Alice in Euroland*

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ABSTRACT

The paper contains a detailed critique of the common currency arrangements of the Economic and Monetary Union, embodied in the laws and emerging procedural arrangements that govern the actions of its key institutions: the European Central Bank and the European System of Central Banks. The main message here is "Great idea, shame about the execution". A number of improvements are then proposed. Some of these require amending the Treaty, including an end to the rule that each EMU member's national central bank has a seat on the Governing Council or the removal of the power of the Council of Ministers to give 'general orientations' for exchange rate policy. Others, notably in the areas of accountability, openness and transparency, could be implemented immediately, including publication of voting records, minutes and the inflation forecast. Improved arrangements are also advocated for the coordination of monetary and fiscal policy. And the article calls for a European Parliament that can both bark and bite.

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LONG ABSTRACT

The legal framework, institutional arrangements and emerging operating practices of the ECB/ESCB are flawed and in urgent need of modification. At the very least, the ECB's deficiencies pose a threat to its continued operational independence. Beyond that, they could put the common currency's survival at risk. A threat to the common currency is a threat to the entire EMU edifice and to the continued success of the post World-War II European integration process.

Change will have to come quickly to the ECB. Some of the necessary changes are constitutional in nature and require amendments to the Maastricht Treaty. This is a difficult, cumbersome and slow process. Among the constitutional changes I propose are the following.

- Abolish the 'one-country-one-seat-on-the-Governing-Council' rule; restrict the size of the Governing Council to no more than nine members and the size of the Executive Board to no more than four members.
- Abolish the clause in Article 109 giving the Council of Ministers the power to formulate 'general orientations' for exchange rate policy. This clause creates doubts about the substantive domain of operational independence of the ECB.
- Charge the ECB explicitly with responsibility for systemic financial stability in Euroland. The words "lender of last resort" should be used in the revised Treaty.
- Create a body that has the power to vet and make binding recommendations about the *procedures* used by the ECB. One possibility is a body composed of MEPs and members of the European Court of Justice.

Other necessary changes can be made overnight, at the discretion of the Governing Council itself. They include the following.

- Publish the minutes of the meetings of the Governing Council and of its relevant committees and sub-committees.
- Publish the individual voting records of Governing Council members.
- Publish the inflation forecast.
- Clarify the operational inflation target.
- Abandon attempts to create a culture of 'collective responsibility'. Presenting a spurious united front to the outside world adds to uncertainty about the likely future stance of monetary policy. It also would slow down the Governing Council's ascent of the learning curve.

A third category of changes does not require Treaty amendments, but cannot be implemented at the sole discretion of the Governing Council either. These include the following.

- Strive for institutional arrangements and practices that make for better co-ordination of monetary and budgetary policy in Euroland.
- Flesh out the lender of last resort function of the ECB. Note that this does not have to wait until the Treaty is changed. While formal recognition, in an amended Treaty, of the ECB's systemic financial stability role and lender of last resort function would be helpful, the existing Treaty does not proscribe such a role and function. The ECB should just get on with it.
- Spread the message that authority in the ECB/ESCB is centralised. National Central Banks are useful conduits for national information. Independent NCB

research departments provide useful safeguards against intellectual ‘democratic centralism’. Beyond that they have no essential function and certainly no substantive authority. The Treaty is clear on this, but not all NCB governors appear to have read or understood the relevant passages. This, too, creates unnecessary uncertainty.

- Evolve a European Parliament with teeth. It does no good either to the European Parliament or to the ECB to have the President of the ECB walk all over the MEPs.

It is my hope and expectation, that the ECB/ESCB will change along the lines indicated above, and that EMU will succeed in generating greater Euroland-wide prosperity than would have been likely under any alternative monetary arrangement.

(I) Introduction

"Would you tell me please, which way I ought to go from here?"
"That depends a good deal on where you want to get to ..."[1]

Economic and Monetary Union arrived *de facto* on 3 December 1998, with Euroland central banks co-ordinating a rate cut. While it did not start *de iure* until the beginning of 1999, the December action was truly the first monetary policy decision of the European Central Bank (ECB) and the European System of Central Banks (ESCB). The UK, true to its tradition of joining new European institutions late and reluctantly, will not participate in EMU until further notice. The launch of EMU is a global political and economic event of the first order. It will profoundly affect the lives of all those in Euroland, on the fringes of Euroland or in the world at large.

The adoption of a common currency by 11 of the 15 EU members is an act without precedent. While there are some analogies with earlier monetary unions, some of which will be reviewed below in Section IV,[2] the differences far outweigh the similarities. It is a bold step into the unknown, not unlike Alice's leap down the rabbit hole[3].

One key difference with 19th century attempts at monetary union, and with other international monetary arrangements such as the classical gold standard, which endured from 1880 till 1914, is that today monetary policy is perceived as the primary macroeconomic stabilisation instrument. Policy makers, including central banks, are held responsible for macroeconomic and financial stability in all its dimensions: price stability; steady growth of real output; stable unemployment and capacity utilisation rates; and orderly financial markets.

A second key difference is that all EMU members have representative, democratic forms of government. This imposes demands for openness and accountability on governments, government agencies and individual policy makers, including central banks and central bankers, that were unheard of in the last century. Indeed, the novelty of demands for openness and accountability of central banks is even this year causing manifestations of severe cognitive dissonance among some previously sheltered central bankers.

A third difference is that EMU is part of an ongoing process of economic and political integration in Europe, and not an isolated, 'technical', monetary arrangement. In this it differs from arrangements like the classical gold standard, which flourished between 1880 and 1914, the heyday of European imperialism and nationalism. EMU is foremost a major step on the road to 'ever closer union' in Europe. It represents the opening of a new chapter in the European federalist agenda, a significant transfer of national sovereignty to a supra-national institution. The European super state is, however, not yet even a twinkle in the federalist's eye. Not only is the EU, or even Euroland, not a federal structure (see e.g. Inman and Rubinfeld [1998]), its supranational institutions are so weak as to not even amount to a confederate

[1] Exchange between Alice and the Cheshire Cat (Carroll [1865]).
[2] See also Bordo and Jonung [1997].
[3] See Lewis Carroll [1865].

arrangement. The existing EMU is probably best characterised as a proto-confederation.

While few technical economic implications for further European co-ordination, co-operation, harmonisation and institutional development follow from the act of monetary union, the political imperatives that created EMU will give momentum to a range of such further developments. For example, the European Parliament, the body charged with the political oversight of the ECB, will get a major role in supervising a highly visible institution with important day-to-day executive responsibilities. I expect that the European Parliament will, despite a rather timid beginning, sharpen its teeth on this oversight function, that it will like the sensation of being involved in true Parliamentary oversight, and that it will use the leverage thus acquired to extend its power throughout the domain of European supranational competence.

In this lecture, I will explore the institutional arrangements and emerging operating practices of the ECB/ESCB, and the embryonic fiscal co-operation and co-ordination arrangements such as the EuroXI. Along the way we will encounter many characters and situations from Lewis Carroll's celebrated oeuvre[4]. It will be up to the reader to identify Alice, the Red Queen, the Cheshire Cat, the Dodo, the Mad Hatter, the Jabberwocky, the Tea Party and the Caucus-Race and to weigh the merits of my proposals for preventing EMU from drowning in the Pool of Tears and for avoiding Humpty Dumpty's cruel fate.

As a long-standing European federalist and proponent of a common currency for all EU members, I find myself in the sometimes awkward position of being in favour of the objectives of ever closer economic and political union (including monetary union), yet highly critical of the current expression of these objectives in institutions, rules and policies[5]. This tension, which I hope to be a creative one, permeates this lecture.

(II) The Perils for EMU and the Perils of EMU

The recent Asian crisis had repercussions as far away as South Africa, South America and the Russian Federation. The resulting international financial turmoil provides a useful reminder of the validity of my long-held view that, with unrestricted international mobility of financial capital, a common currency becomes the only sensible exchange rate regime[6]. Fixed-but-adjustable pegs are accidents waiting to happen. Market-determined or freely floating exchange rates are viable in the technical sense that such arrangements can survive. They do so, however, at the cost of excessive volatility and persistent misalignment. These are inherent in the coexistence of a technically efficient financial market and sluggish price and wage adjustment in the real economy. They are exacerbated by the fact that the foreign exchange market, like any financial market, is often driven not just by fundamentals, but by speculative bubbles, fads, mood swings and herding behaviour. Flexible

[4] The reader should not limit himself to Alice's Adventures in Wonderland, but go on to Through the Looking-Glass and What Alice Found There (Carroll [1872]) and The Hunting of the Snark; An Agony in Eight Fits (Carroll [1876])

[5] See Buiter [1992; 1996a,b,c; 1997; 1998a,b; 1999], Buiter, Corsetti and Roubini [1993], Buiter and Kletzer [1991], Buiter and Sibert [1997].

[6] Certainly the only exchange rate regime that permits the potential gains from capital market integration to be realised in full.

exchange rates are not just a potential adjustment mechanism for dealing with exogenous fundamental shocks. They can also be an independent source of shocks and disturbances. The introduction of the Euro was, quite by chance, very well timed indeed.

(IIA) Technical Survival Issues: Speculative Attacks and Voluntary Quits

EMU cannot be brought down by speculative attacks among member countries, either between January 1, 1999 and the date of the final demonetisation of the national currencies (no later than July 1, 2002), or afterwards. A speculative attack among EMU currencies could no more cause a collapse of EMU than a switch from £5 notes into £10 notes could cause a collapse of UK monetary union (see Buiter and Sibert [1997] and Bulchandani [1997], although not everyone agrees with this obvious point (e.g. Eltis [1997] and Dooley [1998]). Like any currency union, it could be brought down by one or more of the constituent member states or regions *choosing* to leave the currency union. A country could, for example, find the lack of a national monetary instrument prohibitively costly in the face of a particularly unpleasant country-specific or asymmetric shock to the demand for its output. In the past, a sudden, asymmetric surge in the need for national seigniorage revenue (associated, say, with a war), often caused common currency arrangements or fixed exchange rare regimes to break up.

While the Maastricht and Amsterdam Treaties do not provide a mechanism for leaving EMU (or indeed any other of the EU institutions and arrangements), a country that wished to leave would no doubt be able to do so. The likelihood of this happening, in the absence of a major economic or political calamity, is remote, however[7].

(IIB) Legitimacy: the Achilles Heel of the ECB

EMU will survive despite a poor start, marked by the shenanigans surrounding the appointment of its first President. I am not perturbed that the French government insisted on making the appointment of the first ECB President a *political* issue. The presidency of the ECB *is* a political issue. It is quite proper that the Euroland central bankers, who thought they had settled the issue among themselves, were reminded of their proper place by the elected politicians. What is depressing is that the French president chose to make the presidency a *nationality* issue. This violated the letter and the spirit of the Treaties. The gentlemen's agreement that Mr. Duisenberg would serve for only four years and would be succeeded by 'a Frenchman' (any Frenchman?) was a rogues' agreement. It is my hope and expectation that the first incumbent will treat it with the respect it deserves.

The main threat to the continued existence of EMU will be the wide-spread perception that the ECB lacks political legitimacy. This lack of legitimacy has two

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[7] The sudden emergence of massive unbalanced positions in foreign currencies following a break-up would cause nightmares to businessmen and policy makers and would provide bankruptcy experts and lawyers with decades of gainful employment. For an interesting discussion of these issues see Scott [1998].

dimensions: first, the lack of openness and accountability of the ECB[8] and second the problem of monetary integration being ahead of general political and institutional integration. These issues are discussed in the next two Sections.

(III) Legitimacy Issue 1: Openness, Transparency and Accountability

The lack of openness, transparency and accountability written into the statutes of the ECB[9] and reinforced by the ECB's own operating procedures[10] could yet undermine the viability of the whole enterprise[11]. From this perspective, it is a pity indeed that the UK is not among the founding members of EMU. The British 'common law' genius for pragmatic institutional design and adaptation, and the example of openness and transparency in monetary arrangements set by the Bank of England since its independence in June 1997, would have provided a welcome counterpoint to the continental 'statute law' approach and the enduring continental tradition of opaqueness and secrecy in monetary arrangements and procedures.

A frequent counter to expressions of doubt concerning the legitimacy of the ECB is that the institution is grounded in a Treaty approved by 15 national governments, ratified by 15 national parliaments and further legitimised by referenda in a number of EU countries. While all that is true, it misses the point that a vote on the Maastricht Treaty was a take-it-or-leave it vote on the entire contents of a document whose scope was only slightly less encyclopaedic than the Larousse. Had I been in Europe at the time, and in a position to vote in a referendum, I would have voted in support of the Treaty. I would have done so, while simultaneously holding the opinion that further major surgery is required to bring the patient to health. As the Dutch say, "better half an egg than an empty shell".

I hope that a culture of openness will, perhaps against the odds, take root at the ECB. If it does not, I fear the ECB will not survive as an operationally independent central bank, even if the common currency endures.

[8] For a useful discussion, see De Haan [1997].
[9] See European Union [1999a, b] and Barents [1997].
[10] See European Central Bank [1998].
[11] Mr Duisenberg is quite correct to refuse to testify before any of the national parliaments. He (and the other members of the Board) should be answerable, collectively and individually, to the European Parliament alone. The Treaties provide for this, just as the Bank of England Act of 1998 charges Parliament, through the House of Commons Treasury Select Committee and the recently constituted House of Lords Select Committee on the Monetary Policy Committee of the Bank of England, with the political supervision of the Monetary Policy Committee of the Bank of England. Mr. Duisenberg could spend most of the year on a travelling road show around the Euroland capitals if he were to take that particular (French) request seriously. National central bank governors should of course be answerable to their national parliaments, although they too are mandated by the Treaties to act for the Union as a whole, not as agents for their national constituencies.

(III.A) Transparent Policies and Outcomes vs. Transparent Procedures

There is an air of unreality surrounding many of the statements about openness, transparency and accountability emanating from the Eurotower in Frankfurt. Words sometimes do not appear to have their usual meanings. Perceptions of reality are frequently far removed from the consensus outside the Tower. The appropriate response is therefore not obvious. It is rather like the problem of responding to my five-year old's complaint that her brother will not share his imaginary apple.

The central point of my position is the following. It is not sufficient that the monetary policy *actions*, or *outcomes* of the monetary policy process, be transparent. The entire process must be transparent for proper democratic accountability. A clear statement of this principle can be found in the following quote from Dr. Issing, one of the six Executive Board members of the ECB.

> *"The issue of accountability for the ECB's performance with respect to its clearly defined mandate needs to be logically separated from concerns over the transparency of the policy-making* ***process*** *itself (as opposed to the* ***outcomes*** *of this process). Transparency, openness and clarity about* ***how*** *the central bank sets out to achieve its mandate are also desirable, since they reduce the degree of uncertainty in the monetary policy process and help the public to understand and assess the central bank's actions."* (Issing [1999]).

My delight at finding this eloquent statement in Dr. Issing's writings was, however, short-lived. Three paragraphs further down in this same speech, a quite different emphasis is given:

> *"The decision by the Governing Council of the ECB not to publish the minutes of its meetings and not to make public the voting behaviour of its members has been criticised in some quarters as a lack of accountability and transparency.* ***In this context one should recall that, for the purpose of accountability, what matters most will be the ECB's actual track record of stability performance"*** (Issing [1999]; emphasis added).

This last view continues the traditional Bundesbank approach to transparency, openness and accountability[12], and appears to be the dominant one in the ECB, if one goes by the public utterances from Governing Council members and emerging procedural conventions. An extreme variant of this position is that monitoring the performance of inflation in relation to its target is all the transparency the public needs. The following quote from Mr Duisenberg, can be viewed as an expression of that position.

> *"Thus, publication of the forecasts cannot contribute to accountability. Rather, its performance in maintaining price stability in the medium term*

[12] In the traditional Bundesbank view, it did not matter at all that the Bundesbank's procedures were completely non-transparent. The policy actions, or the policy rule adopted by the Bundesbank were completely transparent, and it was only the actions that mattered. See e.g. Stark [1998], and especially Remsperger [1998].

should be used by the public to judge the success of the Eurosystem” Duisenberg [1999a].

I disagree with this position, for a number of reasons. First, one cannot have this paternalistic approach to economic policy making in a contemporary democratic society. Mr. Duisenberg’s accountability model, which suggests that as long as daddy brings home the bacon, mummy and the children ought not to ask where he got it, is not viable as a modern model for the relationship between the citizen and the state. Openness and transparency of the state are indivisible. If one state agency, say the central bank, can deny access to information for reasons other than clear and present danger to the public interest, the citizen’s right to know is impaired across the board. Sunshine laws , openness, freedom of information, and accountability are an essential defense of the citizen against a powerful and overbearing state.

Let us recall why the day-to-day conduct of monetary policy has, across the world, been taken away from elected politicians and delegated to appointed technocrats. It is entrusted to operationally independent central banks as a safeguard against opportunistic behaviour by elected politicians. An independent central bank is a commitment device to ensure that the flexible and powerful monetary stabilisation instrument is not used in the pursuit of short-term political advantage. The objectives of low inflation, financial stability and sustained growth and employment are best served by removing the interest rate instrument from the rough and tumble of partisan politics. By establishing an independent central bank, executive responsibilities are delegated by the elected authorities to an unelected body. In a democratic society, such decision making by technocrats is only acceptable and viable if the institution to which these decisions are delegated is accountable to the public at large and to its elected representatives. Accountability is a good in itself, as well as an important instrument of quality control.

There is a second, practical, reason why, in the case of the ECB, adequate accountability cannot be achieved by relying on the public’s judgement of the performance of the Central Bank with reference to its target. The ECB, at the time of writing, has a track record of just over two months. Even if one were to dismiss the argument for openness as a public good, it will take years, possibly decades, for the ECB to build up a track record on inflation and the subsidiary objectives mandated by the Treaties. “Performance is all the transparency the ECB needs” might work, in an authoritarian European state, and in twenty years time. It is not an option today.

(III.B) What is the ECB’s Target?

It is common ground that accountability is much enhanced if the objectives pursued by the central bank are clearly spelled out. In the UK, the Bank of England only has operational or instrument independence. Even this operational independence, that is, the freedom to set its Repo rate, is qualified by the clause that in “extreme economic circumstances”, the Chancellor can give instructions to the Bank of England for a limited period, and subject to (ex-post) approval by Parliament. These Treasury reserve powers have not been invoked in the 21 months the Bank has been operating under the new rules[13]. The Bank of England Act 1998 states that in relation to monetary policy, the objectives of the Bank of England shall be (a) to maintain price stability and (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment (Bank of England Act [1998]). Not only are the general objectives of the Bank of England set by law, the operational expression of the price stability target is formulated by the Chancellor of the Exchequer. Since June 1997, this has been a symmetric target of 2½ percent annual inflation in the retail price index exclusive of mortgage interest payments (RPIX).

Formally, the ECB also has only operational or instrument independence. Its targets are set by the Treaties. The primary objective of the European System of Central Banks, as defined in Article 2 of the Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute), is to maintain price stability. Without prejudice to the primary objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community. In pursuing its objectives, the ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources.

The operational expression of the overriding objective of price stability is left to the ECB itself, in sharp contrast to the British practice. Recently, the ECB adopted an inflation objective of an annual rate of inflation of no more than 2 percent (for the Harmonised Index of Consumer Prices (HICP)[14]. This appears to be asymmetric, as it sets an upper limit for the rate of inflation but no lower limit (inflation rates can be negative as well as positive). Recent clarifications from Frankfurt have made it clear, however, that the term *inflation*, when used by the ECB, is meant to be interpreted as *positive* rates of inflation only. When the inflation rate is negative, the term inflation is dropped and replaced by *deflation*. This would imply that there is a lower limit on the target rate of inflation (on the HICP index) of zero[15]. The existence of a ceiling and a floor does not mean the target is symmetric, that is, centred in the middle of the range. The ECB, unfortunately, has been adding to the confusion in the markets about the nature of its inflation target by a succession of ambiguous statements by members of its Executive Board.

There now is some evidence pointing to the existence of a "zone of inaction" for monetary policy. The strongest version of this "zone of inaction" monetary policy model has the ECB keeping rates unchanged as long as inflation (on the HICP measure) stays between zero and two percent at an annual rate. Interest rates will be cut when inflation falls below zero and raised when inflation rises above two percent.

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[13] I assume here that during the period June 1997 till June 1998, when the MPC was operating but the Bank of England Act had not yet become the law of the land, the Treasury had the same reserve powers that they now have under the Act.

[14] See European Central Bank [1998].

[15] The following quote confirms this.

"Price stability has been defined and publicly announced as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. This definition mirrors our aversion to both inflation and deflation. Hence neither price increases in excess of 2% nor deflation - *that is, a persistent fall in the price level* - *would be deemed to be consistent with price stability"*, Duisenberg [1999b]. See also Duisenberg [1999a].

Some recent statements by Mr. Duisenberg are consistent with this interpretation (see Duisenberg [1999a,b].

Coupled with his statement to the BBC's Money Programme on 31 January 1999, that *"If there were signs of deflation then the lowering of interest rates would be justified. But we are not there yet"*[16], one is driven to the interpretation that rates are not cut until there is deflation, that is, negative inflation[17].

The ECB clearly is not yet singing from a time-invariant (let alone a predictable) hymn sheet when it comes to explaining to the markets and to the public at large what its inflation target is and how its interest rate instrument will be dedicated to the pursuit of that target. This creates unnecessary confusion and adds to the uncertainty faced by firms and households when making decisions. It also weakens the only kind of accountability the ECB appears to be comfortable with.

(III.C) Limits on the ECB's Operational Independence

There is no provision in the Treaties for any other agency to give instructions about monetary policy to the ECB, under any circumstances, so in that respect the degree of operational independence of the ECB is greater than that of the Bank of England.

In a quite different way, however, the effective domain of ECB operational independence is restricted by a vague and ambiguous set of paragraphs in Article 109 of the Maastricht Treaty concerning the powers of the Council of Ministers to give the ECB Governing Council instructions about the external exchange rate of Euroland.

The first of these restrictions is non-controversial and harmless, from the point of view of ECB independence. It allows the Council of Ministers to conclude formal exchange rate agreements on an exchange rate system for the Euro in relation to non-Community currencies. Basically, this allows the political leadership of Euroland to create a new Bretton Woods, should they wish to.

The second restriction is potentially a threat to the substance of ECB independence: *"In the absence of an exchange rate system in relation to one or more non Community currencies as referred to in (the previous) paragraph … , the Council, acting by a qualified majority either on a recommendation from the Commission and after consulting the ECB or on a recommendation from the ECB, may formulate general orientations for exchange rate policy in relation to these currencies. These*

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[16] The Guardian, 1 February 1999, page 18.

[17] A further source of ambiguity concerns the question of whether the references to inflation and deflation refer to inflation and deflation according to the observable but flawed HICP index or according to some perfect but unobservable true cost of living index. If HICP inflation exceeds true inflation (because of unrecorded quality improvements and the failure to allow fully for substitution from more expensive to cheaper goods when the inflation rates of individual goods prices are non-uniform), interest rates could be cut while the HICP inflation rate was positive, because according to the 'true' price index there would be deflation.

general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability."

This paragraph has given Mr. Lafontaine and Mr. Strauss-Kahn a window of opportunity for proposing exchange rate target zones. It is likely to be a permanent source of tension between the Council of Ministers and the ECB. The effective domain of monetary policy is severely circumscribed, and in the limit reduced to nothing, if constraints can be set on the behaviour of the nominal exchange rate. Note that it is not clear from Article 109, who, in case of a disagreement between the Council of Ministers and the ECB, has the authority to determine whether a particular 'general orientation' is prejudicial to the price stability objective - the Council of Ministers or the ECB. It is most unfortunate that this clause was allowed to slip into the Treaty. One can only hope that, in practice, these 'general orientations' will either not be forthcoming or, if they are, that ECB will be able to impose itself as the final arbiter of what is and what is not prejudicial to its price stability objective.

(III.D) Publication of Individual Voting Records

The Bank of England publishes the individual voting records of the MPC members after 2 weeks. The Federal Reserve Board publishes the individual voting records of the Federal Open Market Committee (FOMC) members after 6 or 7 weeks. The Bank of Japan, under the new Bank of Japan Law which came into effect on April 1, 1998, publishes the individual voting records of its Policy Board about 8 weeks following the meetings, when the minutes are released. In Japan, the dissenters from the majority vote even explain their dissent in an attributed section of the minutes (the bulk of the minutes is non-attributed).

The ECB does not plan to publish the individual voting records of its Governing Council members. Two kinds of arguments are made in defense of this position. The first is that the Maastricht Treaty forbids publication. The second is that the multi-national make-up of the ECB Governing Council makes publication of the individual voting records unwise, because it would undermine the independence of the Governing Council members. The first argument is factually wrong. The second merely makes no sense.

In the Financial Times of 21 September, 1998, Dr. Issing asserts that the Maastricht Treaty specifies that the ECB's Governing Council may decide to make public the outcome of its deliberations, but not the voting behaviour of its members. In fact, in the Protocols annexed to the Maastricht Treaty, it is stated that: *(10.4) `The proceedings of the meetings shall be confidential. The Governing Council may decide to make the outcome of its deliberations public'.* (European Union [1999b]). The statement that the proceedings of the meetings shall be confidential means no more than that the meetings are closed to the public. There will be no spectators in the public gallery and the meetings will not be broadcast live on CNN. It does not mean that edited, non-attributed minutes cannot be released (an issue covered at greater length in Section III.E). The Protocol is also perfectly consistent with publication of the individual voting records, provided the individual votes are defined to be part of the *outcome* of the deliberations, rather than as part of the proceedings. The legal fig-leaf for non-publication of the individual votes therefore is definitely not attached securely.

Dr. Issing also states in his Financial Times article: *"The real issue is whether making the votes known to the public effectively contributes to accountability*". I agree. He goes on to say that *"Making individual member's voting behaviour public would encourage undesirable scrutiny of members' voting patterns. This, in turn, would encourage external pressures on the Council members, arising from local interests. Independence, granted by the Treaty, would be at risk."* The same argument has been made by Mr. Duisenberg. In an interview published Monday, 29 June 1998 in the Frankfurter Algemeine Zeitung, Mr Duisenberg is reported as saying "*If the vote of the national representative were known, there would be unpleasant questions with the aim of pressuring him in future votes*". I share the concern about inappropriate external pressures. The argument of Mr Duisenberg and Dr Issing, however, gets it backwards.

In a speech given on January 28, 1999, Dr. Issing, relying on proof by repeated assertion, simply restates the earlier canard about the link between publication of individual votes and pressures generated on individual members by national or local interests (Issing [1999]).

National political authorities and other interested parties will undoubtedly try to put pressure on `their' nationals serving on the ECB Board as well as on `their' national central bank governors. This is against the spirit and letter of the Treaty, but it will surely happen. The question is how the ECB Board members and national governors can be most effectively shielded from such pressures.

Whatever the formal confidentiality of the ECB Council meetings and votes, the national heads of government (and other prospective lobbyists), will know exactly who voted in favour of what, within five minutes of a vote being taken. Six Executive Board members, eleven national governors, countless staff and possibly a member of the Commission and the President of the Council of Ministers, will be present at the ECB Governing Council meetings. Leaks, and even open breaches of confidentiality arrangements will be the rule rather than the exception[18]. Extensive selective leaking and competitive briefing of the media by individual Governing Council members, behaviour characteristic of the Bundesbank in the past, are poor substitutes for proper accountability.

The information required to bring pressure to bear will be available, *de facto*, to the national political insiders. Borrowing from the language of contract and regulation theory, there will be *observability* of the individual voting records. That information will not, however, be formally available to the bodies charged with supervising the ESCB (the European Parliament for the whole ECB Governing Council, and national parliaments for most national central bank governors). Council members will be able to hide behind the cloak of confidentiality, and to avoid having to justify or defend yielding to national or local political pressures. In the language of contract theory, there will not be *verifiability* of the individual voting records (Laffont and Tirole [1993, p. 211]).

[18] The voting records were in fact leaked as early as February 1999, by the Belgian governor, Mr. Verplaetse.

The exercise of undue influence is not deterred by secrecy and confidentiality, but only by openness. Smoke-filled rooms and confidentiality are more likely to allow the ECB mandate and its independence to be perverted by national political pressures than openness and the occasional short-term embarrassment that this entails. Confidentiality of the votes also destroys any vestige of individual accountability of ECB board members. It encourages excessive consensus-seeking and compromise. If enforced, it is likely to greatly enhance the power of the President relative to that of the other members. The only defence of the other Board and Council members against an excessive concentration of decision-making power in the President are the Bundesbank-style extensive selective leaking and media briefings already referred to. There can be no effective accountability if the individual votes are not in the public domain.

(III.E) Publication of the Minutes

Unlike the Bank of England, the FOMC and the Bank of Japan, the ECB does not publish the minutes of its Governing Council meetings[19].

I believe that, like the individual voting records, the minutes should be in the public domain as soon as possible, but on a non-attributed basis. The reasons for this concession to procedural opaqueness are practical. The early release of verbatim transcripts, or even just of selected but attributed opinions of individual members, would kill the usefulness of the Council meetings. Members would come with prepared positions and statements which they would read into the record. There would be no scope for open-minded discussion of alternative courses of action, for 'what-if', counterfactual thought experiments. The formal meetings would become set-pieces, for the record only. The real discussions would move elsewhere, defeating the purpose of the publication of the minutes. The FOMC transcripts fit this model well, even though the release of the transcripts takes place five years after the meeting.

The foregoing is not a valid argument against a form of minutes that presents the key facts and considerations that determined how each of the members voted and how the Council reached its decision. This has been the practice adopted by the Bank of England's MPC, by the Bank of Japan (which in addition publishes attributed explanations of dissenting votes), and by the FOMC. The free, frank and uninhibited exchange of views is not discouraged by this form of publication. Twenty-one MPC meetings I have attended bear witness to that.

Dr. Issing, in his emerging role as enforcer for the ECB Opaqueness Squad, insists on confusing the publication of verbatim transcripts of the Governing Council meetings with the publication of the minutes of the meetings in the form of a non-attributed summary account. His recent comments on the issue warrant quoting in full,

> *It is not quite obvious to my mind that the legitimate and important cause of transparency would be advanced if central banks were to make available to the public the maximum amount of information at their*

[19] It isn't clear to me whether Mr. Duisenberg's statement that the minutes would be released after 16 years was a serious statement or just another way of saying: "not now, not ever, never". I suspect the latter interpretation is more likely to be correct.

> *disposal. You could perhaps imagine all data and records continuously being put on the Internet. You could, in addition, imaging live broadcasts of all Governing Council meetings, committee meetings, perhaps including the coffee breaks and all words uttered in the halls and corridors of power. George Orwell in reverse, if you will. Apart from all practical difficulties, would such complete openness really enhance the general public's (and even the specialists') understanding of monetary policy? Moreover, could the public ever be sure that some important information was not withheld, some ulterior motives hidden, some decisions not revealed?* (Issing [1999], p. 6).

Disdain for the public's right to know is, unfortunately, not uncommon among continental central bankers[20]. When it comes to the release of information, too many of them genuinely 'don't get it'. They are sincerely baffled by demands for openness because they never had to operate in a culture of openness, transparency and accountability. The knee-jerk response to any request for information is to deny it. Only if there is a compelling reason for releasing a particular item of information will they (reluctantly) allow it to enter the public domain. A culture of openness and accountability operates at the other end of the spectrum. All information is automatically in the public domain, unless there are overriding public interest reasons for not releasing a particular item. The distinction between Dr Issing's approach towards the release of information, and the approach I favour is a fundamental one, as basic as the distinction between the presumption of guilt and the presumption of innocence in criminal proceedings[21].

(III.F) Publication of the Inflation Forecast

The Bank of England publishes the MPC's inflation forecast in its quarterly *Inflation Report*. This forecast, and the Report, are the forecast and Report of the MPC. The Inflation Report is the result of long and intensive meetings and plays a key role in supporting the monthly rate-setting deliberations of the MPC. It is also an important input into the accountability process, as it reveals the MPC's thinking about where the economy is and where it is likely to be going.

The ECB is proposing to keep its inflation forecast 'in-house'. A justification for this is provided by Mr. Duisenberg [1999a]: *"Internal forecasts of economic activity and inflation in the euro area can also contribute to the success of an appropriately forward-looking monetary policy. However, the Eurosystem should not be judged on, or held accountable for, the accuracy of its internal forecasts. Thus, publication of*

[20] This attitude is by no means restricted to current and former employees of the Bundesbank and the Nederlandsche Bank. In a recent interview with the NRC-Handelsblad (05-02-99), Mr. Alfons Verplaetse, governor of the Belgian Central Bank, responds in a dismissive manner to questions about the desirability of publication of the ECB minutes. (The translation from the original Dutch is mine): *"If we come to a decision, it must be stated clearly why. That is transparency. Not those minutes, that is unhealthy curiosity. If we give in to that, we are weaklings".*

[21] The secrecy bacillus is a constant threat to openness and accountability in any organ of the state or public organisation. Given the long-standing obsession with secrecy of successive UK governments, and of the British state generally, it is rather surprising that the Bank of England Act 1998 put so much emphasis on openness, transparency and accountability.

the forecasts cannot contribute to accountability. Rather, its performance in maintaining price stability in the medium term should be used by the public to judge the success of the Eurosystem".

This statement makes no sense. Without knowing the forecast, it will be impossible to determine whether meeting (or not meeting) the inflation objective is due to luck or to technical expertise. The decision not to publish the internal forecasts represents an unnecessary reduction in the availability of information that would allow market participants, the public at large and those formally charged with the political oversight of monetary policy, to reach a more informed view about the performance of the ECB Council.

(III.G) Collective Responsibility[22]

It is important that the published record clearly identifies any disagreements about facts and data, about the nature of the transmission mechanism, about the interpretation of the target, and indeed about any other issue that influences a Governing Council member's vote. When there is disagreement, there is no merit in presenting a common front to the outside world, in pretending that decisions were reached unanimously when they were not. This means that there is no case for insisting on 'collective responsibility' in the rather special sense that this phrase has acquired: unanimous and unqualified support in public by the members of a group for decisions that need not have been taken unanimously.

In the context of the board of a company, or a council of government ministers, it is possible to make a case for collective responsibility as defined above. Even there the case is rather less than overwhelming, and has as much to do with intra-group power games or with making life easy for the chair of the group, as with good governance.

A council of ministers takes a vast number of decisions about a range of issues. Most of those voting know little or nothing about the vast majority of issues that they have to vote on. Only one, or at most a few, of those voting have any direct executive responsibility for the issue being decided collectively. It therefore makes some sense to insist that, after a decision is reached, each minister should be given the choice of following the party line or shutting up.

Not so with monetary policy. The policy-making council of a central bank does just one thing. It sets a short nominal interest rate. The people that make up the council are, or should be, experts on how this one narrow task is best accomplished. They are responsible as a group for choosing a rule for this short nominal interest rate so as to achieve the objectives of monetary policy as closely as possible.

The relationship between the monetary instrument and the objective(s) is highly uncertain at each point in time, and changes over time in an unpredictable manner. Monetary policy makers therefore virtually always 'get it wrong'. The only real question is how mistaken they are and how effectively they learn from their mistakes.

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[22] I have benefited in writing this section from comments made, in a quite different context, by my colleague on the MPC, DeAnne Julius. She of course is in no way responsible for what I have done with her insights.

It makes sense for an expert or technocrat who finds himself in a minority at a particular meeting, to be able to argue, publicly, his case for a different monetary policy action or policy rule, and to engage the wider community of experts, outside the central bank, in this debate. This is the only way to improve the quality of policy-making in the long run. Interest rates are decided by majority voting. Truth is not.

Competence matters in monetary policy. Without a track record of individual votes, and of on-the-record explanations of these votes, there is no hope of ever assessing the competence of the individual members. In a system like the British, where external MPC members have short (3 year) renewable terms, competence should, together with independence, be the key consideration for possible reappointment. Even in systems where the policy making council members are not re-appointable, it is important that each retiring council member leave the central bank with the fullest possible track record in the public domain. The employment histories of former monetary policy makers suggest that, after completing their stint at the central bank, they are quite likely to be viewed, other things being equal, as plausible candidates for responsible positions in the public or private sectors. If ceteris were rather less or more than paribus, it is important that this information be in the public domain[23].

Collective responsibility, in the sense that a Council member who finds himself in a minority is obliged to pretend that the majority position he disagreed with was superior to the minority position that he actually subscribed to, has no place in monetary policy making.

(III.H) Confusing the Markets and the Public

One further argument is made in support of the ECB's decision not to publish the minutes. The same argument is used to rationalise the insistence by Mr. Duisenberg on collective responsibility and on conveying the views and opinions of the Governing Council to the outside world as collective views and opinions rather than as the union of the views and opinions of its individual members. This argument is that publication of the minutes would give false and confusing signals to financial markets and to the public as a whole. In the words of Mr. Duisenberg: "*If we would do this* (publish the minutes), *we would influence expectations of the markets ahead of the next meeting. We do not want to do this.*" (Frankfurter Algemeine Zeitung, Monday 29 June, 1998). This argument too makes no sense. By not publishing minutes that offer a fair summary of the Council meetings, all that is achieved is that *informed* speculation by market participants is replaced by *uninformed* speculation.

Revealing the nature of any disagreement that may exist will also reduce market uncertainty in anything except the very short run. To argue otherwise is to confuse a situation in which there *is* no disagreement with a situation in which the ECB *pretends* there is no disagreement, even though there is. When the disagreement does come out (as it will, in dribs and drabs and with distortions) uncertainty is greater than it would have been had fake unanimity not been imposed.

[23] Neither MPC members nor ECB Governing Council members can be dismissed for mere incompetence.

There are neat examples in non-cooperative game theory of circumstances under which the release of more information worsens welfare and deliberately adding noise to the signal improves welfare. It is, however, difficult to think of conditions relevant to the setting of monetary policy by the ECB that would cause better and more timely information to worsen economic performance. The argument is unconvincing.

There are signs that the climate of opinion at the ECB may be beginning to change somewhat. While still resolutely opposed to publication of the individual voting records[24] , Mr. Duisenberg has recently hinted at his willingness to consider the publication of a summary of the considerations that motivated the decision taken by the ECB Council. It is unclear whether anything other than the arguments that support the eventual majority decision will be reported. If dissenting views are also reported (in a non-attributed manner), the information provided could end up looking rather similar to the MPC and FOMC minutes. It seems unlikely that the ECB will become as open in its minutes as the Bank of Japan.

(III.I) Other Dimensions of the ECB's Accountability Deficit

In addition to the parliamentary oversight provided by the Treasury Select Committee, the non-executive members of the Court of the Bank of England are charged, under the Bank of England Act 1998, to review the MPC's procedures, and in particular to ascertain whether the Committee has collected the regional, sectoral and other information necessary for formulating policy. There is no counterpart to this role of Court in the case of the ECB.

Accountability of monetary policy in the UK is enhanced by the requirement that the Governor of the Bank of England, on behalf of the MPC, must write an open letter to the Chancellor if the inflation rate deviates from the target by more that 1% in either direction. This letter must spell out why the target was missed, what the MPC proposes to do about it, over what time horizon it expects inflation to be back on track, and how all this is consistent with its mandate. There is no counterpart to this 'open letter' procedure in the case of the ECB.

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[24] The following exchange during the Hearing at the European Parliament's Sub-Committee on Monetary Affairs on 18 January 1999, demonstrates the breath-taking ease and confidence with which the ECB can swat away legitimate Parliamentary requests for information.

Mrs Randzio-Plath: If I may put my question. Do you think there will be new thinking in the ECB concerning the publication of the minutes ; may this 16 year period be subject to review in order to move closer towards the transparency as in the German Bundesbank? There has been a broad discussion about greater transparency, and perhaps that might encourage you to achieve progress in that area in terms of democratic accountability.

Mr Duisenberg: Well, the answer I have given already many times, and that answer is no Madame Chair.

Mrs Randzio-Plath: Well that's a question I'm going to have to keep on putting until I have a different answer I think. I can assure you that this Parliament is optimistic that there will indeed be a positive change. ...

The ECB will have to learn that independence, far from being inconsistent with openness and accountability, cannot, in a democratic society, survive without these two awkward customers. The attitude of the ECB is typical of a central banking tradition that was, until very recently, dominant across the world, which views central banking as a sacred, quasi-mystical vocation, a cult whose priests perform the holy sacraments far from the prying eyes of the non-initiates. *Secrets of the Temple* indeed[25]! This mystique of the central bank, and the excessive clubbishness and clannish behaviour it sometimes encourages, is both entirely unwarranted and a threat to the achievement of the purposes central banks are intended to serve: price stability, preventing and coping with systemic financial risk and minimising avoidable output and employment gaps

(IV) Legitimacy Issue 2: The Transfer of National Sovereignty to the ECB

Monetary union involves a transfer of national sovereignty to the central or federal level. Unless this transfer of power is perceived as legitimate by Euroland residents, the authority of the institutions of the ECB and the ESCB will be challenged by those who perceive themselves to be adversely affected by it. In the past, common currency arrangements, including a supranational central banking system with centralised authority, have survived only when, at the time of their creation, a stronger and more legitimate federal government structure was in place than is currently the case in the EMU area.

For instance, monetary union in the USA was not complete until long after political unification. Italian monetary unification occurred in 1862 after political unification had been completed in 1861[26]. Centralisation of note and coin issuance and of other central bank functions did not occur until 1893.

The history of German monetary and political union in the 19th century is open to two very different interpretations. While full, de-facto monetary union did not occur until 1875, after the establishment of the German Reich in 1871, many of the key steps towards monetary union were taken before 1871, in 1837, 1838 and 1857.

There have been exceptions to the rule that political unification precedes monetary union. Even if one ignores the ambiguous German 19th century experience, the seven provinces that formed the Dutch Republic established a monetary union with only the weakest (con)federate political institutions and with almost completely decentralised fiscal authority. It lasted for two centuries, until the conquest of the Republic by Napoleon (Dormans [1991]).

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[25] *Secrets of the Temple* is the first part of the title of Mr. William Greider's book *Secrets of the Temple; How the Federal Reserve Runs the Country*, (Greider [1989]). The first part of the title is, however, also the best part of this book, which is short on economic literacy and indulges in unsubstantiated conspiracy theories. The serious point is that the attitude of the ECB towards procedural openness, transparency and accountability is a open invitation to conspiracy theorists and other Mad Hatters.

[26] Venetia was incorporated in 1866 and the Papal States followed in 1870.

Monetary unions between admitted unequals, the monetary equivalent of a marriage between an elephant and a mouse, have endured on a number of occasions without either prior political union or subsequent political unification or absorption. Belgium and Luxembourg were in a monetary union from 1922 until they were both absorbed in Euroland in 1999. France-Andorra, France-Monaco, Italy-Vatican City, Italy-San Marino and Switzerland-Liechtenstein are other examples.

Slightly different in nature are the currency unions adopted by contiguous former colonies following independence. The Communauté Financièere Africaine (CFA) franc Zone, set up in 1959 by thirteen former French colonies in west and central Africa, survives till this day, with the active assistance of France, despite a devaluation of the CFA franc by 50 percent in 1994,. The East Caribbean Currency Area, consisting of 7 former British colonies, has survived since 1966. The East African Currency Area between Kenya, Uganda and Tanzania lasted only from 1966 until 1977.

Monetary unions among near-equals that occurred without prior political unification and that did not subsequently lead to political unification, have not survived. The Latin Monetary Union among France, Belgium, Switzerland and Italy, and the Scandinavian Monetary Union among Sweden, Denmark and Norway, began in 1865 and 1873, respectively. They lasted in practice until World War I, although both arrangements were only officially put out of their misery in the 1920s.

Attempts by 'successor states' to maintain monetary union following the break-up of a larger political entity, have been short-lived, with the possible exception of the 'monetary union' between the UK and Ireland (a currency board arrangement for Ireland, rather than a "symmetric" monetary union), which lasted from 1922 till 1979.

Examples of spectacular failures to maintain a common currency following a political break-up include the attempts by some of the successor states of the Austro-Hungarian Empire following the defeat of the Habsbourg empire in World War I; the ill-fated rouble zone among 11 CIS members between 1991 and mid-1993[27], following the dissolution of the Soviet Union; and the collapse of the monetary union among the successor states to the Federal Republic of Yugoslavia after 1991. All three political break-ups led to hyperinflations. Czechoslovakia broke up as a political union on January 1, 1993; the Czech-Slovak monetary union collapsed on February 8, 1993 (Fidrmuc and Horváth [1998]), albeit without hyperinflation.

I have considerable sympathy for the long-standing German position that further political integration should have accompanied (or even preceded) monetary union [28]. On the other hand, the whole European integration experiment, from the Coal and Steel Community on, has been a political wolf dressed in economic sheep's clothing. It has been successful so far, and it could continue to be so[29]. It is essential, however, that the European Parliament act as an effective watchdog over the ECB. The

[27] Ukraine left the rouble zone in 1992. Tajikistan did not establish its own currency until 1995.
[28] See e.g. Tietmeyer [1998a,b]. For a general discussion see Eichengreen [1996].
[29] There have been times, however, that the economics got too far ahead of the politics. The Werner Group's recommendation in 1970 of full monetary union by 1980 clearly was a bridge too far at the time.

legitimacy of the ECB will depend on the extent to which it is effectively accountable to the European Parliament.

(V) The Size of the ECB Governing Council

The ECB Governing Council has 17 members - 6 Executive Board members and 11 NCB governors. If all current EU members join EMU in due course, and if the current rule of a seat for each Euroland NCB governor remains in effect, there will be 21 members. With enlargement to up to 25 EU members in prospect sometime during the next decade, membership would top 30. A group of 17 is already too large for the serious and productive exchange of views, open discussion and effective group decision taking. Based on my own limited experience, a policy making body with 7 members would probably be optimal. A squad of 21 will be quite unwieldy. Thirty would be a mob. In contrast, the Bank of England's MPC has 9 members, as has the Bank of Japan's Policy Board. The FOMC has 12 (7 Board Members and 5 regional Reserve Bank Presidents). The Bundesbank Council also has 17 members, 8 Board (Directorate) members and the Presidents of the 9 Land Central Banks. To remain an effective deliberative body, the one country-one-vote principle will have to be given up sooner rather than later, here as in other areas of EU decision taking. This of course would require an amendment to the Treaty.

(VI) The Lender of Last Resort Vacuum

The phrase 'lender of last resort' does not occur in the Treaties and systemic stability issues are not addressed. The only references I have been able to find in the Treaties concerning financial stability issues are in Chapter II, Article 25.1 and 25.2 and Article 3.3.

"25.1. The ECB may offer advice to and be consulted by the Council, the Commission and the competent authorities of the Member States on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system."

"25.2. … the ECB may perform specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings."

"3.3. … the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."

It isn't much. That is the bad news. The good news is that the Treaties do not rule out the ECB and the ESCB fulfilling the lender of last resort function. There is a tradition among some central banks of not mentioning the existence of the lender of last resort. The argument is that recognising its existence would create additional moral hazard. Bank executives might engage in imprudent and excessively risky financial operations in the knowledge that, should their bets succeed, they will get the reward, while if their bets fail, the central bank, and ultimately the tax payer, will pick up the tab. Constructive ambiguity by central banks as regards their interpretation of the lender of last resort function is then concluded to be the preferred option. This attitude seems unduly coy. Bagehot's lender of last resort only intervenes when there is systemic risk. Individual institutions that are not large or strategic enough to cause systemic risk, can fail. For those too large to fail, the second half of Bagehot's dictum which can be paraphrased as 'in times or crisis, lend freely but at a penal rate' should act as a sufficient deterrent. When institutions are solvent but illiquid, emergency assistance should be priced painfully. When insolvency looms, all private equity should be extinguished when public money goes in, and the top management is fired without a golden handshake.

The information necessary for effective lender of last resort support is likely to be decentralised. The authority to provide financial support must, however, be centralised in Frankfurt. Any action by any ESCB member that has monetary consequences has to be authorised in the centre. This tension between informational decentralisation and centralised authority to extend funds is unavoidable. It will be felt especially acutely during a financial crunch, when decisions have to be made at very short notice. It should not be insurmountable. The Fed, after all, seems to be coping reasonably well.

The view that the Maastricht and Amsterdam Treaties were severely deficient in not dealing explicitly with the lender of last resort responsibilities of the ECB and the ESCB is widely shared in the international financial community. In its 1998 Annual Report on International Capital Markets, the IMF warns of the increased risk of financial crisis in Euroland following monetary union, and notes that the ECB does not have all the tools to handle such a crisis (International Monetary Fund [1998]).

I hope and expect that, even if they are not telling us about it, the ECB and ESCB are creating the informational channels and chains of command to effectively implement the lender of last resort function at the level of Euroland as a whole. There are issues that need to be settled urgently. Prior to EMU, a national financial crisis in a Euroland member state was a systemic crisis from the point of view of the national lender of last resort. In the larger Euroland pond, a national financial crisis may be viewed as a regional rather than a systemic crisis, unless there is contagion across national borders.

(VII) Tension Between Centralised Authority, and Operational and Informational Decentralisation

In the ECB and ESCB there is no role for national central banks in the formulation, design and implementation of monetary policy. Monetary policy is made by the ECB Governing Council. The NCB staffs may influence the opinions of their governors, but decisions are made centrally. Similarly, the ECB staff will provide support for the 6 Executive Board members. That the eleven NCB governors outnumber the six ECB Board members does not alter monetary policy being made centrally. All policy actions that have monetary consequences (open market operations, foreign exchange sales and purchases, changes in lending and borrowing rates) have to be authorised centrally. The role of each NCB is to be a minority shareholder of the ECB, to provide research support for the national governor and to act where necessary as national branch bank of the ECB for the operational implementation of decisions.

For the quality of the ECB's monetary policy, it is beneficial that most NCBs will retain an independent research capability, rather like the Regional Reserve Banks of the Federal Reserve System. Every research department, regardless of its quality, is at risk of developing a dominant 'in-house' view that is intolerant of challenges to the local orthodoxy. It would be unfortunate for the citizens of Euroland if all seventeen General Council members drank only from the same fount of economic wisdom. Intellectual portfolio diversification is essential. This recognition of the value of diverse and independent sources of information, analysis and advice cohabits quite comfortably with centralisation of monetary policy authority in the ECB.

The history of the Federal Reserve System provides a warning of what happens when monetary policy authority is decentralised. The proto-confederate structure of the original Federal Reserve System created by Congress in 1913 was spectacularly incapable of coping with the banking crises of the Great Depression. The Banking Act of 1935 replaced it with a substantially centralised structure. The most recent example of a supranational monetary system under which substantial policy autonomy resided with the 'regional' or national central banks was the rouble zone of the early CIS, not a promising role model.

Those who drafted the ECB constitution did not need to be convinced of the need for a centralised, unified monetary authority. The Treaties are quite unambiguous about the fact that all monetary policy authority is centralised in Frankfurt – and properly so.

Why do a number of Euroland NCB governors appear to wish to retain substantial national autonomy in a number of dimensions? There are, I fear, only bad reasons. Apart from nostalgia for the good old days of national monetary autonomy, the following factors probably play a role.

(VII.1) Personnel Management Issues.

One perfectly understandable but quite unacceptable reason is a natural reluctance to contemplate the large-scale redundancies among NCB employees that seem to be the inevitable implication of the loss of national monetary policy.

The central banks of most Euroland members appear grossly overstaffed. Figures from the Morgan Stanley Central Bank Directory for 1999 show that the 11 NCBs of Euroland employ more than 53,200 staff. This is only 2 percent down on a year ago. The ECB currently employs about 600 staff, although this number is growing quite rapidly, and may reach 750 by the end of 1999.

By comparison, the Bank of England currently employs 25 percent fewer staff than two years ago, at just over 3,100. This reduction in numbers reflects the loss of the Bank of England's regulatory and supervisory functions since 1997. The US Federal Reserve system employs just over 23,200 staff. Only 1,700 of these are Washington-based. The rest is employed by the 12 Regional Reserve Banks. Most of the staff is engaged in the Fed's substantial regulatory and supervisory tasks. The ECB has none of these (although in about half the EU states, the central bank has some supervisory or regulatory role (see Begg and Green [1996])).

Some of the central banks of the smaller EMU members (the Netherlands, Austria, Ireland and Luxembourg[30]) have actually increased the size of their staffs in the past year. This is not surprising. In all except Ireland, there has been no national monetary policy and no need to think about monetary policy for many years, with the Netherlands and Austria effectively 'on the D-mark' and Luxembourg in a currency union with Belgium. Suddenly their governors have to contribute to the debate about monetary policy in a large economy that is rather closed to international trade and has a floating exchange rate. The experience of monetary (non-) policy in a small economy that is very open to international trade and has a fixed exchange rate is poor preparation for that task. Some serious learning curves will have to be climbed, and the national governors will need all the help they can get.

(VII.2) National Financial Centre Protection and Patronage

By decentralising the administration of certain monetary policy functions of the ESCB, NCBs can maintain some operational capabilities. National financial centres may benefit from close physical proximity to the NCBs charged with these tasks. This form of operational decentralisation is likely to be somewhat inefficient, but otherwise harmless. One expects that this grandfathering of NCB operational arrangements will gradually die out, and that the bulk of all ESCB financial operations will be concentrated in a single financial centre, probably in London, assuming the UK joins EMU.

(VII.3) Informational Decentralisation of the Lender of Last Resort Role

Some NCBs have domestic supervisory and regulatory functions. These will be retained. To the extent that the proper exercise of these functions requires actions that have monetary implications (financial support, bail-outs, recapitalisations etc.), the authority for these actions cannot reside with the NCBs, but must be exercised by the ECB. Information will often be local - decentralised. Authority will be centralised at the ECB. Over time, as Euroland-wide regulators and supervisors develop and encroach on the domain of the national supervisors and regulators, this problem will become less acute. Note, however, that whenever the central bank and the regulator/supervisor are distinct entities, co-ordination between the agency with the firm-specific information (the regulator/supervisor), the agency with the short-term deep pockets (the central bank) and the agency with the long-term deep pockets (the ministry of finance) will be essential and not straightforward. This will be as true in Euroland tomorrow as it is today in member states where the central bank does not have regulatory and supervisory functions.

[30] Luxembourg's Monetary Institute did not have central bank status until the start of EMU.

(VIII) Co-ordination of Monetary and Fiscal Policy

Co-ordination between monetary and fiscal policy in Euroland is likely to be a problem for some time to come. The Germano-Dutch wing of the ECB mistrusts the EuroXI as an attempt to undermine the operational independence of the central bank. While this concern is certainly not without merit, there appears to be little awareness among the ECB top that independent agents can *choose* to co-ordinate their actions and that this may be fruitful, even when the co-operating parties have somewhat different objectives. Economic policy is not a zero-sum game, so co-operation could benefit all parties.

Even if the problem of mutual mistrust can be overcome, getting the balance between monetary and fiscal policy right is a challenge at the best of times, even when there is a single monetary and a single fiscal authority. In the UK prior to Bank of England independence, a single authority, the Chancellor of the Exchequer, determined both monetary and fiscal policy. The track record of UK macroeconomic stabilisation policy since World War II is, however, hardly the envy of the world. Co-ordination between the ECB and eleven national finance ministries will be as much a logistical challenge as a political problem.

The use of fiscal policy for cyclical stabilisation will be severely circumscribed in Euroland until the average budgetary position of the member states is sufficiently below the Stability and Growth Pact ceiling (a *structural* general government budget deficit-GDP ratio no higher than 1% and an *actual* general government deficit-GDP ratio not exceeding 3%), to allow counter-cyclical increases in public sector deficits to perform their normal cycle-amplitude dampening function. The only alternative would be the non-enforcement of the budgetary ceilings. While some shading will no doubt occur, I anticipate they will be a binding constraint on a number of Euroland governments in the next two years.

Action to ward off an unexpected downturn will therefore have to be taken by the only player in the economic concert of Europe who has both bow and violin: the ECB. It was therefore encouraging that its December 3, 1998 action demonstrated that this new institution could be serious about price stability without suffering from rigor mortis. It has been rather less encouraging that neither the ECB nor the Federal Reserve Board were willing, in early February 1999, to contribute to the necessary shift of aggregate demand away from the US and towards Euroland, through a rise is short-term nominal interest rates in the US and a cut in Euroland.

(IX) Conclusion

The legal framework, institutional arrangements and emerging operating practices of the ECB/ESCB are flawed and in urgent need of modification. At the very least, the ECB's deficiencies pose a threat to its continued operational independence. Beyond that, they could put the common currency's survival at risk. A threat to the common currency is a threat to the entire EMU edifice and to the continued success of the post World-War II European integration process. As an EU citizen, and a-fortiori as a European federalist, this worries me greatly.

Change will have to come quickly to the ECB. Some of the necessary changes are constitutional in nature and require amendments to the Maastricht and Amsterdam Treaties. This is a difficult, cumbersome and slow process. Among the constitutional changes I propose are the following.

- Abolish the ‘one-country-one-seat-on-the-Governing-Council’ rule; restrict the size of the Governing Council to no more than nine members and the size of the Executive Board to no more than four members.
- Abolish the clause in Article 109 giving the Council of Ministers the power to formulate ‘general orientations’ for exchange rate policy. This clause creates doubts about the substantive domain of operational independence of the ECB.
- Charge the ECB explicitly with responsibility for systemic financial stability in Euroland. The words “lender of last resort” should be used in the revised Treaty.
- Create a body that has the power to vet and make binding recommendations about the *procedures* used by the ECB. One possibility is a body composed of MEPs and members of the European Court of Justice.

Other necessary changes can be made overnight, at the discretion of the Governing Council itself. They include the following.

- Publish the minutes of the meetings of the Governing Council and of its relevant committees and sub-committees.
- Publish the individual voting records of Governing Council members.
- Publish the inflation forecast.
- Clarify the operational inflation target.
- Abandon attempts to create a culture of ‘collective responsibility’. Presenting a spurious united front to the outside world adds to uncertainty about the likely future stance of monetary policy. It also would slow down the Governing Council’s ascent of the learning curve.

A third category of changes does not require Treaty amendments, but cannot be implemented at the sole discretion of the Governing Council either. These include the following.

- Strive for institutional arrangements and practices that make for better co-ordination of monetary and budgetary policy in Euroland.
- Flesh out the lender of last resort function of the ECB. Note that this does not have to wait until the Treaty is changed. While formal recognition, in an amended Treaty, of the ECB’s systemic financial stability role and lender of last resort function would be helpful, the existing Treaty does not proscribe such a role and function. The ECB should just get on with it.
- Spread the message that authority in the ECB/ESCB is centralised. National Central Banks are useful conduits for national information. Independent NCB research departments provide useful safeguards against intellectual ‘democratic centralism’. Beyond that they have no essential function and certainly no substantive authority. The Treaty is clear on this, but not all NCB governors appear to have read or understood the relevant passages. This, too, creates unnecessary uncertainty.
- Evolve a European Parliament with teeth. It does no good either to the European Parliament or to the ECB to have the President of the ECB walk all over the MEPs.

It is my hope and expectation, that the ECB/ESCB will change along the lines indicated above, and that EMU will succeed in generating greater Euroland-wide prosperity than would have been likely under any alternative monetary arrangement[31].

[31] For an extreme antidote to this optimism, see Feldstein [1997], who attributes to EMU an increase in the risk of virtually every disaster that could befall mankind, including war (but excluding pestilence).

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