively, a rotation process could be instituted that permanently reserves two ECB Board seats for the larger member states. We have a slight preference for the first solution because our enhanced rotation proposal would involve a partial 're-nationalisation' of the ECB Council through the permanent seats for certain member-states. We believe, however, that the ECB would shed some of its 'national' characteristics to become more 'European' in nature. But this will only happen if the possibility of forming 'coalitions' within the Governing Council is strictly limited – which is why the second proposal has strong attractions for us.

III.2. Europe's optimal policy mix

The ECB's strong independence from political influence has not at all discouraged it from making public recommendations for the budgetary policies of the member-states. The Bank has shown itself deeply concerned about fiscal

relaxation across Europe, which, it fears, may prove inflationary. Nor has it always been happy with the way in which the large member states, especially France and Germany, have interpreted the SGP. On the whole, however, the SGP suits the Bank perfectly well since it sets in stone the preponderance of monetary policy in the European policy mix (Fitoussi, 1999).

III.2.1. The Stability Pact: theoretical foundations and political credibility

Europe's budgetary rule-book, the Stability and Growth Pact, not only includes the 'excessive' deficit procedure, which can be applied if a national fiscal deficit exceeds 3% of GDP, but also an obligation for governments to commit themselves "to comply with the medium-term budgetary objective of positions close to balance or in surplus." These fiscal rules are the flipside of the EU's monetary policy rules. There are many things to be said in favour of these rules: they are designed to enhance the credibility of budgetary policy by ending public suspicions that EU governments could succumb to temptations of profligate spending. As such, they can help to reduce not only direct inflationary pressures emanating from large budget deficits, but also help to dampen inflation expectations. And by improving the dialogue between the monetary and budgetary authorities, they could also help to improve the European policy mix and thus avoid a non-co-operative equilibrium in which both interest rates and budget deficits are unnecessarily high.

Nevertheless, we believe that the SGP is flawed, not only because it is based on questionable theoretical assumptions (Fitoussi, 1999), but also because of its political implications: it falls to the (unelected) European Commission to publicly reprimand elected governments for not implementing policies that they themselves have drawn up.

* **Dubious theoretical foundations:** The rationale behind the SGP is to prevent the fiscal profligacy of one Euro area government to impact on the entire Euro area economy – through higher ECB interest rates than would otherwise have been the case -- and thus bring economic disadvantages for fellow Euro area members. The risk of this happening is even greater in a single-currency zone, where fiscal policies are more potent than in a system where national currencies are available to smooth out shocks. There is thus a strong temptation for governments to react to any kind of economic problem by increasing public spending while 'externalising' the effects on monetary policy to the entire Euro area. In theory, a government could reap all the benefits of higher spending while the 'losses' are effectively collectivised. Other countries may even be forced to tighten their own budgets to make up for the overspending of one single Euro area member.

Even more worrying is the possibility that fiscal profligacy in one Euro area leads to effective default. In order to preserve macro-economic stability in the Euro area, the ECB could then find itself obliged to 'bail out' the government in question by buying up, or monetising, its debt. The resulting monetary loosening would be a serious blow to ECB credibility and would obliterate hard-won disinflation gains.

However, the rationale commonly invoked in defence of the SGP is biased and therefore only tells half the story. It may equally well be argued that it is in the interests of a Euro area government that its neighbours *loosen* their fiscal policies, which is the exact opposite of what the SGP entails. For one, the impact of an expansionary fiscal policy in one member-state on Euro area interest rates is likely to be minor, if not negligible. Even an increase in a national budget deficit of 1 per cent of GDP will increase the Euro area's overall fiscal gap by no more than 0.1-0.2 per cent of Euro area GDP. This is unlikely to induce the ECB to tighten monetary policy.

What is more, fiscal laxity in one Euro area member-state will, in most cases, be beneficial for its neighbours. Assume a member government is following an irresponsible fiscal policy, such as boosting fiscal spending at a time when growth is already strong, in an attempt to win an election or fulfil past promises. The result would be a rise in inflationary pressure and the threat of economic overheating as production moves close to capacity. Clearly, the country's neighbours would benefit from this in two ways. First, they would be faced with higher demand for their exports as the 'irresponsible' country's industries cannot keep up with domestic demand. Second, their competitiveness vis-à-vis the country in question would improve, since the former now has higher inflation, which implies higher input costs for its industries. The other Euro area countries may therefore experience higher growth, increased employment and, as a result, a rise in budget revenue and a smaller public deficit.

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

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

Meanwhile, the danger of insolvency is overrated. A country that pursues a reckless fiscal policy would be the first to suffer the consequences. Financial markets would shy away from its national debt, which would push up long-term interest rates in relation to short-term Euro area ones. It is in any case hard to imagine why European government would pursue such policies. They have never done so in the past, despite the absence of fiscal constraints on the Europan level. Fiscal positions are generally sound – with public debt below the Maastricht threshold of 60% of GDP in most countries – and an increase in budget deficits of 1-2 per cent of GDP is unlikely to lead to a financial crisis. Numerous studies have shown that the Euro area countries have generally followed 'responsible' anti-cyclical fiscal policies in the past (Creel, Latreille and Le Cacheux, 2002)

* **Poor credibility:** Were it observed to the letter, the SGP would require the entire Euro area to pursue restrictive fiscal policies from 2002 to 2005, even, or even particularly, if growth stays below potential. In the current sluggish economic climate, the Pact encourages most European countries to follow a pro-cyclical fiscal policy, forcing them to cut public spending or raise revenue at a time when the economy faces a downturn. None of the large Euro area countries, Germany, France, Italy – has sufficient room for manoeuvre to allow automatic fiscal stabilisers to operate fully, i.e. let social spending grow and fiscal revenues decrease during the downturn. Despite slow growth, all these countries will have to follow restrictive budgetary policies in 2002 and 2003 if they want to stay within the limits set by the SGP. Their fiscal room for manoeuvre is further restricted by high interest payments on public debt. In 2001, these amounted to 2.7 per cent of GDP in Germany, 2.9 in France and 5.7 in Italy. These costs, included in the fiscal deficit, limit the ability of fiscal policy to respond to even temporary shocks.

Having transferred monetary and exchange-rate policy to the ECB, Euro area governments now only have one macro-economic policy tool, namely their

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

Every year, the member-states have to present their fiscal blueprints, the Stability Programmes, to the Commission. According to a Council resolution, it is the task of the Commission to “facilitate the strict, timely and effective functioning of the SGP”. To some extent, the Commission has become the guardian of the budgetary orthodoxy agreed by elected governments. It is responsible for issuing warnings to countries whose public finances risk transgressing Europe’s fiscal rules: a public deficit of less than 3% of GDP and a balanced budget or a surplus over the medium-term. This is politically problematic, not least because the Commission’s warnings are issued publicly and widely discussed by the media. The final decision about whether a country has infringed the rules of the SGP lies with the Council of European Finance Ministers (Ecofin). If Ecofin agrees with the Commission, the ‘offending’ country may face fines and penalties. If, on the other hand, the partner countries in Ecofin decide to let the ‘offender’ off, this may look like a suspicious political climb-down from previously agreed budget precepts. The Ecofin Council is quickly accused of undermining the credibility of the SGP. In fact, it is the Pact itself that has no credibility.

The implications of this procedure can be illustrated by three actual cases, that of Ireland, Germany and Portugal. The following table gives an indication of these countries’ macro-economic situation in recent years.

Table 1: macroeconomic indicators in the Euro area

	Budget surplus relative to GDP				*Rate of growth of GDP (in %, fixed prices)*				*Rate of inflation (in %)*			
	Ger.	Eire.	Port.	Euro area	Ger.	Eire.	Port.	Euro area	Ger.	Eire.	Port.	Euro area
1999	-1.6	3.9	-2.1	-1.2	1.7	9.8	3.4	2.5	0.6	2.5	2.2	1.1
2000	-1.3	4.7	-1.8	-0.7	3.2	10.7	3.4	3.3	2.1	5.3	2.8	2.3
2001	-2.5	4.3	-2.2	-0.6	0.8	8.8	2.0	3.1	2.4	4.0	4.3	2.6

Sources: Stability programmes (European Commission) for national data and the ECB for Euro area data

In February 2001 the Council of Ministers agreed unanimously to address a ‘recommendation’ to the Irish government, advising it to revise its budget targets for 2001, which were seen as too expansionary for an economy under the threat of overheating. By the autumn of the same year, the Commission acknowledged as appropriate Ireland’s measures to combat the inflationary impact of its expansionary fiscal policy. With the benefit of hindsight – in the light of the global economic downturn in 2001 -- the Commission’s criticisms turned out much less pertinent. Consumer price inflation actually declined in 2001, to 4%, from 5.3% in 2000.

The Euro area’s first fiscal recommendations to a member-state were mainly motivated by worries about inflation, although the rules set out in Maastricht treaty and the SGP define economic policy co-ordination in terms of the overall sustainability of budgetary positions. The recommendations did not sufficiently take into account the differences between Ireland’s situation and that of the other member-states. Because of its demographic structure, Ireland did not face an immediate question of the sustainability of its pension system. At the same time, the need for infrastructure investment is greater than in other European member-states to allow Ireland to continue its catch-up growth. Arguable, Ireland could therefore justify higher fiscal spending. The fact that the country was actually running a fiscal surplus made the EU’s recommendations even more difficult to comprehend in Ireland and elsewhere. This first episode of the SGP in action has

only served to diminish the credibility of the entire procedures for drawing up Stability Programmes and assessing their validity.

The second episode diminished it even more. In February 2002, Ecofin rejected the Commission's proposal to issue warnings to Germany and Portugal about the risk of 'excessive' budget deficits. Instead Germany and Portugal agreed to commit to strict control of public expenditure and a rapid reduction of their deficits. Many saw this compromise as breaching the SGP since it was always highly unlikely that Germany would fulfil its pledge of achieving a balanced budget in 2004. The impression was that Germany escaped a warning thanks to active lobbying and the support of the other large member-states. Portugal also escaped, although the Council ruled that its failure to meet the target set in the previous Stability Programme derived more from a lack of control over public expenditure than from any economic slowdown.

Although both countries avoided an official warning, they received an informal caution and had to commit to "strict monitoring of their budgetary policy at every level of government", "avoiding to take discretionary measures that could aggravate the budgetary position", "using any budgetary room for manoeuvre to reduce the deficit" and "reaching a balanced budget position by 2004 unless growth is slower than expected".

The problem with the Commission's warnings is that they are triggered automatically and appear to have a generic character despite the fact that they address very different fiscal situations. This clearly illustrates the limits of the SGP and undermines its credibility. What is there in common between the situation in Germany, where a growing fiscal deficit is largely the result of the economic downturn while inflation remains subdued; Ireland, which is enjoying catch-up rates of growth with the resulting higher rates of inflation and budget surpluses; and Portugal, where deteriorating public finances are the result of

rapidly rising public expenditure? It is abundantly clear that the SGP is not suited to achieve optimal fiscal policies in Europe. What is desirable in one country may be pernicious in another. Germany needs to allow its automatic fiscal stabilisers to operate; Ireland needs a programme of public investment and Portugal has to address the problems that have led to a continuous deterioration in the budget, such as high public-sector employment[14] and too many tax exemptions.

III.2.2- The Stability Pact and monetary policy

The SGP is even more inadequate if viewed in the context of a single European monetary policy. The ECB's level of interest rates is highly unlikely to be suitable for all Euro area members. The fastest-growing countries, which would require higher interest rates, also tend to have higher inflation, which implies that the real level of interest rates is even lower. Ireland, for example, had inflation well above the European average in 2001, which resulted in negative real interest rates and a large gap between the economic growth rate and the level of interest rates. In Germany, on the other hand, both inflation and growth were low in 2001, which meant that monetary conditions were very tight.

Those Euro area countries for whom the ECB's monetary policy is too lax should be required to follow a more restrictive budgetary policy. Those for whom monetary policy is too tight should be allowed to disregard the 3 per cent limit in their fiscal policies, if only on a temporary basis. The downside of such an approach is that it would increase public debt in those countries with the highest real interest rates, but this appears inevitable. Because the Euro area encompasses so much diversity, the optimal policy mix at the European level is by definition

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[14] In 2000 employment in the public sector accounted for 17.3 per cent of employment, compared with 11 per cent in Germany and Ireland and a Euro area average of 15.7 per cent (Sources:

the optimal policy mix of each individual member-state. The Commission's warnings to Ireland and Portugal may still have been justified under this approach, but it is hard to see the rationale behind the instructions given to Germany, even if it escaped an official reprimand.

On a theoretical level, it is generally accepted (see for example Taylor, 2000) that monetary policy, rather than fiscal policy, should fulfil the function of stabilising economic activity. Changes in interest rates are obviously quicker to implement – despite the fact that they impinge on the economy with a lag -- than changes to the budget. However, this only works if the automatic fiscal stabilisers operate fully. The latter mitigate the uncertainty of private sector decisions. If the stabilisers are not allowed to operate, the economic cycle is systematically accompanied by changes to the structural context in which private sector decisions are taken, such as tax changes and expenditure fluctuations. As Taylor highlights: "the overall extent of changes in taxes and expenditure caused by the automatic stabilisers is generally much greater than that brought about by discretionary changes. Both types of change have an impact on overall levels of demand but those which derive from the automatic stabilisers are much more predictable and work much more quickly than those which derive from discretionary changes".

This conclusion is only valid if monetary policy is very active. If it is rather inert, discretionary budgetary policy must take over. This should also be the case in a situation where budgetary policy is totally decentralised and there are only limited, if any, fiscal transfers from the central budgets to the sub-regions. In this case – this describes the situation in Europe – common shocks to the entire region have asymmetrical consequence for individual parts.

OECD, authors' calculation).

Yet the SGP is based on the a-theoretical notion that in a monetary union, national fiscal deficits should converge. Both intuition and most research into the topic (Fitoussi, 1999) lead us to think the opposite.

Given the above argument, differences between national deficits (their diversion from the European average) should increase in the aftermath of an economic shock to help the stabilisation of the entire Euro area economy. However, a look at national Stability Programmes implies that this diversion is likely to *decrease* in the years ahead, despite the fact that all countries had very different fiscal conditions to start with. Those that try to diverge will soon face the unifying discipline of the SGP. This is not only economically dangerous; it also creates political antagonism towards the ECB since governments have no discretion to counterbalance an unsuitable Euro area monetary policy. The SGP does not encourage a constructive dialogue between the budgetary and monetary authorities – which would be the only way to achieve an optimal European policy mix.

III.2.3- Reforming the Stability Pact

Economists generally agree that the SGP's reliance on headline fiscal deficits is misguided and that it would be preferable to focus on 'structural' deficits[15] -- a definition of the deficit that strips out the impact of economic fluctuations on revenue and expenditure. Using headline deficits as a benchmark has a number of disadvantages. It forces governments to tighten fiscal policy exactly when growth is weak and thus limits or even prohibits the functioning of automatic fiscal stabilisers. Since current expenditure, such as public-sector wages or unemployment benefits, tend to be fixed in advance, government are often forced to slash public investment – the most flexible part of the budget – to cut the

deficit. This can be seen as undesirable, especially during an economic downturn. This also implies that the SGP may be particularly detrimental for the EU's less developed member-states, which require high public investment to support their economic catch-up. A focus on structural deficits, on the other hand would allow current spending to go up if growth slows and not just in a recession (defined as a contraction of at least 0.75%) as laid down in the SGP. The EU appeared to warm to this idea in 2001, when it agreed that the medium-term Stability Programmes should also take into account unforeseen risks and other possible sources of fluctuations and uncertainty in public finances. However, clearer rules are needed if a modified SGP is to both reinforce the credibility of budgetary policy and reassure the ECB about inflationary risks. Buiter et al (1993) have long proposed to set a limit of 3 per cent for structural deficits, based on the fact that public investment spending typically represents around 3 per cent of a country's GDP and that it is normal for this to be funded by borrowing.

Given the importance of public investment for growth, Europe's fiscal framework could be based on the 'golden rule' of public finances[16], which stipulates that over the medium term the current public deficit -- excluding investment spending -- should be zero. Although this would be a better solution than the current SGP, there would be a number of problems as well. Just like the SGP, the golden rule may prevent the automatic stabilisers from operating.

The best fiscal rule would thus require a balanced structural deficit, excluding investment spending. It may therefore be better to rely on a 'golden rule' that has been amended to allow for cyclical fluctuations in public finances. In this case, the rule would require that the structural deficit *excluding* public investment is

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[15] See Buiter, Corsetti and Roubini, 1993; or Creel, Latreille and Le Cacheux, 2002..

[16] Economists have been arguing for this rule for a long time, see for example Eisner, 1986; Modigliani et al., 1998.

balanced over the medium term. Distinguishing current spending from public investment can be very tricky. In the European context, it would best be left to the Council to clarify the distinction. By defining what can be classified as investment spending, the Council may even encourage governments to orientate their fiscal spending towards policy areas that have been highlighted as European priorities, such as trans-European transport links, research and development (R&D), higher education and new technologies. Much superior to current economic policy co-ordination, which is cumbersome and controversial, this modified rule may even help the emergence of a genuine set of European policies in those areas that are crucial for the future of Europe.

The modified rule would impose enough restrictions on national budgetary policies to calm ECB fears whilst at the same time giving European governments enough room to manoeuvre to react to unforeseen circumstances and to pursue policies adapted to national circumstances. It would give European countries a degree of autonomy in deciding what percentage of their national revenue they wish to devote to public investment. No definition of sound public finance management would expect this percentage to be the same from country to country. The European Council, by defining what constitutes public investment, gains new powers to instil priority policy areas with new momentum. Although the new rule would not guarantee the stabilisation of public debt, it would ensure that any increase is based on rising public investment. Moving the SGP from a zero headline deficit to a zero structural deficit excluding public investment would therefore allow the Euro area governments to invest in future growth, without fearing the wrath of the European Commission.

For the European policy mix, this ‘liberation’ of fiscal policy would be a breath of fresh air. The constant pressure on the ECB to adopt a more active macro-economic management would cease once European governments are no longer constrained by the strict rules that now characterise the SGP. In addition,

increases in public debt, the inflationary effects of which the Bank so dreads, would be associated with investments likely to be profitable in the future and hence there would no longer be any reason to classify them as inflationary.

Appendix

Over the sample period 1981Q1-1998Q4, the reaction function of the Bundesbank as estimated by Creel and Fayolle (2002a) was as follows[17] :

(1) $$i_t = \underset{(3,2)}{0,65} + \underset{(23,4)}{0,86}\, i_{t-1} + \underset{(2,7)}{0,12}\, \text{inf}_t + \underset{(4,3)}{0,15}\, gap_t\,, \quad \bar{R}^2 = 0,95;\ see = 0,5;\ DW = 1,1\,,$$

where i is the nominal short-term rate, *inf* the rate of inflation and *gap* the output gap, both expressed in terms of an annual percentage.

Equation (1) shows that the Bundesbank did not overreact to changes in inflation: in the long-term ($i_t = i_{t-1}$), a rise in inflation of 1 point resulted in a rise in interest rates of 85 basic points ($0,12/(1-0,86) = 0,85$), representing a drop in real interest rates. It should also be noted that the impact of the output gap on monetary policy was greater than that of inflation. Finally, there was a large delay built into the equation for calculating interest rates. Some commentators (e.g. Woodford, 1999) view this as reflecting a high level of inertia in monetary policy whereas others (e.g. Rudebusch, 2001) see it as a reaction to the continual crises with which the members of the German central bank were faced.

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[17] Data source: OECD. Method: Ordinary least squares; t-stat in brackets.

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