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ECOFIN-11 and the European Central Bank.

A Rational Choice Perspective.

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Introduction.

An overwhelming majority of analysts are predicting EMU policies and institutions are doomed to face failures and mismanagement given the lack of EU political union. The argument comes frequently when the so-called EMU set of economic and monetary policies are considered. This paper, following a study on the Pact of Stability and Growth (Campanella, 1998), challenges this idea arguing that the lack of political accountability suits the euro member states perfectly in two ways: 1. They can profit from falling interest rates and lower dollar/euro exchange rates to offer some relief to sluggish continental economies; 2. They can also threaten the ECB by triggering a legitimization crisis to force the ECB to accommodate their own preferences.

Drawing from a public choice perspective, the paper challenges the dominant normative view that in order to fill the lack of accountability in the ECB statute (Eijffinger, 1998; 1998) a fitting democratic interlocutor should be created (Tabellini, 1998). Though a normative approach may prove to be limited in real application, but useful as a regulative principle, the paper takes a realistic stance. It considers the limited provision of accountability not as a technical defect, but as a result of a deliberate political design to weaken ECB in its capacity of consensus building. Under providing a central bank with accountability creates smoke screens for governments looking for re-election. By shifting attention toward euro governments' preferences, the paper finds that the EMU project incorporates such a constraint. In Section 1., after reviewing the rationale of delegation of monetary policy, which is at the basis of independence status, the paper finds how, little room, instead, is devoted in the Maastricht Treaty to the issue of accountability. Section 2. reviews some recent projects on re-shaping the workings of ECOFIN relative to coordination policy, target zones and interest rate policy. Section 3. Assesses the ECB monetary policy in the perspective of strategic interaction perspective.

Keywords: accountability, strategic interaction games, collusion.

1. The ECB's lack of accountability: a strategic interaction perspective.

By reviewing recent literature on central banking, it is easy to find that there is a discrepancy between the number of studies dedicated to the subject of independence of monetary institutions in respect to those reserved, with very few exceptions, to the subject of accountability (). Such a situation is particularly striking in the case of the European Central Bank, the newly created supranational institution in charge of running monetary policy as set out in the Treaty on Economic and Monetary Union. A likely explanation of this state of affairs is that analysts, in their attempt to tackle the major problem facing the new institution of showing its capability of winning credibility, have ended up neglecting the problem of accountability of the European Central Bank. In fact, the independence of political bodies is stressed as being one of the major incremental factors which increases the credibility of any central bank's monetary policy.

Agreements in favor of the decisional bodies of the new monetary institution being built firmly on a strong principle of independence, even if there is a lack of transparency in their decisions can be seen in the outcome of the recent debate in the euro area with political authorities intruding in one way or another in the conduct of monetary policy.

Those views are at the origins of a certain non-chalance vis-à-vis the accountability of the ECB which explains the lack of provisions in the ECB statute, and a limited number of studies in the literature, too. However, very recently, things have begun to take a different turn. Not only are EU institutions, such as the European Commission and ECB, falling under closer scrutiny as mounting criticisms against European Commission mismanagement and cases of cronism arise, and the latter's stubborn attitude which seem to be evidence of its indifference towards public opinion is no longer tolerated. It would appear that this lack of accountability can provoke a legitimization crisis of the EU supranational institutions in several ambiances¹. Considering the ECB, a prevailing argument now is that the lack of accountability can not only reduce the bank's credibility but also can raise questions about the legitimacy of its operations and policy among various publics and especially among operators on the financial markets. Some studies, few indeed, (Eijffinger, etc), find a correlation between high degrees of independence and lack of accountability and warn that this state of affairs is particularly true for the ECB.

The fact that EU institutions suffer a problem of a lack of democracy and that it is a challenge which the ECB in particular should face is not new to our ears. In the last few years, political analysts have pointed

¹ At the time of writing this paper the EU Commission, one of the most powerful and secretive institutions in the EU, has been forced to resign by the EU Parliament.

out that a democratic deficit was likely to turn out to be a de-legitimizing threat to EU institutions, which were after all not yet and perhaps never were, a federal polity. The European Parliament, an elected institution, was regarded as not being up to matching the legitimacy of a truly political federal parliament such as that of the USA or Federal Republic of Germany. Though Padoa Schioppa contends that the EMU and the ECB can be identified as a major area which lacks political democracy. The accountability problem, similarly to the democratic deficit, is proper to the EU institutions. Accountability is meant to feature a technical problem relating to the functioning of bureaucratic institutions such as the European Commission or, as the case considered in this paper, the ECB. (citare un articolo pubblicato su public choice).

Although central banking literature has not yet given the same importance to the accountability deficit as to independence, the two problems are interwoven. If independence relates to the problem of insulating the bank's policy-making and decision-making from political pressures, accountability relates to the legitimacy of the bank's policy. A problem of legitimacy which, however, is not limited to the bank's legally performed operations, but extends to affect the content and rationale of those operations. Conceptually, independence and accountability are equally important to central bank credibility, in that both go hand in hand to build up the bank's reputation vis a vis markets and the public at large. The fact that the ECB does not show that there is a sufficient degree of accountability can mean that there is the risk that only its own functioning and operation, but also its own legitimacy is in danger, a factor that can produce unwanted consequence in terms of the bank's credibility.

Though this paper is not intended to offer advice on whether and how the ECB and the EU member states should endow the ECB with more accountability, it cannot ignore the damage that the lack of accountability can cause to the ECB operating strategies. The aim of this paper is in a different direction and initially it tackles the ambiguity of the Maastricht Treaty that apparently granted to the ECB great independence while at the same time it does not state very much about accountability.

In order to answer this question, we have to ask what good reasons persuaded EU political governments to grant the ECB with high degree of independence, and, at the same time, renounce asking the bank to be accountable to them and to the public at large.

Differently to what a normative approach is expected to do, this paper does not propose second best choices to the accountability problem. Its scope is to inquire into the governments' preferences and expectations in as much as the Treaty on Economic and Monetary Union is regarded as a "political deal" and not as a compelling economic necessity. The paper proposes a different departure point. The deficit of accountability is viewed not as an oversight when designing the Euro institutions. On the contrary, the provisions of great independence and lack of accountability, as those stated in the Maastricht Treaty, are viewed as the outcome of conscious decisions on the part of the governments involved.

The point was recently worked out in an article by Philip Stephens in the Financial Times² where he argues, in relation to the European Commission crisis, caused in recent weeks by the Commission' mass resignation, that the lack of accountability of that institution, which has fatally endangered its constitution, "is not some accident of history. It represents a conscious choice on the part of governments." This point of departure develops in this paper in the direction of a perspective, which stresses the significance of the political deals in the institutional design and in the likely outcomes of the ECB monetary policy. A major argument in this paper is that the ECB's lack of accountability cannot be resolved with a normative approach in that the lack of these provisions are the result of a conscious choice on the part of the governments to limit the ECB's monetary dominance. A limitation that, by restricting ECB legitimization before the public, means that governments can legitimately interpret and supply the political objectives of its monetary policy. The claims that several EU governments and representatives have made in the first three-month of this year on the ECB in Frankfurt are part of the game.

Drawing on a perspective concentrating on the EU governments' preferences, the paper challenges the predominant normative approach as it calls on the EU political institution, in this case the European Parliament, to fill the void of accountability attributed to the ECB so as to get over the lack of transparency. Though the paper's scope is not concurrent with the normative approach as it is not aimed at supplying a viable solution to the problem, it considers that without a comprehensive explanation of the rationale which is at the core of the present architecture there is the risk of underestimating the mix of interests in the game. By shifting the analysis of the ECB's lack of accountability from a normative rule-bond perspective to a one in which the ECB and the Council of Ministers are equal protagonists, the paper finds that a strategic interaction perspective is indispensable. By considering the terms within which the Maastricht Treaty places the ECB, there is some evidence that the lack of accountability can hardly corrected in the way the normative approach suggested. The paper identifies the lack of accountability to a deliberate choice of the EU governments in order to reach other priority outcomes regarding the management of European monetary governance. The rules of the game, termed in the letter and content of the Maastricht Treaty, concur to define a strategic interaction game in which both parties get their own gains.

On the side of EU governments:

Picture 1.

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|--|
| <ul style="list-style-type: none"> • A strategy, aimed to regain decisional power over the management of monetary issues. |
| <ul style="list-style-type: none"> • A lasting outcome: reversing the trend of monetary dominance, won by a combination of globalization of capital markets and the subsequent capital mobility, and the central bank's monetary dominance so as to regain room for governments' fiscal dominance. |
| <ul style="list-style-type: none"> • Sizeable political payoffs in the emergence of a political cycle. |

² (FT Friday 19 March, 1999.

- **Means:** setting Ecofin-11, an informal institution, lead by euro member countries with the function of “economic government” whose objective is that of getting from the ECB a “coordination” policy which accommodates governments preferences.

On the side of the ECB:

- **A strategy** aimed at increasing and retaining a reputation of “absolute” independence from political bodies and public opinion at large.
- **A lasting outcome:** gaining credibility vis a vis any monetary policy of the Bank, even at risk of annoying financial operators and commentators.
- **Sizeable political payoffs:** storing a sizeable amount of credibility so as to accommodate political priorities, off record.
- **Means:** resisting transparency demands and economic governance by resorting to the ECB statute and to resisting to political pressures.

As the paper considers the two parties as acting according to a rational actor model (Picture 1.), it is also prepared to see the parties arranging for a “political deal” (Gretschmann, 1993, Italianer, 1993 etc.)³ (Picture 2.).

In the latter case (Picture 2), Pareto joint gains which account : a) the resignation of the German Finance Minister and abandoning the French option favoring the installation of a “gouvernement économique” and “target zones”; b) a sensible policy of the ECB towards euro governments. A couple of weeks (April 8, 1999), after Lafontaine’s resignation, the ECB cut interest rate for a full (unexpected) half point percentage. Both the Council of Ministers (under the cloth of ECOFIN-11) and the ECB get their own way by setting a co-ordination game, which eventually comes to accommodation i.e. collusion.

2. Central Banking Theory and EMU.

2.1 Independence.

In related literature⁴, granting independence to a central bank (CB) is a means to solving the so-called “time inconsistency problem” in that studies into central banking argue that delegating monetary policy to an independent central bank resolves a time inconsistency problem.

Further, studies into CBs have identified an association between an independent CB and lower inflation rates and the political economy of central banking in the EMU area adds historical evidence to the above

³ In support of this thesis are accurate and non-conformist studies which do sustain that the rationale of EMU very project is not an economic compelling rationale, but a sophisticated “political deal” between two groupings of countries led by France and German (Gretschmann, 1993).

⁴ For a review of central bank independence and ECB statute, see M. Campanella 1997.

argument. Since the early 80s, with the globalization of capital markets and with some corporate actors starting to “vote with the feet”, European countries began to taste some disruptive effects of capital mobility. Between 1982-83, the French government, led by a socialist program, was badly hit by flight of capital flight. The French economy started to suffer higher interest rates. According to a widely respected literature, the subsequent movement of European governments towards capital freedom was a lesson they learned at their own expense. The lesson was especially tough for whom, politicians and public officials, state interventionist policies were considered to be as technically necessary as socially desirable. From then on, the specter of capital mobility and disruptive exchange rate were to form the obsession of EU governments. According to a wide range of economic literature, under conditions of capital mobility, exchange rates and interest rates are no longer within a government’s control but set elsewhere in global markets. What governments can do in these circumstances is little but to regain market credibility by relinquishing monetary policy to an independent institution. Independence of a central bank is part of an institution-building policy aimed at endowing non-elected institutions with capabilities, which can no longer be used by politically elected bodies. Studies into central banking agree on one important point: that an independent central bank can counter the systematic inflationary bias of elected (political) governments by giving a solution to the time inconsistency dilemma. After Kyndall and Prescott (1977) and Barro and Gordon (1983), the time inconsistency dilemma is believed to be generated by elected (political) governments and manifests itself in the gap between the optimal policies that would be announced to the public *and* the policies that would be carried out if, in fact, those beliefs or expectations were acted upon. As Akhtar puts it “The time inconsistency arises because authorities may not follow through if their announcements were believed and acted upon by private agents”(1995, p. 424). Though in the EMU case study, that theoretical premise needs to be supplemented with the historical events relating to the effects of Bundesbank monetary policy in the EU area, EMU provisions, among them the independence of national central banks, have been reputed to have contributed to fiscal policy losing their “historical” dominance. The independence of the central bank, which EU governments undertake to grant to member central banks under the auspices of the Maastricht Treaty, appear to have brought several EU governments very solid gains. Data relating to the years before Stage 3 (see Table below) is evidence that central banks’ independent monetary policy correlates to a reduction of the GDP deficit ratio.

Table 1. Euro area countries – deficit (ECB Monthly Bulletin, March 1999, p.23 with star)

2. 2. Accountability.

Central banking literature, however, goes further, and finds that independence is not enough. Eijffinger and associates find that if accountability is neglected, greater independence can be associated to

unaccountability, which fatally reduces the central bank's performance. By defining accountability in relation to the decision-making process, Eijffinger lists some key-points:

- decisions about the ultimate objectives of monetary policy;
- transparency of the actual monetary policy;
- who bears final responsibility with respect to monetary policy. (Eijffinger, 1998:4)

In one way or another, all of the three items mentioned are lacking, or are not sufficiently supplied in ECB statute. In relation to the first point, though the statutes⁵ of many central banks are rather vague in terms of *final objective*, the objective of price stability recognized by the ECB does not solve the problem, entirely. As the ECB is by statute an independent, non-elected, and a supranational institution, the fact that it can also set its own the benchmarks to assess the bank's performance of price stability does not mean more accountability. In the case of New Zealand, the governor of the Bank has to agree with the government a tight target range for inflation. In this so-called Policy Target Agreement (PTA) the concept of "price stability" is clearly defined and a target range for the inflation is provided. That contracting approach, is a "way to achieve accountability". This is not the case with the ECB as the objective of "price stability" hardly seems to offer clear "ultimate objectives", as it is defined neither in terms of numerical performance (), nor in terms of range of target. In fact, it lends itself to different interpretations (Fischer, 1994 quoted in Eijffinger, 1998 p.4), and eventually can open "some room for maneuver for the ECB with respect to the goals of monetary policy" (De Haan, 1997 quoted in Eijffinger, 1998 p. 4). One consequence is that the monitoring of performance is also difficult to carry out as the existence of multiple and unranked goals inhibit authorities and public opinion in their assessment of the Bank's operation (Glastra, 1997).

Transparency is also an important aspect of central banking accountability. According to the definition given by Glastra "Accountability requires that the central bank, at the very least explain and justify its policies or actions, and give account for the decisions made in the execution of its responsibility" (1997: p.323, quoted in Eijffinger, 1998, p.5). The modus in which transparency is provided depends on the extent the decisional bodies of the bank make public the very process of taking decisions. This can be translated into a few, but crucial acts on the part of the bank: a) minutes which allow public opinion to

⁵ An example is the Statute of the USA Federal Reserve. According to Sectio 2A (1) sentence 1 of the Federal Reserve Act: "The Board of Governors of the Fed and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so to promote effectively the goals of maximum employment, stable process, and moderate long-interest rates". As Eijffinger comments "Neither the Federal Reserve Act nor any othe law provides for any hierarchy". (p. 5).

know the reasons and the votes of participant members; b) a report on past performance and future plans in accordance with the monetary objectives. Though it is true that not everything should be made public, it is right to regulate the conditions under which the minutes and decisions may be suspended. At this regard the ECB enjoys the privilege of not having to publish either the minutes, or the votes. These negative provisions are justified as a measure which protect the bank's governing bodies⁶ from external pressure, especially unpleasant nationalistic oriented public opinion.

When final responsibility for monetary policy goes under scrutiny, the ECB is found to have a low score in the regard to provisions, too. Eijffinger severely criticises the adequacy of the ECB in terms of responsibility. He selects three important issues: 1. The relationship with Parliament, 2. The existence of some kind of override mechanism; 3. The dismissal procedure for the central bank governor.⁷

By comparing two indicators, one measuring the central bank's independence and the other measuring its accountability, the ECB wins a 6 point for the former, but scores a mere 4, for the latter (Eijffinger, 1998: pp.15-16), while the Bank of England takes a 3 and a 11; Switzerland 5 and 2; the US Federal Reserve 6 and 3; Bundesbank 3 and 5. The ECB, which gets together with the Bundesbank and the Bank of Switzerland the highest score in independence with a full 5, gets a mere 4 in accountability, but a little higher than Switzerland's 2 and Germany's 3. Looking at the Eijffinger accountability indicator, the Achilles' heel of the ECB is not so much the issues relating to the ultimate objectives of monetary policy, where it scores a good 3 (versus a 4 for the UK, but a mere 1 for the US, and a scarce 2 for the "stubborn" Bundesbank); its main failure relates the transparency indicator which scores a slim 1 (against a 3 for th UK, a 3. for the US Federal Reserve, but a bad 0 for the Buba), and the indicator subtotal which assesses final responsibility for the bank's monetary policy. Relating to the latter, three major questions are asked:

1. is the central bank subject to monitoring by Parliament?
3. can a simple majority in Parliament change the central bank law?
4. is past performance grounds for the dismissal of a central bank governor?

⁶ Governing bodies of the Bank are the Governing Council of the European Central Bank (ECB), which consists of the eleven governors of the national central banks (NCBs) of the participating Member States and the six members of the Executive Board of the ECB. The implementation of the single monetary policy is the responsibility of the Eurosystem, which is comprised of the ECB and the eleven NCBs of the participating Member States. The Executive Board of the ECB is a separate decision-making body. Its role is to ensure that the tasks conferred upon the European System of Central Banks (ESCB) are implemented, either through its own activities or through the NCBs.

⁷ Eijffinger, 1998, p. 6.

The ECB, alone among 16 major central banks in the world⁸, scores 0 on all three counts. This negative record can explain why recently analysts have turned their attention to the issue of final responsibility as it is this question which makes the ECB so different from the major existing central bank in the world.

2. 3. A normative approach to the ECB accountability problem.

If the one best way to manage central banking accountability is to provide full transparency and empower a politically elected institution to oversee central bank monetary policy, then the Maastricht Treaty does not satisfy the case. As the accountability indicators find, the ECB clearly has not been given the golden rules of an accountable central bank. It lacks both decisional transparency and final responsibility, two aspects, which make the ECB among the least accountable bank in the world.

Acknowledging that state of affairs, Tabellini has worked out a second best choice, which centers on the European Parliament, an elected body, and suggests it should take over as the right institutional interlocutor to make the ECB more accountable⁹. This approach, however, has an Achilles' heel as it counts on the ECB being willing to revise its stance. Such an approach goes on with an accurate analysis of the technical problems that a lack of transparency can cause to the operation of the ECB¹⁰, and raises puzzling questions about the legitimacy of ECB decisions taken in secrecy. Those decisions can easily be alleged to favor one country against the others. A situation far from being unlikely as the economic cycles of Euro countries are not perfectly synchronized.

The monetary policy of the ECB- he observes- can be under enormous pressure and the first three months of the Euro era have shown the great amount of pressure put on the ECB,¹¹ with clearly formulated demands of interest rate cutting so as to ease the poor economic performance of Euro economies. A further difficulty that the ECB is likely to meet regards the independence of its policy vis a vis single country economies. The economic performance of the euro countries is different from one country to another. Countries like Holland and Ireland, which enjoy unemployment rates even lower than those of the USA, have nothing to be worried about with a 3% interest rate on main refinancing operations. Quite different are the cases of Germany, France or Italy where there is an average of 12% unemployment rates.

⁸ According to the Eijffinger (p. 15) indicator in the issues of final responsibility UK takes 4, US 2, Switzerland 1, Germany 1.

⁹ Guido Tabellini, Statement prepared for the public hearing on "Democratic Accountability in the Third Phase of EMU" organized by the European Parliament. Subcommittee on Monetary Affairs, on January 6 1998.

¹⁰The Economist, European Central Bank. Smoke Signals. See above, pp. 71-72.

¹¹ It is well known the case the pressure on the ECB exercised by the former German Finance Minister Oskar Lafontaine.

How, then, can European citizens be persuaded that the Bank, indeed, is pursuing policies which are appropriate for Europe as a whole, and that it is not favoring one country over another?

A recipe to overcome this setback is not easy to find. After giving the warning that the lack of transparency and accountability can make “Monetary policy decision in Europe (...) extremely difficult, not only for technical reasons, but also because Europe is not yet a political entity.”, Tabellini considers whether the European Parliament should act as a legitimate institutional interlocutor of the ECB, so as to avoid a legitimization crisis breaking out.

Though a subsidiarity function by the European Parliament (EP) is likely to raise the hostility of the Commission and Council of Ministers, and of the ECB itself, as it is by statute free to decide what it should to account or not. The response to the question “What shall the EP solicit the ECB to account for?” reveals the limits that inhibit the normative approach to account for the ECB preferences and the multiple equilibria it is set to handle.

Though the script of the Maastricht Treaty states that the ECB monetary policy should be committed to price stability¹², Tabellini goes straightforward to argue that the EP *shall hold the ECB accountable as if it*

¹² In this very long quotation (reported in Appendix 1) is expressed a clearly different and opposite view to the one underwritten by the normative approach. In a more refined version of this paper, the author will consider closely the strong monetary policy implication embodied.

In the Inaugural Speech done by Wim Duisenberg, President of the ECB, price stability is carefully defined as follows: “Price stability is to be maintained over the medium term. According to the published definition, price stability has been defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Neither would deflation - that is, a persistent fall in the price level - be consistent with price stability. The annual rate of inflation in the most recent available data of around 1%, measured on this harmonised basis, is consistent with the definition of price stability. The Eurosystem has therefore enjoyed the good fortune to assume authority over monetary policy in the euro area in an environment of price stability, owing to the successful process of disinflation and convergence achieved within Europe over the past decade.

Monetary policy needs a forward-looking, medium-term orientation. This takes into account the fact that monetary policy affects the price level only with variable, usually long and unpredictable time lags. It is not able to control all short-term movements in the price level. To maintain price stability, we have chosen a distinct monetary policy strategy, one that reflects the special circumstances that exist at present as well as those likely to prevail in the foreseeable future. The chosen strategy ensures as much continuity as possible with the former strategies of the NCBs. At the same time, it gives due consideration to the unique situation which will prevail in the early years of Monetary Union.

The stability-oriented monetary policy strategy rests on two “pillars”. The first pillar is a prominent role for money. This is deemed to be important on account of the essentially monetary origins of inflation over the longer term. The second pillar of the monetary policy strategy is a broadly based assessment of the outlook for price developments and the risks to price stability in the euro area as a whole. The Governing Council recognises that it is important, in parallel with the assessment of monetary growth, to look at a wide range of financial and other economic indicators, including economic forecasts. This systematic analysis of all other relevant information about economic and financial conditions will ensure that the Governing Council is as well-informed as possible when taking monetary policy decisions.

Monetary developments can reveal useful information about future price developments and thereby offer an important compass for the conduct of monetary policy. Therefore, it is absolutely essential for any central bank entrusted with the task of keeping prices stable to analyse and monitor the developments of monetary aggregates closely.

Consequently, the Governing Council of the ECB has announced a quantitative reference value for broad monetary growth as measured by M3, which should, under normal circumstances, give some indication of

had an explicit inflation target, and he says that the countries that have a more accountable and transparent procedure are those that have adopted explicit inflation targets, it is necessary to make the ECB more accountable by setting up a) a monetary policy which aims at an inflation target, and b) an institution, the EP, which can monitor the ECB through report and hearing procedures. Tabellini lists some seven requirements:

1. *"The ECB should be accountable primarily for European inflation", and not for long run measures of economic activity. Examples are easy: growth output, unemployment, etc.*
2. *"The European Parliament should insist on having the ECB publicly state its medium term monetary goals in the form of an inflation target".*
3. *Announcements of intermediate monetary targets, such as M3, would be counterproductive and should be discarded as much as possible.*
4. *The European Parliament should insist on receiving a periodic "inflation report" (...).*

future inflationary pressure. The choice of M3 as an aggregate is supported by empirical evidence regarding the long-run stability and leading indicator properties of this aggregate. Moreover, conceptual arguments pointed to the considerable importance of including in the monetary aggregate those assets which have a high degree of substitutability with narrower definitions of money. Therefore, in addition to currency in circulation and deposits, repos, units or shares of money market funds and money market paper as well as short-term debt securities, all of which are close substitutes for more traditional bank deposits, have also been included in this definition.

The first reference value for M3 growth has been set at an annual rate of 4½%. This reference value is consistent with the maintenance of price stability over the medium term, while allowing for sustainable output growth and the trend decline in the velocity of circulation of M3. In setting the reference value for monetary growth, the Governing Council has taken account of various factors and emphasised its medium-term orientation. First, the Governing Council is committed to maintaining price stability according to the definition enshrined in the Treaty on European Union. This requires increases in the HICP for the euro area of "below 2%". Second, the Governing Council takes the view that a figure in the range of 2% to 2½% per annum for the trend growth in real GDP in the euro area appears to be reasonable. Third, the uncertainties concerning short-term developments in velocity linked to the start of Stage Three have led the Governing Council to assume that the medium-term trend decline in velocity lies approximately within a range of ½% to 1% each year. This range reflects historical experience over the past twenty years.

Substantial or prolonged deviations of current monetary growth from the reference value should, under normal circumstances, signal risks to price stability in the medium term. Monetary policy does not react to deviations of monetary growth from the reference value in a "mechanistic" way. In the first instance, such deviations will be thoroughly analysed to infer any signals which they may offer about the prospects for price developments. If the deviation points to a threat to price stability, monetary policy will react in a manner appropriate to counter this threat, rather than attempt to eliminate the deviation of monetary growth from the reference value in the short term.

Although monetary data contain information which is vital for monetary policy decision-making, monetary developments alone will not constitute a complete summary of all the economic information necessary to take appropriate policy decisions. There is a clear need for the Governing Council to look at a wide range of other economic and financial indicators

5. *Monetary policy decisions should be evaluated by comparing the inflation forecast with the inflation target.*
6. *If actual inflation happens to be excessively high (or low), in light of (implicit or explicit) inflation target, The European parliament should request a specific explanation from the ECB, and obtain assurances about the appropriate course of action. The Treaty allows for ad-hoc convening of the ECB President.*
7. *This reporting procedure could fruitfully be institutionalized through an agreement between the ECB and the European Parliament.*

Though the above propositions may contain a strong bias for ECB accountability, they can also threaten to corrode ECB independence. It is revealing that in detailing the last point, Tabellini argues that “such an agreement is not necessary, and the European Parliament could unilaterally decide to follow these procedures even without the formal assent of the ECB”.

In relation to the amount of information that the EP should require from the ECB, Tabellini is adamant: “The ECB should be induced to reveal as much information as possible”. The list includes:

- Minutes of the ECB meetings and other decision-making instances.
- Voting records of individual members.

The above recipe, Tabellini asserts, is meant to provide “the highest possible standard of transparency” so as to increase the credibility of the ECB, at a time, it is likely to face serious pressures from political bodies. The actions indicated by Tabellini are intended to counter such possible pressures as the European Parliament is asked to take over the task of ensuring the transparency of the ECB policy-making, but not to intrude in the content of its decisions.

An inflation targeting approach to central banking is gaining favour in central banking literature as countries such as New Zealand, UK, Canada, Austria, which have adopted it, have performed pretty well in monetary policy and in strategy. An example of the way the approach has been implemented in the UK is given by Dornbusch et alii (1998). A paradigm of accountability is that of the Bank of England, which had to go through some steps before gaining full independence. The first step was the publication of the minutes of the monthly meeting between the Chancellor and the Governor of the Bank of England when the Bank adopted an inflation targeting approach and started publishing an Inflation Report, the scope for the Government to control monetary policy, while legally still present, became smaller and smaller. Independence became the next logical step and was publicly granted in 1997. The success of a communication strategy has a lot to do with a simple message. Formal and explicit inflation targeting is of course, a far better story than monetary aggregates, which are alien to the everyday experience of the average citizen.¹³

¹³ Tabellini, 1998.

The normative approach leaves to much questions unanswered?

Has it realistically considered the willingness and the capability of the European Parliament to take on with initiating a policy of accountability without any further permission from Euro-governments?

The normative approach, however, is not the one the ECB is inclined to adopt. In several recent statements, the ECB President and the Governing Council were adamant in stressing the Bank's commitment to price stability. Should this position simply be explained as a sign of loyalty to the Maastricht Treaty or should it be interpreted as opening up a more strategic field of analysis?

Though the normative approach relies on some, few margins of intervention, it seems unlikely that the EP can stand independent from national governments whose inclination is to manage relations with the ECB. A literal interpretation of the Maastricht blueprint, that the normative approach suggests, can at best offer a regulative principle to be adopted in the process of institution building of the major European elected institutions. It is doubtful, however, whether the Parliament can do more than require ECB officials to testify. It has little power to hold them accountable. Further the independence of the ECB could be modified by amending the international treaty, but it is subject to veto by any of the signatories, and not by the European Parliament¹⁴.

The text and the meaning of EMU arrangements should be regarded as economic institutional arrangements incorporating a knowledge of the European economic situation and challenges¹⁵: 1. The lack of political union and, because of that, a weak public consensus for the single currency; 2. A difficult economic and social environment, as a consequence of the liabilities incurred by Euro welfare systems; 3. An inadequate financial environment with a fragmented banking system¹⁶. “; 4. Last but not least, the difficulties of creating a truly Euro-system among countries whose unemployment rates range between 20% in the South of Italy and Sachs-Anhalten and a good 3,6% in Holland.

The normative approach to ECB accountability seems unlikely to be successful in that it underestimates the EU member governments and the ECB's joint interest in sticking to the institutional arrangements

¹⁴ Similar points are made by Eichengreen, 1994 and Keenen, 1992.

¹⁵ See Padoa Schioppa, Eurosystem. A Speech delivered at the Goethe Universitaet, Frankfurt 1999.

¹⁶ Padoa Schioppa warns “Financial transformation will also produce a hardening of competition and competition will be, to a considerable extent, one between *national* financial centers and industries, not only between *individual* banks or institutions. The propensity to defend national champions may prevail over the pursuit of efficiency.”, in Eurosystem, Section vi.

and equilibrium reached in the Maastricht Treaty. It is unlikely that new observers to monitor ECB policies will be accepted in that ECB officials are concerned about building to build up their own credibility¹⁷.

On the other hand, Euro governments¹⁸ are eager to gain more space of maneuver¹⁹. The two sets of preferences make a case for strong convergence between the Council of Ministers and the ECB, in arranging a pact ad excludendum regarding the ECB accountability. Both share a strong preference for a “two-person game”, excluding other interested parties, in this case it is the European Parliament, which would try to intrude in the game. Though parties are supposed to act according to a rational actor model, they are also prepared to arrange a “political deal”²⁰, in which multi-equilibria can be achieved. With such a dynamic outcome are prepared both the ECB Governing Council and the Euro governments in their way to drop out the idea of an “ad hoc” institution.

After the Lafontaine resignation Picture 1 turns Picture 2.

<ul style="list-style-type: none"> • A strategy, aimed at regaining decisional power over the management of monetary issues.
<ul style="list-style-type: none"> • A lasting outcome: reversing the trend of monetary dominance, established by a combination of the globalization of capital markets, the subsequent capital mobility, and the central bank’s monetary dominance so as to regain space for governments to fiscal dominance.
<ul style="list-style-type: none"> • Sizeable political payoffs in the emergence of a political cycle.
<ul style="list-style-type: none"> • Means: smoothing on formal “economic government”, acquiescent with a policy of “intra-institutional” relations²¹.

¹⁷ As Cooper observes” The Maastricht agreement would create a powerful body of Platonic guardians to look after monetary affairs, effectively accountable to no one, yet with strong influence on the course of economic affairs”, in “Whither Europe?” Yale Review 80 (July): 10-17.

¹⁸ I refer to Euro governments here and further to the 11 countries admitted to Third Stage of EMU.

¹⁹ Willem F. Duisenberg, The euro, the dollar and national economic policies: what room for manoeuvre? Speech at J+80 conference on 25 March 1999 in Paris.

²⁰ In support of this thesis are accurate and non-conformist studies which do sustain that the rationale of EMU very project is not an economic compelling rationale, but a sophisticated “political deal” between two groupings of countries led by France and German (Gretschmann, 1993).

²¹ Maastricht Treaty, Art. 109.

On the side of the ECB:

- A strategy aimed at increasing and retaining a reputation of “absolute” independence from political bodies and public opinion at large.
- A lasting outcome: gaining credibility vis a vis any monetary policy of the Bank, even at risk of annoying financial operators and commentators.
- Sizeable political payoffs: storing a sizeable amount of credibility so as to accommodate political priorities, off record.
- Means: a) resisting transparency pressures appealing to the ECB statute; b) sticking to interest rate cutting measures; c) taking decisions on interest rates only when political pressures have been removed.

Streamlining the above picture, it brings to a two-level strategic interaction game:

1. Euro governments appreciate the benefits of a stubborn and independent ECB, as it shows that it is capable of getting a) credibility, and, on doing so, b) accommodate governments' failures in economic policy-making.
2. ECB gains reputation as a “hard-nosed” and independent institution and provides smoke screens for possible governance failure in monetary policy.

Picture 2 also suggests that a dynamic evolution of governments' preferences has occurred. As an “ad hoc institution” (ECOFIN-11 as “economic government”) and “target zones”, two major stumbling block on the possible arrangements with the ECB, have been abandoned²² with the departure of Oskar Lafontaine from the German government, the way is clear for the EMU project to functioning properly.

Once has been acknowledged that an offensive stance against the ECB, either under the guise of a “gouvernement économique” or under the ambitious “target zones”, the two players are ready to start a game of mutual gains. For the ECB, the acknowledgement of its independence is a bonus to its credibility and for the euro governments there is cheaper debt servicing and a weak currency, which can help the euro economies to get out of a difficult situation.

The following chapter (3.) describes with some details the major strains between politicians on one side, and the ECB governing Council, on the other. The fight which can be represented as a “chicken game”,

²² “It is with a certain non-chalance that Eugenio D. Solans, Member of the ECB Governing Council, has liquidated the question of target zones in a Speech of April 15, 1999: “Instead of establishing exchange rate fluctuation bands, European experience has shown that certain good common macroeconomic fundamentals represent the best strategy for achieving a better co-ordination of exchange rates.”.

ended with the departure of Lafontaine²³, and the ECB ready to reduce interest rates for an unexpected half point percentage.

3. ECB , Lafontaine or the “chicken game” .

“The idea of a political body that interacts with the ECB is shocking: Europe and the world have moved a healthy distance from short-term political control of monetary policy” (Dornbusch, et Alii, 1998,p.28)

The arrival and departure of the German Finance Minister Oskar Lafontaine epitomizes more than any other episode the difficulties which euro governments and ECB have had to face in setting the scene of inter-institutional relations in the euro area. Between October 1998 and March 1999, the ECB had to face three major challenges, which, if they had been successful, would have jeopardized its major institutional asset, that of enjoying the status of the most independent central bank in the world.

The ECB successfully resisted these pressures. The German Finance Minister eventually resigned both as finance minister and as leader of the SPD on March 11, 1999 and the ECB paid for it by trimming interest rates by a large half point on April 9, 1999. After Mr. Lafontaine’s departure and interest rate cutting, there are signs of an armistice between the Ecofin-11 and the ECB. Is it all that good?

Though long before his appointment, Mr. Lafontaine had not concealed his economic creed²⁴, it did shock the economic community in the early months of 1999, when economists and political analysts eventually began to realize that the red-green German coalition which had come to power in September 1998 was to be taken seriously. In several speeches, the newly appointed Finance and Economy Minister,

²³ On March 11, 1999 Oskar Lafontaine resigned as Finance and Economy Minister. Lafontaine was not only a powerful minister in the Schroeder cabinet. He was also the most powerful SPD party leader since Willy Brandt. Though his leadership was almost disastrous as he did not feel the mood in favor of German unification, he steered his party to general election victory of September 1998 challenging successfully Helmut Kohl’ chancellorship. Sources are FT articles on March 12,p.13.

²⁴ He wrote a book with Christa Mueller, his third wife, entitled: Don’t worry about globalization – prosperity and work for all (full-reference in next footnote).

Oskar Lafontaine,²⁵ set out to confront the new born European Central Bank on at least three points: 1. Economic government; 2. Lowering interest rates²⁶, and 3. Target Zones.

3. 1 Setting the stage for the battle.

Several socialist politicians, including French and Dutch governments officials have in several occasions tried to pave the way to introduce coordination policy as an issue.

Though the public justification put forward by French government officials is that a lack of coordination²⁷ and a lax budget policy lead the ECB to stick to a rigid monetary policy, with higher interest rates and, as a consequence, an overvalued exchange rate against the dollar, the u-turn in the EMU countries is clearly a consequence of the new political cycle. The German Finance Minister, a left-wing socialdemocratic leader- is a strong believer Keynesian macroeconomic demand management policy and his closest adviser, Heiner Flassbeck, one of Germany's best known Keynesian economists is also director of the Berlin-based "Deutsches Institut fuer Wirtschaftsforschung"²⁸.

²⁵ For an intellectual and political portrait of the former German Finance and Economy Minister, our source comes from Wolfgang Munchau, "Return to Keynes", in FT Monday October 26 1998. Oskar Lafontaine and Christa Mueller, *Keine Angst vor der Globalisierung*, Dietz Verlag Bonn 1998. A paper by Heiner Flassbeck, *Employment, Stability and Efficiency. Strategic Essentials of European Economic Policy*. March 1999, is also a source for this chapter.

²⁶ Though a narrative of these events, which took place during the seven months following the fixing of exchange rates, May 1998 through March 1999, can be very helpful, in that they provide evidence to the strategic interaction game perspective which is at the basis of this paper, I am compelled for reasons of time, to limit comments in this First Draft to a brief outline.

²⁷ The mention of the USA and Federal Germany is to make more suggestive the argument. As Louis argues: "It is impossible to conceive of the USA Federal Reserve without the President and the Treasury Secretary, or the Bundesbank without the Finance Minister and the French Bank without the Economic and Finance Minister" (Louis, 1998).

²⁸ The new political economy is summarized in a book written with Christa Mueller, and in a document circulating some weeks before Lafontaine's resignation. In the conclusion, after a lip service paid to market dynamism: "Impediments and distorting state incentives that hinder competition on the European markets must be removed.", the document lists three priority policies 1. The imperative of medium-term budget consolidation policy, which sounds a tacit threat to industrialists that no "procyclical cut" in corporate taxes can be obtained: "Budgetary policies of the Member States must credibly be oriented towards medium-term consolidation. This is not in contradiction to the free play of automatic stabilisers. Industry

There is a wealth of evidence that the coordination policy implied in the “gouvernement économique” is aimed at getting a significant pay-off in the two related sectors of interest rate and exchange rate policy. In November 1998, a vivacious debate with some bloody noses developed around the idea of introducing an economic government as a balancing economic institution. Jeurgen Stark, vice President of the Bundesbank, is reported have said that the European Central Bank needed “no counter-government and no “gouvernement économique”. A reference to ECOFIN-11, a French-inspired informal institution for macroeconomic policy co-ordination among the 11 member states of the economic and monetary union. Vice-president Stark is adamant in opposing a so called “economic policy pillar” (FT, November 3, 1998). At the same time, Wim Duisenberg, the new designed President of the ECB rejects the demand by European socialist leaders to set up an “ambitious system of target zones to stabilize the euro, dollar and yen”(FT, November 3, 1998).

Mid-November, with the crisis of pegged currencies spreading in Latin Americas, gloomy forecasts of likely recessionary trends in the USA and the UK, and a slowdown forecast in continental Europe, with a growth forecast being downgraded from 3.2 to 1.5, and the virtual disappearance of inflation gives rise to a demand side policy being favoured by almost all euro governments. Euro socialist governments²⁹ are unified in asking for major changes from EMU authorities:

must be able to rely on the fact that financial policy does not destabilise economic slumps through procyclical expenditure cuts”.

2. Wage policy is clearly addressed in terms of demand side policy and as a stabilisation anchor against inflationary and deflationary pressures: “ Wage policy plays a central role in terms of stabilisation policy. It must prevent both inflationary and deflationary potentials with wage rises within the framework of the overall economic productivity trend. It is the stabilisation anchor within EMU.”

In conclusion, the new economic policy, favoured by the leader of red-green government, is aimed at attaining two major objectives: a) a consolidation strategy of public budgets at federal and regional level (commitment to the Pact of Stability); b) slightly rising unit labour costs that are in line with the inflationary objective. The way is paved for a “new monetary policy that gives an impetus to investment and does not jeopardise the stability objective at the same time”.

²⁹ Euro socialism is not an opinion: 13 out of 15 governments in the EU are in the hands of center-left coalitions. In the euro area apart from Ireland and Spain, all the other 9 governments have center-left parties in power. All 13 governing parties gather together in the Party of European Socialists (PES), an umbrella group of socialist and social-democratic parties which has begun to have an influence on several issues of economic policy. Meetings of leftish ministers are scheduled four times per year. Further, “the PES summits of party leaders have turned in something of a caucus ahead of meetings of the European Council of Ministers” (The Economist, A continental drift – to the left, pp.41-42, October 3rd-9th 1998, quotation p.41).

- An economic government” in the office of ECOFIN-11 to offset the newly created supranational monetary institution;
- An interest rate policy which takes into account growth performance;
- Exchange rate management (target zones policy) to stabilize the Euro exchange rate against the dollar and yen

The priorities of the euroland political economy are set. However, only the second one, interest rate cuts down, has actually been achieved, and it seems likely to be the one which is more suitable to the euro area in the near future. The other two priorities were soon abandoned with the Lafontaine’s departure. The rest of this chapter tries to explain why just one out of the three is set to be a pivot in the ECB monetary policy.

3.2 Coordination, interest rate, and exchange rate: three pillars of the new leftish political economy.

Coordination as a full-fledged institution is mentioned in the Werner Report but not in the Maastricht Treaty, the new proponents of “a macroeconomic coordination” argue that only an “ad hoc institution” (ECOFIN-11) can be the appropriate interlocutor speaking for 11 or even 15 countries to the ECB. In Lafontaine’s extreme version, this “ad hoc” institution must organize the EMU countries so as to form an “effective counterpart to the ECB”(Munchau, FT). The argument won a large consensus in the aftermath of German elections(September, 1998). In October 1998, Oskar Lofontaine, future Finance Minister, met with the French Finance Minister Dominique Strauss-Kahn, to discuss a strategy for exchange rate target zones, and co-operation policy. The latter priority was high in their agenda. The issue of an institutionalized coordination body is an old dream among European countries. In the Werner Report a “center of decision for the economic policy” was designed as to take the lead of the community-wide economic policy. Though vague in details, the Werner Plan, written in March 1971, sketches out the creation of an economic center dedicated to putting forward the Community’s interest :

“The center (..) will exercise in an independent way, for the sake of the Community’s interest, a decisive influence over the general policy of the Community. Given that the role of the Community budget as a conjuncture instrument will be insufficient, the Community’s center of decision making has to take the appropriate measures suitable to influence national budget policy. Especially the level and the content of expenditure as well the methods of deficit financing and the use of surpluses should be monitored and assessed. Further, any change in the parities of the new currency or of the basket of the national currencies should be handled by this Center. Eventually, in order to ensure the necessary link with general economic policy, its responsibility should be extended to other domains of the economic and social policy which are being transferred to the Community level (etc).”³⁰

³⁰ The rough translation from the French is provided by the author.

The Werner Plan was not implemented because of the untenable policy of fixed exchange rates, and its “dominant Keynesian” philosophy. The architects of the Maastricht Treaty as those of its predecessor the Delors Report were careful not to reawaken interest in “center of decision”. In the mid 80s, with increasing capital mobility and neo-liberalism policy at its peak, a “center of decision” was perceived as an old-fashioned tool. Conservatism in monetary policy, with a relaunch of central banking, and market-oriented surveillance came into fashion. At the end of the 80s, the Delors Report mentions private markets as a means of fiscal discipline³¹, and references to an “economic center of decisions” is dropped. With regards to monetary policy, governments were barely recognized as having the right to set exchange rate parities, and only a few and vague words were said about a coordination policy, which in the Maastricht Treaty is limited to coordinating and monitoring budget discipline, and not to its earlier meaning of coordination among governments over the objectives of the monetary policy. In the Stability Pact (Amsterdam 1997), coordination is clearly designed as a means of surveillance aimed at insulating the ECB from inflationary pressure, or from having to bail out high debt and deficit countries.³²

Under the legal rules, as the Maastricht Treaty does not have any provisions for economic management only informal coordination can be achieved through cooperation between governments³³.

2. The second main objective of Euro governments is to get a policy of lower interest rates. It was in the fall of 1998, four months after the qualification session of May 1998, and in the aftermath of the victory of the green-red coalition in Germany that the issue of interest rates was again placed high up on governments agenda. With an overwhelming majority of socialist and former communist parties in government, the Euro-countries achieved their major objective by gaining admission to the Euro club. In the last week of December 1998, the impending European Central Bank made its first, interest rate cut

³¹ Delors Report, 1988: “to some extent, the forces of market can exercise a discipline effect”.

³² The Pact of Stability and Growth signed in Amsterdam 1997 is specifically designed to this objective. For a critical assessment of the Pact of Stability in a perspective which draw on a public choice approach, see Campanella 1998a, 1998b.

³³ The Maastricht Treaty, however, sets somewhat as an informal “communication” line between the Council of Ministers, in the office of ECOFIN and ECOFIN-11 and the ECB’s Governing Council. In a public speech done by Wim Duisenberg May 5, 1999 at the Bank of Poland, there is reference to the practice of formal “invitation” and informal meeting with ECOFIN-11: “(..) independence should not mean isolation. It is important to have a regular exchange of information and views with other policy-makers. The Maastricht Treaty stipulates that the President of the ECB is invited to meetings of the EU Council meeting in the composition of the Ministers of Economy and Finance whenever there are issues on the agenda which are relevant to the ECB’s tasks. The President of the Council of Ministers and a member of the European Commission may attend meetings of the Governing Council, although they do not have the right to vote. The President of the Council of Ministers may submit motions for deliberation. Apart from these formal contacts, there are many informal contacts, for example in the context of the so-called Euro-11 group of finance ministers from the euro area countries. I regularly attend meetings of this group.”

setting it at 3%. "The Economist" commented: "One reason why many European politicians were so keen on the single currency was to loosen the Bundesbank's grip and so make it possible to have lower interest rates across Europe."³⁴ Though, especially the neo-elected German politicians are publicly pressing for lower interest rates on the ground that inflation rate was at its lowest ever level in Germany (0,7 against an Italian 1,7%), it turned out to be a rare opportunity for euro governments to shift attention away from painful structural reforms to a policy of lower interest rates. Blessed by the disappearance of intra-european exchange rates, unable to attain those structural reforms which are called for by the Maastricht "convergence criteria", Euro governments are now eager to earn all benefits that a single currency offers. Lower interest rates and pressure on the ECB to ease borrowing and debt servicing fit in perfectly with the preferences of socialist oriented governments.

The economic theory argument goes that in a low inflation environment, a monetary policy limited to price stability, can become dangerous. Louis puts it with strength:

"It is not economically, nor socially, nor politically justifiable to realize the objective of price stability at the price of recession" (Louis, 1998).

3. Exchange rate and target zones are the major cause of disagreement between of the euro governments and the ECB. The launch of the euro has raised many questions concerning the relationship between the exchange rate, the ECB's monetary policy and the national governments' room for maneuver. However, since January 4, a "natural" fall of the euro exchange rate against the dollar, with a more than 10% loss of the new currency, has come to the help of both parties, and the ECB has refrained from adopting an interventionist policy. The underlying theory is that an exchange rate policy has become less important in the monetary policy of the Eurosystem with the introduction of a single currency³⁵. Firstly, because taken separately, most euro area countries are exceptionally open economies with the sum of their exports plus imports as a share of their combined GDP reaching about 53% (1997). Instead, looking to whole euro area in the world economy, trade in goods, measured as exports and imports combined, is

³⁴ The Economist, "Not Cut and Dried", Nov. 28th-December 4th 1998, p.97

³⁵ Wim Duisenberg, The Euro, the Dollar, and National Economic Policy. Paris, 25 March 1999. "For the purpose of today's discussion I would propose to break down this rather complex issue into three aspects: namely, the role of the exchange rate of the euro in the Eurosystem's monetary policy strategy, the ECB's view of recent developments of the euro exchange rate vis-à-vis the US dollar, and the relationship between the single currency in the euro area and the flexibility of macroeconomic and structural policies in euro area countries.

Nevertheless, exchange rates affect the maintenance of price stability as they influence import prices and activity, and thereby consumer prices, in the euro area. Moreover, they reflect market expectations about future economic developments and policies. Furthermore, due consideration has to be given to the exchange rate of the euro against the background of the importance of the euro area in the international monetary and financial system.

around 26% of GDP and thus only little higher than that of the United States and Japan. As a consequence of SEA and EMU, the euro area has grown as a “bloc” economy with a common currency and a lower exposure to world market. Against this background, a certain instability in the euro exchange rate because domestic economic contingencies turns out to be less important compared with the same instability in the exchange rate of a national currency in the past. The ECB, in the words of its President, is not set to ignore (benign neglect attitude) the likely effects that instability in the exchange rate of the euro can trigger on economic activity and prices. The ECB – Duisenberg insists- takes the exchange rate as a significant variable in the “outlook for price stability”, and it “still undoubtedly plays an important role in the monetary policy of the Eurosystem”.

In the ECB’s practical theory, the primary objective of the single monetary policy is the maintenance of price stability. “Monetary policy will always be geared to this objective”. As a consequence, Duisenberg adds, “the monetary policy strategy of the Eurosystem does not embody an implicit or explicit exchange rate target or objective, since gearing monetary policy decisions to maintaining such an exchange rate target may, at times, conflict with the goal of price stability”.

On balance, the ECB commitment to price stability carries more weight than exchange rate stability. Though Duisenberg insists on exchange rate movement as a natural dynamic of open economies, it does not come as a surprise that analysts and some economists have started to perceive a kind of “mild benign neglect” in the ECB’s exchange rate policy³⁶.

A rejection of exchange targeting (or target zones)³⁷, a policy aiming at ensuring exchange rate stability is the logical consequence of the above approach. The ECB reminds those who argue for “target zones” that the Bundesbank’s approach would be fundamental to such a parameter. As a consequence the burden of exchange rate stability has to shift on the shoulder of euro governments:

“(..)the ECB subscribes to the view that the exchange rates are primarily the outcome of current and expected monetary, fiscal and structural policies as well as cyclical and other economic developments, rather than an objective or target of monetary policy”.

Economic literature agrees that exchange rate misalignments and excessive volatility often reflect macroeconomic imbalances and/or market uncertainties. One of the pillars of the stability culture is that only stability-oriented macroeconomic policies pursued in a transparent way are the best contribution that

³⁶ Tony Barber, ECB attempts to soothe fears over euro’s weakness. FT April 26, 1999. In this paper p.

³⁷ Exchange rate target is one of the most controversial topics in monetary literature. The consequences on a country economy of an active stance or inactive *laissez faire* policy are still being debated. For a review and assessment see Kathrin M. Dominguez and Jeffrey A. Frankel, Does Foreign Exchange Intervention Work? Institute for International Economics. Washington DC. 1993. Pp.43-49.

policy-makers can make to foster exchange rate stability. In Duisenberg's words, only by "addressing their underlying causes should contain misalignments and excessive volatility. The Eurosystem's stability-oriented monetary policy strategy ensures that the single monetary policy makes the best possible contribution in this regard". Against the sustainers of target zones, Duisenberg emphasizes the necessity of exchange rate movements. Instead, "direct targeting does not address, by themselves, the underlying causes of misalignment. Monetary policy in particular cannot correct misalignments caused by structural or fiscal policies. They need to be addressed via other policy actions".

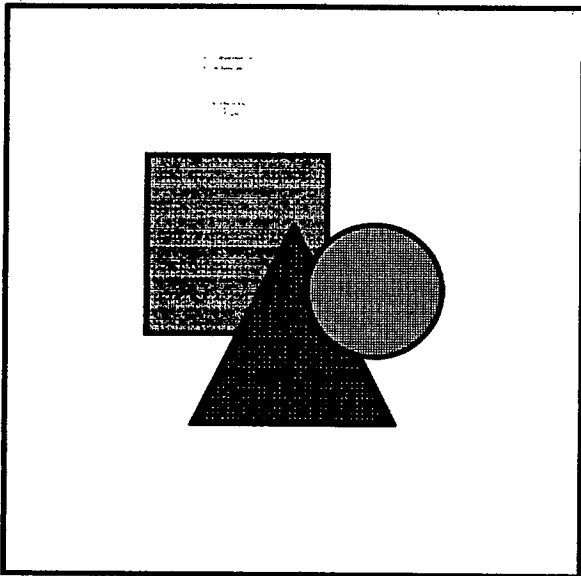
The key-argument in Duisenberg's speech comes, however, from globalization of financial markets. "(I)n a world characterized by integrated and highly liquid international financial markets, there is serious doubt as to whether pegging or targeting exchange rates is feasible. The sophistication, depth and liquidity of today's financial markets make it increasingly difficult for a central bank to defend an exchange rate for a prolonged period. In addition, the experience with exchange rate co-ordination among the G7 countries shows that it has always been very difficult to agree on a common objective. Some ERM Member states also experienced obstacles to exchange rate co-ordination. When during the late 1980s and early 1990s economic developments in some Member States of the ERM diverged, their bilateral exchange rates came under pressure, and eventually the exchange rate bands had to be widened to ensure two-way risk for speculators. Some currencies were even forced to abandon the ERM. These experiences are now reflected in ERM II. ERM II has relatively wide standard fluctuation bands and the ECB has the possibility of suspending intervention and financing if these could impinge on its primary objective of maintaining price stability. ERM II is explicitly designed to foster convergence to the euro area of countries that have not yet adopted the euro".

As a consequence, Duisenberg argues that "the ECB subscribes to the view that the exchange rates are primarily the outcome of current and expected monetary, fiscal and structural policies as well as cyclical and other economic developments, rather than an objective or target of monetary policy. Exchange rate misalignments and excessive volatility often reflect macroeconomic imbalances and/or market uncertainties. Accordingly, stability-oriented macroeconomic policies pursued in a transparent manner are the best contribution that can be made by policy-makers to fostering exchange rate stability. In other words, addressing their underlying causes should contain misalignments and excessive volatility. The Eurosystem's stability-oriented monetary policy strategy ensures that the single monetary policy makes the best possible contribution in this regard. By contrast, attempts to suppress exchange rate movements through direct targeting do not address, by themselves, the underlying causes of misalignment. Monetary policy in particular cannot correct misalignments caused by structural or fiscal policies. They need to be addressed via other policy actions".

Further it should be remembered that the European experience of Exchange Rate Mechanism and its disruptive consequences on exchange rate fluctuation bands occurred through 1992-1993. As Solans declares "European experience has shown that certain good common macroeconomic fundamentals represent the best strategy for achieving a better co-ordination of exchange rates."

If this is the general theory against target zones, a second argument developed by ECB officials is less tenable. On the contrary, the arguments in defense of the euro exchange rate performance against the USD, though technically acceptable some two months ago, are turning to be too weak later this month³⁸. Nevertheless taking the ECB officials arguments, there is some truth that during the first 100 days of the introduction of the euro, there was no sharp volatility in the euro exchange rate against the other major currencies. The money markets worked smoothly and there were no too rapid or too large shifts in the share of financial assets denominated in euro.

As Solans observes: "As regards the exchange rate, the euro has gradually depreciated from the beginning of the year, but volatility has been small compared to what was expected for a new currency. In any case, - he sustains- if you compare the present exchange rate of the euro vis-à-vis the dollar with the 1998 average of the so-called synthetic euro, you will realize that they are similar".



With a similar argument, Sirkka Hämäläinen, member of the Executive board of the ECB, argues that "The euro is at present traded at a level close to the levels prevailing for its predecessor ecu for most of 1997 and 1998. This level should be seen against the economic situation in the euro area as compared to the US. The US economy is continuing to grow rapidly, the employment situation is favourable and the fiscal situation is well under control with a healthy surplus in the government budget. In contrast, economic activity in the euro area is more subdued. Unemployment is high and the confidence of enterprises is weak, while consumer demand and consumer confidence remain rather good. At the same time, the economic slowdown and insufficient structural measures have resulted in a stagnation in the efforts to achieve fiscal discipline". To a large extent, the developments in the foreign exchange markets over the last few months can be characterised as a period of "dollar-strength" rather than "euro-weakness". The US dollar has

appreciated against all other widely-traded currencies. The positive development of the US economy is a major factor behind this "dollar-strength". In addition, the US dollar appears to have gained further strength due to the Kosovo-crisis in Europe. (..).

3.3 The game of the chicken.

In conclusion, a battle of fiscal-monetary dominance has characterized the first 6 months of the euro era. Leadership is at stake and the battle is between Lafontaine (and euro-governments), whom we assume to favour a "fiscal dominance" policy, [an assumption that is clearly proved by the strong convergence of views between Lafontaine and Strauss-Kahn], the two top finance ministers in the euro area- and the monetary dominance cast by the ECB, in the cloth of its President Wim Duisenberg.

Consider monetary-fiscal policy interaction as being similar to that represented in Fig. 1. Payoffs are arbitrary and chosen to capture the benefits derived from fiscal and monetary policy paths being coordinated in the short run and mutually consistent in the long run. Conversely if policymakers are on a collision course, the payoffs are negative (-1,-1). Figure 1 also shows that both sides have an incentive to fall in line, that is to say, to accommodate. Faced with lax fiscal policy, the monetary authorities³⁹ will in the end be forced to accommodate and, likewise, facing a tough ECB fiscal authorities will "chicken out" and accept discipline.

There are two Nash equilibria in the game shown in Figure 1. The Central Bank prefers the "tight" equilibrium (top-left) with tight monetary and fiscal policies (4,2), whereas the fiscal authorities prefer the "lax" outcome (bottom-right) with relaxed policies (1, 3). The payoffs are as in the standard game of "chicken". Figure 1. portrays pretty well the dynamics of the game between the ECB and the euro governments, epitomized by Lafontaine stance.

In the last three months of the euro era, the ECB has stuck to a tight monetary policy maintaining interest rates at 3% against a growth of inflation rate below 2%.

³⁹ Monetary authorities are the Governing Council of the European Central Bank (ECB), which consists of the eleven governors of the national central banks (NCBs) of the participating Member States and the six members of the Executive Board of the ECB. The implementation of the single monetary policy is the responsibility of the Eurosystem, which is comprised of the ECB and the eleven NCBs of the participating Member States. The Executive Board of the ECB is a separate decision-making body. Its role is to ensure that the tasks conferred upon the European System of Central Banks (ESCB) are implemented, either through its own activities or through the NCBs.

Figure 1. A Game of Chicken.

		Fiscal Authorities	
		Tight policy	Lax policy
ECB	Tight policy	4, 2	-1, -1
	Lax policy	0, 2	1, 3

How to assess the ECB monetary stance after Lafontaine resignation? By cutting interest rates by a half point (2.5 %) in the midst of a euro weakening exchange rate against USD, it seems that the ECB is set to fall in line and to accommodate euro governments preferences: payoff bottom left :1,3.