

The Politics of the European Central Bank: Principal-Agent Theory and the Democratic Deficit

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ABSTRACT

The institutional design of the European Central Bank (ECB) has been the subject of considerable political debate. In particular, it has been argued that the Bank suffers from a 'democratic deficit'. This article applies the principal-agent approach to this debate so as to identify more clearly the logic that underpins the basic arguments about the democratic legitimacy of the ECB. Moreover, on the assumption that the Bank does suffer from a democratic deficit, the article also shows how principal-agent theory can point to the ways in which this problem may be addressed. Thus, the principal-agent approach is used as an heuristic device to help identify the empirical and normative claims that underpin the debate about the accountability of the ECB and how it might be reformed.

KEY WORDS:

accountability; democratic deficit; delegation; ECB; principal-agent theory; shirking

The introduction of Stage III of Economic and Monetary Union (EMU) constituted the most important policy development in the European Union (EU) in recent times. The creation of a common currency affecting nearly 300 million people in one of the world's wealthiest areas has tremendous implications not

just for the economics of Europe but for the global system more generally. At the heart of the EMU project is the European System of Central Banks (ESCB), which is responsible for defining and implementing monetary policy in the 12 EMU countries, and the linchpin of the ESCB is the European Central Bank (ECB) itself. The ECB has the power to make decisions that directly effect the rate of growth and the level of inflation both within EMU countries and outside. At least partly for this reason, the ECB has already been the subject of considerable political controversy. Some claim that it is an accountable institution that works in the best interests of EMU countries. Others, though, assert that the ECB suffers from a 'democratic deficit'. They argue that the citizens of 'Euroland' have little or no opportunity to shape the decisions that so profoundly affect them.

The aim of this article is to recast this debate. It does so by applying the principal-agent approach, a variant of rational choice institutionalism, to the politics of the ECB. The principal-agent approach is useful as a framework for understanding the debate about the Bank's alleged democratic deficit. It helps to conceptualise more clearly the logic underlying the basic positions in an otherwise messy and often acrimonious debate. More than that, on the assumption that the institutional architecture of the ECB is problematic and that the Bank does suffer from a democratic deficit, principal-agent theory also points to the ways in which this problem may be remedied. In this article, then, the principal-agent approach is being used as an heuristic device to help identify the empirical and normative claims that underpin the debate about the accountability of the ECB.

There are six main parts to the article. The first part outlines the basic assumptions of principal-agent theory. The second part sketches the powers of the ECB. The third part outlines the debate between the supporters and critics of central bank independence in general and the ECB in particular. The fourth part

systematically applies principal-agent theory to the ECB, highlighting the logic behind conflicting positions of both the defenders and the critics of the Bank. The fifth part draws upon principal-agent theory to suggest the most fruitful ways in which critics of the Bank might propose that the democratic deficit could be alleviated. The final part concludes by reflecting briefly on the principal-agent approach itself.

1. The basic assumptions of principal-agent theory

Principal-agent theory is derived from work initially carried out in the field of economics. In recent times, though, it has been increasingly applied to the realm of political science. In this domain, it can be classified as a branch of rational choice institutionalism. Here, the general aim has been to explore issues of “institutional design under conditions of imperfect information” (Pollack, 1997, p. 101), most notably with regard to the role of public bureaucracies. Whatever the subject field and whatever the focus of inquiry, the basic reason why principal-agent theory has been so influential is because it is said to “[cut] through the inherent complexity of organizational relationships by identifying distinct aspects of individuals and their environments that are most worthy of investigation, and it integrates these elements into a logically coherent whole” (Moe, 1984, p. 757). In short, it is a useful analytical tool for examining real-world problems.

The principal-agent approach is derived from the so-called ‘new economics of organisation’.¹ In this context, the basic starting point is the situation where one actor (the principal) has an incentive to delegate power to another actor (the agent) with the expectation that subsequently the latter will act in a way which is consistent with the initial preferences of the former. The

incentive to delegate is usually motivated by a desire to reduce transaction costs. These costs are incurred because of information asymmetries. In this respect, the basic problems are those of adverse selection and moral hazard. Adverse selection refers to the situation where an employer cannot necessarily know which candidate is best qualified for a job. Given that all candidates will try to sell themselves equally well, the employer may well appoint an applicant whose price is greater than their economic value. Moral hazard is the situation where an employer cannot know how well a person is working once they have been employed. The employer simply cannot observe everything that the employee does. Faced with these problems, the solution is to design a contract that provides an incentive for the employee to work efficiently. If such a contract can be established, then only candidates who truly are well qualified will apply (lazy candidates will not) and, once employed, there will be no need for the employer to monitor the employee's behaviour. Thus, principal-agent theory suggests that in an ideal situation "well-chosen agents, in an agency constructed to channel their incentives correctly, can be left alone to determine the policy that the elected officials would themselves have chosen, given the time and resources" (Calvert, McCubbins and Weingast, 1989, pp. 590-91). All other things being equal, therefore, in terms of the new economics of organisation delegation is a rational act.

In terms of political science, most attention has in effect focused on the problem of moral hazard. In this context, the literature has concentrated upon two basic issues associated with delegation. The first is known as agency 'shirking'. Otherwise called agency 'loss', 'discretion', or 'drift', shirking denotes "any form of noncompliance by the agent and results from a conflict of goals" (McCubbins and Page, 1987, p. 410). Slightly more specifically, agency discretion is said to consist of "the departure of agency decisions from the positions agreed

upon by the executive and legislature at the time of delegation and appointment” (Calvert, McCubbins and Weingast, 1989, p. 589). The point to note here is that the agent may act in a self-interested manner or in a manner which is at least deliberately at odds with the expressed preferences of the principal. The second related, but nonetheless distinct, issue is known as agency ‘slippage’. This is an “institutionally induced” (McCubbins and Page, 1987, p. 411) problem, which occurs “when the structure of delegation itself provides perverse incentives for the agent to behave in ways inimical to the preferences of the principals” (Pollack, 1997, p. 108). The key element here is that individual actors within an agency may try to act in good faith and follow the preferences of principals, whereas the decision-making process of the institution may be such that the collective decision of the agency still diverges from the initial preferences of the principal.

In response to these problems, the literature on principal-agent theory has suggested two standard solutions: *ex ante* and/or *ex post* controls (ibid). *Ex ante* controls comprise “any actions that the executive or legislature can take, prior to agency choice, that influence the later goals of the agent or the set of feasible choices available to the agency. Such actions include the structuring of the agency itself, the denomination of its powers and jurisdiction, the specification of administrative procedures to be followed, and the type of personnel with which the agency is to be staffed ...” (Calvert, McCubbins and Weingast, 1989, p. 604). *Ex post* controls concern both oversight and sanctions. Oversight is usually deemed to consist of ‘police patrols’ and ‘fire alarms’. Here, police-patrol oversight “is comparatively centralized, active, and direct” (McCubbins and Schwartz, 1984, p. 166). It includes legislative hearings and special enquiries. By contrast, fire-alarm oversight “is less centralized and involves less active and direct intervention than police-patrol oversight” (ibid). It includes procedures

that encourage citizens to bring agency discretion to the attention of principals. More straightforwardly, sanctions include budgetary controls, legislative veto over agency actions, the power to dismiss agency officials and so forth.

In addition to these responses, there are other non-standard solutions to the problem of agency delegation. For example, it may be possible to delegate power to multiple agents. In this case, the aim is to encourage “competitive interaction” (Ferejohn, 1999, p. 132) so that agents are encouraged to produce policy outputs that take account greater account of popular preferences.² An alternative view suggests that researchers should concentrate on more unobtrusive forms of control and influence that principals might employ (Weingast and Moran, 1983; Calvert, McCubbins and Weingast, 1989). Here, emphasis is placed on the particulars of the day-to-day relationship between the principal and the agent, including the rules that establish “unspoken” (Calvert, McCubbins and Weingast, 1989, p. 606) agency expectations as to when principals may invoke sanctions. In this case, therefore, the relationship between principals and agents is affected not just by formal procedures but by informal practices as well.

All told, in the field of both economics and politics principal-agent theory is fundamentally concerned with institutional design. In terms of politics, the basic aim is to construct agencies in such a way as to avoid slippage and, perhaps above all, shirking. In the language of liberal democracy, the key task is to design institutions that carry out the wishes of the people. In section three, principal-agent theory will be applied to the case of the ECB to clarify the logic underpinning the basic positions of both the supporters and the critics of the Bank. Prior to this analysis, though, the institutional design of the Bank needs to be sketched.

2. The institutional design of the European Central Bank

The ECB is one of the most independent central banks in the world. The ECB's statutory independence is derived from the relevant Articles and Protocols of the Maastricht/ Amsterdam treaties. In this respect, the basic observation to be made is that the Bank exhibits both a high degree of economic and political independence.

The economic independence of the ECB is mainly derived from Articles 105 and 108 of the Amsterdam Treaty. Here, for example, it is stated that:

The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community (Article 105). ... When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB, nor a national central bank, nor any members of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and governments of the Member-States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks (Article 108).

Thus, although exchange rate policy is set by the Council of Ministers (Article 111.2), the statutes indicate that the ECB has a primary mission to maintain price

stability and that it is the sole authority with the power to decide monetary policy. In this respect, the Commission or the Council has no power to veto the Bank's monetary policy decisions. Indeed, in formal terms it has few, if any, ex post ways of influencing the Bank's decisions.

The political independence of the ECB is derived from a number of other Treaty articles. So, for example, the Governing Council of the ECB is composed of a six-person Executive Board (a President, Vice-President and four other members) as well as the Governors of each national central bank participating in the single currency. Members of the Executive Board are appointed for eight-year non-renewable terms by common accord of the governments of the member states at the level of heads of state or government, at the recommendation of the Council of Economics and Finance Ministers (ECOFIN), after consultation with the European Parliament and the Governing Council of the ECB itself (European Communities, 1992, *Protocol on the Statute of the European System of Central Banks and of the European Central Bank*, Article 11.2). Moreover, members of the Executive Board must be appointed "from among persons of recognized standing and professional experience in monetary or banking matters ..." (ibid). In addition, the salaries of the members of the Executive Board are determined by Governing Council of the Bank (ibid, Article 11.3) and in effect Board members can only be retired if they have been found guilty of serious misconduct (ibid, Article 11.4).

The other main aspect of the Bank's political independence concerns its formal reporting commitments. Here, the Treaty states that the Bank "shall address an annual report on the activities of the [European System of Central Banks] and on the monetary policy of the previous and current year to the European Parliament, the Council and the Commission, and also to the European Council. The President of the ECB shall present this report to Council and to the

European Parliament, which may hold a general debate on that basis” (Amsterdam Treaty, Article 113 (3)). In addition, the Protocol states that the “ECB shall draw up and publish reports on the activities of the ESCB at least quarterly” (European Communities, 1992, *Protocol on the Statute of the European System of Central Banks and of the European Central Bank*, Article 15.1) and that a “consolidated financial statement of the ESCB shall be published each week” (ibid, Article 15.2). Finally, it is also indicated that the “President of the ECB and other members of the Executive Board may, at the request of the European Parliament or on their own initiative, be heard by the competent Committees of the European Parliament” (Amsterdam Treaty, Article 113.3).

Overall, the ex ante design of the ECB created an extremely independent institution in terms of both economic and political indicators of independence.³ Moreover, in terms of ex post oversight the ECB is subject to only a minimum number of formal reporting requirements. In short, the ECB is an extremely independent monetary policy agency and was deliberately designed to be so.

3. The debate about independent central banks and the ECB

The institutional design of the ECB has provoked considerable political comment. There is an ongoing debate between two different sets of people who hold mutually exclusive viewpoints: one supportive of the ECB and one critical. Indeed, more often than not these positions are related not just to the position of the ECB *per se* but to the role of independent central banks more generally. In a recent article, Berman and McNamara (1999) highlighted three aspects of this more general debate: the theoretical element; the empirical element and the

normative element. Each will be reviewed in turn and, where appropriate, will be applied to the ECB.

The first element of the debate concerns the theoretical rationale for central bank independence. This rationale is derived from the so-called 'expectations-augmented Phillips curve'. The original Phillips curve purported to show that there was a trade-off between unemployment and inflation. In this case, governments could supposedly manipulate the economy by allowing demand to rise in times of deflation and *vice versa*. Increasingly, though, this trade-off was challenged. It was argued that the public remembered that previous bouts of inflation had adversely affected their real wages and profits and reacted rationally to the prospect of future bouts by constantly revising their inflationary expectations upwards. The result was that whenever unemployment was below its natural level the public would continue to demand higher and higher wage, or price, increases and so inflation would accelerate. In other words, in the long-run the expectations-augmented Phillips curve was vertical. In this situation, the only way to bring down inflation was to reduce the level of inflationary expectations amongst the public. The best way to do this, it was argued, was by the adoption of a rule-based monetary regime (Barro and Gordon, 1983). In such a regime there would be clear monetary targets and publicly announced medium-term financial strategies showing that decision-makers were serious about reducing inflation. In turn, this would reduce the level of inflationary expectations amongst the public. The corollary of this work was the argument that responsibility for managing the rule-based regime, and, hence, for setting monetary policy, should be transferred from governments to independent central banks. Politicians, it was argued, were not sufficiently credible to be able to reduce the level of inflation. They sacrificed the need to keep to medium-term inflationary targets in order to boost their short-term

electoral needs (the so-called time-inconsistency problem). Consequently, the level of inflationary expectations remained high. In this context, Rogoff (1985) argued that there were gains to be made by entrusting responsibility for monetary policy to an independent, conservative inflation-averse central bank that would establish a reputation for sound money. In so doing, it would resolve the time-inconsistency problem and drive inflationary expectations down.

For many people, the theoretical rationale for central bank independence is a compelling one. Moreover, there is a good case for arguing that the EMU process was driven at least in part by a powerful epistemic community that championed the need for a highly independent ECB on the basis of the above logic (Dyson, 1994). However, there are objections to the theoretical case. For example, Berman and McNamara (1999) argue that there is nothing special about monetary policy. Plenty of policy areas suffer from the equivalent of the time-inconsistency problem. In fact, politicians, they say, “frequently shrink from prescribing bitter medicine for fear of paying an electoral price” (ibid, p. 3). Thus, either people should be willing to transfer policy making to independent decision-makers in every domain or they should be willing to do so in none. For their part, Berman and McNamara recommend the latter. A similar line of argument has been taken by Taylor (2000). He points out that even when so-called ‘experts’ have been entrusted with a special decision-making responsibility, this does not mean that they will necessarily agree with each other. Moreover, these disagreements are just as likely to concern value judgements about welfare effects on different groups of citizens as purely technical matters of policy implementation (ibid, p. 186). Indeed, a similar point is made by Verdun and Christiansen (2000). For them, any belief that an institution like the ECB is “purely technical and/or non-partisan rather than political is flawed” (ibid, p. 173). In this case, the issue “lies less in the pursuit of a

Pareto-optimal resource allocation, but in the way in which the institutional arrangements respond to a wider social understanding and thereby manage to remain 'unquestioned'" (ibid). All told, there are those who remain unconvinced of the theoretical case for central bank independence.

The empirical case for central bank independence is a result of the studies that have established a positive correlation between a high degree of central bank independence and a low level of inflation. One of the earliest studies of this sort argued that "there is a positive association between the legislation of a price stability objective and the achievement of a relatively non-inflationary and low variability monetary policy" (Parkin, 1978, p. 182). A slightly later but equally influential study reached a more general conclusion: "independent central banks have conducted monetary policies over the years that have been less accommodative to outside pressures than the policies of their less autonomous counterparts; consequently, their countries have experienced substantially lower rates of inflation" (Banaian *et al*, 1983, p. 13). Indeed, over the years the empirical case for central bank independence has been strengthened by the argument that there is no equivalent correlation between central bank independence and low growth. For example, Grilli *et al* famously concluded that "having an independent central bank is almost like having a free lunch: there are benefits but no apparent costs in terms of macroeconomic performance" (1991, p. 375). Indeed, some evidence has suggested that central bank independence may even be associated with positive growth (De Long and Summers, 1992, p. 14).

As with the theoretical rationale for central bank independence, the empirical case has also been criticised. In particular, it has been argued that the correlation between central bank independence and low inflation is spurious. In other words, while central bank independence may be a factor in bringing about low inflation, other factors may be just as important or maybe even more so. For

example, Posen has argued that the interests of the financial sector are crucial in determining the level of inflation. Thus, he states that “similar degrees of political independence will offer significant degrees of protection from inflation over time as the political situation alters” (Posen, 1993, p. 53) and he concludes that the “predicted anti-inflationary success of the European Central Bank ... rests on the ECB’s political context, not on the institutional features of the bank itself” (ibid, p. 54). Similarly, Hall (1994) and Hall and Franzese (1998) have drawn attention to the importance of coordinated wage bargaining in the determination of the rate of inflation. On the basis of this logic, Hall and Franzese argue that the existing nature of coordinated wage bargaining procedures in Britain, Ireland and France may mean that these countries have something to gain from EMU by virtue of acquiring an independent central bank (ibid, p. 527). Equally, Greece, Portugal and Spain may also gain slightly. However, all other countries are likely to be net losers (ibid). Thus, again, for some people the empirical case for an independent ECB is not as strong as others would suggest it to be.

The final argument is a normative one. Here, there is a basic agreement that independent central banks should be accountable. At the same time, though, there is a clear difference of opinion as to whether the ECB meets this requirement. On the one hand, there is no doubt that the members of the Bank’s main decision-making authorities have spent a considerable amount of their time defending the Bank from the accusation that it suffers from a democratic deficit. The Bank’s position in this regard has been consistently repeated in the period since 1 January 1999. For example, the ECB’s 1999 Annual Report reiterated the Bank’s commitment “to the principles of openness, transparency and accountability” (European Central Bank, 2000, p. 129). Moreover, one of the members of the Bank’s Executive Board, Otmar Issing, indicated that Bank was

indeed true to these principles stating unequivocally that the ECB “is both accountable and transparent” (Issing, 1999a, p. 28). A similar position was adopted by the President of the Bank, Wim Duisenberg, who stated that the ECB “is fully independent, but also fully accountable to Parliament, Ministers and the public” (Duisenberg, 2000a, p. 15). Another member of the Bank’s Executive Board, Tommaso Padoa-Schioppa, reiterated this view, arguing that the Eurosystem “fulfils its accountability obligation, *inter alia*, by way of a comprehensive dialogue with political bodies” (Padoa-Schioppa, 2000, p. 6). Finally, the Bank’s sensitivity to the issue of democracy was underlined by further member of the Executive Board, Sirkka Hämmäläinen, who confessed that bringing decision-making at the European level closer to citizens was “a matter of vital importance” to her (Hämmäläinen, 1999, p. 1).

In stark contrast, however, critics of the Bank have argued that it is a highly unaccountable institution. In this regard, the Bank has been criticised by both left- and right-wing politicians. For example, in the 1992 referendum campaign in France the *de facto* leader of the ‘no’ campaign, gaullist politician Philippe Séguin stated that “when it comes to a question of monetary choices, the economic and social consequences of which are considerable, I believe that democratic control is always a better guarantee than technocratic irresponsibility” (in the supplement to *Libération*, 31 August, 1992, p. 9).⁴ The left-wing British Labour MP, Dianne Abbott, was even more succinct, arguing that “monetary policy is too important to be left to central bankers” (Abbott, 2000, p. 230). Academics too have underlined the undemocratic nature of the ECB. For example, prior to the start of Stage II of EMU Hirst and Thompson argued that: “[t]he effect of the ‘independence’ of the European central bank would be to allow virtually unaccountable officials to dictate economic policy, at a time when the central organs of the EU will still lack legitimacy and citizen identification”

(Hirst and Thompson, 1996, p. 162). Finally, practitioners too have criticised the ECB. For example, Willem Buiter, a member of the Monetary Policy Committee of the Bank of England, has argued that: “[t]he 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” (Buiter, 1999, p. 205).

Overall, it is clear that there are opposing views about central bank independence. Moreover, it is also clear that these views are reflected in the theoretical, empirical and normative assumptions that underpin this debate. The rest of this article focuses on the normative issue surrounding the institutional design of the ECB. In so doing, it adopts a principal-agent approach.⁵ The advantage of such an approach is that the debate about ECB’s purported democratic deficit can be recast so as to highlight the essential differences between the two opposing camps, while at the same time maintaining a consistent terminology based on a common set of first principles.

4. Recasting the debate in terms of principal-agent theory

This section applies principal-agent theory to the debate about the accountability of the ECB. Here, the aim is not to judge whether the position adopted by the Bank’s supporters is ‘correct’ or whether its critics are ‘right’. Instead, the aim is simply to demonstrate how principal-agent theory can be used to defend the positions of those on each side of the debate. In this way, it simply reconstructs the views of the protagonists in the debate and reports what they would be likely

to say if they were to argue in principal-agent terms. Thus, principal-agent theory is being used as an heuristic device to identify the assumptions that underpin the debate about the accountability of the Bank.

Principal-agent theory and the supporters of the ECB

In terms of principal-agent theory the ECB's position is consistent with the belief that there has been no agency shirking or slippage. According to this line of thought, it would be argued that the Bank was delegated the sole authority to conduct monetary policy and in carrying out this responsibility since 1 January 1999 it has simply followed the provisions of the Maastricht Treaty. In so doing, the Bank has been faithful to the clearly expressed preferences of the principal at the moment of delegation. On the basis of this reasoning, therefore, principal-agent theory can be interpreted to suggest that the Bank does not suffer from a democratic deficit. The logic behind this argument can be justified in two different ways.

The first stresses the general preferences of the actors when authority was delegated to the Bank in the first place. Here, it can be acknowledged that the ECB has operational independence and, thus, that it enjoys great autonomy. In most principal-agent studies agency autonomy and shirking go together. After all, the usual assumption is that the more autonomy an agency enjoys, the more opportunity it has to act self-interestedly and diverge from the preferences of the principal. However, for the ECB, it might be argued, this is not the case. This is because the initial preference of the principal was precisely to delegate power to an autonomous institution. An independent ECB was the express wish of EU governments and, by extension, EU citizens as a whole. Here, therefore, anything

that the ECB does, at least within the confines of the Maastricht/ Amsterdam treaties, can be considered democratic and should not be treated as shirking.

Representatives of the ECB have often based their arguments on this sort of logic when justifying their activity. Indeed, Issing has made explicit reference to principal-agent theory in this regard, stating that “the principal, which could be assumed to be collectively the people of the EU11, ... has delegated the conduct of monetary policy to a specialised agent (the ECB) ...” (Issing, 1999a, p. 27). In a similar way, although without explicit reference to principal-agent theory, Hämäläinen has justified the Bank’s activity on the basis of the “fact that the participating countries handed over an important economic policy tool i.e., their monetary policy, to a common European institution ...” (Hämäläinen, 1999, p. 2). Equally, the political underpinnings of the delegation process have been emphasised by the Vice-President of the Bank, Christian Noyer. He has argued that:

the introduction of the euro and the establishment of the ECB constitute a new, important step in the process of European integration ... This process is based on the political view that an integrated Europe is in the interest of stability, security and prosperity. The European integration process is primarily a political process with, of course, important economic aspects and benefits (Noyer, 1999a, p. 2).

The logic behind all of these declarations is the same, namely that the Maastricht Treaty established an extremely independent central bank. As a result, the ECB is perfectly justified in acting autonomously because in so doing it is not diverging from the preferences of the principal as expressed at the time of the delegation. To put it another way, the citizens of EU member-states gave the ECB a blank

cheque to act autonomously. The Bank cannot be criticised, therefore, for jealously guarding this autonomy and maintaining its independence.

The second way in which the ECB's autonomy can be justified in terms of principal-agent theory is similar but slightly more specific. The Maastricht Treaty specified the Bank's primary objective to be the maintenance of price stability (see above). Moreover, the Treaty allowed the Bank to decide for itself exactly what was meant by this term. Thus, when the Bank decided that price stability should be defined as a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area of below two per cent, and when it determines interest rate changes with a view to keeping inflation below this level, then it is perfectly justified in so doing. In other words, it cannot be considered to be acting in a way which diverges from the preferences of the principal at the time of delegation. Once more, therefore, principal-agent theory can be interpreted to suggest that the Bank does not suffer from a democratic deficit.

The representatives of the ECB frequently rely on this logic when justifying their actions. For example, Issing argues that accountability "simply means that we 'do what we are supposed to do'" (Issing, 1999b, p. 508), namely maintain price stability. Even more explicitly, for Noyer accountability, or democratic responsibility as he puts it, is to undertake "to do what the Treaty requires us to do, which is to ensure price stability" (Noyer, 1999b, p. 6). Indeed, this is the logic of the ECB's 1999 annual report. Here, in the section on public information and accountability, the report states that:

The primary objective of the Eurosystem is to maintain price stability in the euro area. This primary objective is the ultimate benchmark against which the performance of the Eurosystem has to be evaluated. The ECB has announced a quantitative definition of price stability which further specifies, in precise terms, the

yardstick against which the Eurosystem's performance should be measured, thereby facilitating accountability (European Central Bank, 2000, p. 130).

In other words, members of the ECB believe that they are acting in a manner consistent with the initial preferences of member-state governments (the principal)⁶ if they manage to limit the annual growth in the rate of inflation to less than two per cent. Indeed, they can act as autonomously as they may wish in this regard, within the confines of the Maastricht/ Amsterdam treaties at least, as long as they can maintain the level of inflation below this level. The result is that, however much people (and politicians) may complain about the adverse effects of the ECB raising interest rates (or at least not lowering them), the Bank is still justified in acting independently because it can claim that it is simply following the preferences of those who delegated this power to the Bank in the first place. Again, therefore, principal-agent theory can be interpreted so as to suggest that the ECB is an accountable and democratically responsible institution.⁷

Principal-agent theory and the critics of the ECB

In contrast to the ECB's position, principal-agent theory can also be used to justify the arguments of those who criticise the Bank. In this case, the logic of the previous sub-section is reversed. The assumption here would be that the ECB is guilty of shirking. Since the introduction of EMU, it might be argued, the preferences of the Bank and the principal have diverged. In this way, principal-agent theory can be interpreted to suggest that the Bank has acted in an undemocratic manner and that it suffers from a democratic deficit. As before, this line of argument can be justified in two particular ways.

The first places emphasis on the Bank's secondary objective. Since 1 January 1999, representatives of the Bank have repeatedly stressed that their fundamental concern is price stability. For example, Duisenberg has stated that "[a]ll other objectives are ... subservient" to this end (Duisenberg, 2000b, p. 6). However, while this is indeed the Bank's primary objective, it also has a secondary objective, namely to support the general economic policies in the Community (see above). The aims of these policies are set out in Article 2 of the Treaty establishing the European Community and they include promoting a balanced and sustainable development of economic activities, and a high level of employment and social protection. Thus, the Bank may be considered to have shirked on the terms of its original delegation, and to have acted in an undemocratic manner, if can be shown to have ignored, or at least paid insufficient attention, to its second statutory objective.

The most high-profile person who has consistently been identified with this line of argument is the chair of the European Parliament's Committee on Economic and Monetary Affairs, Christa Randzio-Plath.⁸ When ECB representatives have appeared before the Committee she has repeatedly argued that the Bank has failed to place sufficient importance on its secondary objective. For example, in the period immediately after the Bank became operational she complained to Duisenberg in the following terms: "There is a kind of asymmetry between the competence of acting in the ECB in questions of inflation and deflation and how do you interpret in the ECB Article 105 [sic]. I still fail to understand when the time is that the ECB must act in order to support employment" (Duisenberg, 1999a, p. 13). Later in the year, she pressed Noyer on the same issue: "In your opinion, is there a threshold for non-inflationary growth where the European Central Bank would actually have to intervene, where you would be supporting this policy through your interest rate policy and then

having to tread on the brakes?" (Noyer, 1999b, p. 16). More recently still, she quizzed Duisenberg again about the same matter. This time she was even more blunt, asking "[when] is the ECB going to make clear how it interprets Article 105 and the secondary objective of the ECB?" (Duisenberg, 2000a, p. 7). Indeed, just to show that this was not a lone crusade, the same point was highlighted by the Committee's *rapporteur*, Christopher Huhne. In his report on the ECB's activities he recommended that the EP resolve to consider "it necessary, in the interest of transparency and credibility, for the ESCB to make clear how monetary policy is intended, over and above the objective of price stability, to contribute to a balanced and appropriate policy mix, with a view to promoting sustainable growth and employment" (Committee on Economic and Monetary Affairs, *Report on the Annual Report for 1998 of the European Central Bank* (C4-0211/1999), p. 6).

This type of reasoning clearly runs counter the ECB's position. It does not question the terms of Maastricht Treaty and, hence, the legitimacy of the initial delegation of power. Instead, it argues that since power was delegated the ECB has acted in a discretionary manner which runs counter to the expressed terms of the initial delegation. In short, the Bank has shirked. It has gone against the initial preferences of the principal by not taking full account of its secondary objective and, therefore, it can be deemed to have acted undemocratically.

A second line of argument takes a slightly different starting point. This argument suggests not that the ECB has gone against the initial preferences of the principal, but that these preferences have changed since this time. According to this line of argument, it can be acknowledged that the initial aim was to take monetary policy-making out of the hands of politicians, but now, it might be asserted, the principal wishes to recuperate some of this lost power and requires the Bank to be more responsive to its demands. In this way, principal-agent

theory can be understood to imply that whatever the initial preferences of the principal may have been, the ECB is acting in an undemocratic manner because it is going against the preferences of the principal as they are expressed now.

The clearest expression of this train of thought can be found in the renewed attempts by the French government to try to establish an economic government, meaning a political counterweight to check the ECB.⁹ Immediately after taking over the presidency of the Council on 1 July 2000 the French government emphasised that this was one of the main aims of its term of office. So, for example, the official government statement entitled 'A Europe of Growth, Employment and Innovation' stated that "the French presidency will ... suggest to its partners that the role of the Euro 11 should be enhanced, by further improving its operation, giving its proceedings greater visibility vis-a-vis the financial markets and heightening its political profile in the outside world". Unsurprisingly, the same theme was underlined by the French Finance Minister, Laurent Fabius, who stressed that "explaining what we do better and giving more visibility to the Euro 11 will be one of the main aims of the French presidency" (interview in *Le Monde*, 4 July, 2000, p. III).

The fact that the French government is actively promoting this policy may be seen as an indication that the preferences of the principal have changed since the initial delegation of power as set out in the Maastricht Treaty. Needless to say, this position is at odds with the preferences of the ECB. The Bank considers any attempt to establish a political counterweight to the ECB to be detrimental to prospects for EMU and, hence, the Bank's capacity to achieve price stability. In this case, therefore, principal-agent theory can be interpreted to suggest that the preferences of the principal and the agent have moved out of line and that the Bank is suffering from a democratic deficit.

5. Principal-agent theory and the reform of the ECB

It is apparent, therefore, that principal-agent theory can be applied in ways which suit the arguments of both the supporters and the critics of the ECB. In this context, two points need to be made. The first is that this situation should not be seen as a weakness of the theory itself. On the contrary, it is a strength. Principal-agent theory clarifies the conflicting logics that underpin the positions held by the different actors. In this way, it helps us to conceptualise the debate surrounding the institutional architecture of the ECB more clearly. The second point is that, as stated previously, this article does not aim to determine which of the conflicting logics outlined above is 'correct'. Quite the opposite, the aim of setting out the debate surrounding the ECB in principal-agent terms is to illustrate that both parties have intrinsically sound positions. Therefore, even though the rest of this article draws upon principal-agent theory to indicate how the ECB's democratic deficit might be addressed, this should not be taken as an endorsement of the Bank's critics. Instead, in this section it is simply assumed that the Bank is guilty of shirking. On the basis of this assumption the aim is merely to show how principal-agent theory can be called upon to indicate the most appropriate ways in which the relationship between member-states and the ECB could be reformed so as to reduce the Bank's putative democratic deficit.

In section one it was shown that there are standard and non-standard solutions to the principal-agent problem. The standard solutions comprised ex ante and ex post controls with the latter comprising police-patrol and fire-alarm oversight as well as sanctions. With regard to the ECB, ex ante controls, sanctions and fire-alarm controls, it will be argued, are inappropriate. By contrast, police-patrol oversight and some non-standard solutions, it will be suggested, may be feasible.

Ex ante controls are ruled out by the very design of EMU. The Maastricht Treaty established the institutional framework of EMU. However, as has been discussed, the aim of the principal at this time was to provide the ECB with operational independence. Thus, the decision was made ex ante not to impose a systematic set of checks and balances on the Bank. Moreover, the nature of the EU and, in particular, the realities of EMU are such that any renegotiation of the set of ex ante controls is unrealistic. The structures of the Bank can only be reformed by amending the Treaty and this is unlikely to happen. It is, as Pollack puts it, a “nuclear option”, meaning a “relatively ineffective and noncredible means of member state control” (Pollack, 1997, pp. 118-19). Moreover, even if member-state governments began to go down this path, the financial and economic repercussions would most likely be substantial as the markets would almost certainly react in a negative fashion. In practical terms, therefore, while critics of the Bank may wish to see Treaty amendments (for example, Buitter, 2000, p. 243), it would be very difficult to increase the accountability of the ECB without actually undermining the institution’s credibility, threatening the stability of the euro even further and squandering any of the potential benefits to be gained from EMU. Thus, ex ante controls, meaning a renegotiation of the terms of the delegation, have in effect been ruled out.

The same is true for sanctions and fire-alarm oversight. In terms of sanctions the same logic applies as above. The Maastricht/ Amsterdam treaties establishes few, if any, controls with regard to the ECB and the introduction of any such procedures would require Treaty amendment which, as with the previous point, is simply not possible at this stage. In terms of fire-alarm oversight the situation is slightly different. Here, such oversight is inappropriate because of the peculiarities of the ECB. In general, fire-alarm oversight is applicable when the principal is the legislature and when there is a well

established judicial procedure to which interested parties may have redress. In this situation, shirking may be brought to the attention of legislators either directly by constituents/lobbyists or indirectly through litigation. In the case of the ECB this situation simply does not apply. The principal is well aware of the ECB's shirking, but there is nothing that can be done about it. In short, the alarm has been sounded but the fire brigade is not in a position to respond. Thus, sanctions and fire-alarm oversight may also be ruled out.

By contrast, there is some scope for increased police-patrol oversight and for the application of certain non-standard solutions to the principal-agent problem. In terms of police-patrol oversight, McCubbins and Schwartz state that an "agency's activities might be surveyed by any number of means, such as reading documents, commissioning scientific studies, conducting field observations, and holding hearings to question officials and affected citizens" (McCubbins and Schwartz, 1984, p. 166). On the basis that these activities are carried out not simply with the aim of surveying whether there has been shirking but to discourage the ECB from any further activity of this sort, then there is room for more police-patrol oversight of the ECB.¹⁰ In this regard, the European Parliament (EP) has a key role to play.

The EP is well placed to oversee the activity of the ECB because it can do so without the need for Treaty reform. Indeed, to date the EP has been moderately successful in expanding its influence over the Bank in this regard (Westlake, 1998). For example, at the time of his nomination as President, Duisenberg stated that he would be likely to withdraw his candidacy if "there was a wave of unanimous disapproval" (Duisenberg, 1998, p. 19), even though there was no statutory obligation for him to do so. Indeed, he implied that he might withdraw even if the level of disapproval was somewhat less strong. Similarly, the EP successfully managed to obtain Duisenberg's agreement that he

would appear before the Committee on Economic and Monetary Affairs four times a year. Moreover, the information from the initial meetings suggests that these appearances are somewhat more than just a mere formality. The President and other representatives have been subject to rigorous questioning and the EP's opposition to some of the Bank's policies has been clearly stated. Finally, there is some evidence to suggest that the EP has managed to encourage the Bank to pay greater attention to its secondary objective regarding growth and employment (see above). For example, in response to the EP's persistent questioning in this regard Duisenberg has gone on record as saying that "we hate [deflation] as much as we do inflation" (Duisenberg, 1999b, p. 11). Indeed, he repeated this phrase almost word for word four months later (Duisenberg, 2000b, p. 11).¹¹ More importantly still, when the Bank decided to cut interest rates on 8 April 1999 Duisenberg justified the decision on similar grounds, stating that "price stability and social stability are not conflicting, but supplementary and mutually reinforcing policy objectives. As economic policy-makers, we should keep this in mind when we formulate strategies to promote employment and social stability" (Duisenberg, 1999c, p. 3).

In these ways, then, without weakening the statutory responsibilities and the nascent credibility of the ECB, the EP has managed to increase the conditions for a greater degree of police-patrol oversight. In terms of future changes, the EP should consider debating more frequently the conduct of the ECB's affairs even in the absence of the President or one of his representatives, passing resolutions concerning the Bank's monetary actions, and presenting the public more clearly with its own preoccupations for the conduct of monetary policy. Any such developments, along with those that have already occurred, may help to reduce the divergence between the preferences of the principal and the agent with regard to EMU.

In addition to increased police-patrol oversight, there is room for certain non-standard solutions to be considered. In this respect, there may be the opportunity to create competition between multiple agents and, hence, increased responsiveness of the ECB to member-state preferences. For example, if powers were delegated in the field of fiscal and social policies too, then the institutional conditions for a more balanced policy-mix may be facilitated. Needless to say, however, this could be a medium-term policy with an indeterminate guarantee of success. More realistically, member states might be encouraged to find ways of shaping the unspoken expectations of the EMU process. In their article Calvert, McCubbins and Weingast emphasise the importance of “the indirect and, in real life, subtle effect of the wishes of elected politicians upon the actions of unelected bureaucrats” (Calvert, McCubbins and Weingast, 1989, p. 607). In this regard, there is the potential for the Euro group to play a key role.¹²

At present, the powers of the group are limited. It merely allows the exchange of economic information; it discusses budgetary policy; and it can comment on interest rate levels which, of course, are set by the ECB. Moreover, it is statutorily forbidden from seeking to influence the members of the decision-making bodies of the ECB. So, it is not in a position to pressurise the ECB in any formal sense whatsoever. What is more, there is little to be gained by the group ignoring its mandate and provoking a public clash with the ECB so as to try to force the Bank’s hand. Such a clash would only be likely to make the ECB more intransigent and less likely to be receptive to the preferences of member states. Indeed, this was shown very clearly when the former German Finance Minister, Oskar Lafontaine, tried unsuccessfully to change the Bank’s policy in the period from January to March 1999. However, the group does have the potential to establish a more discrete and subtle dialogue with the ECB. If the group conducts itself in a discrete way, it has the opportunity to create a favourable and

mutually respectful environment within which the ECB may be encouraged to give greater importance to popular sentiment when making its decisions. In other words, it may encourage the Bank to cut interest rates. The best evidence for this point so far can be found in the events surrounding the Bank's first interest rate cut in April 1999. This cut, it should be appreciated, followed Lafontaine's resignation. In the press conference which followed the Bank's decision Duisenberg was asked whether he had met governments halfway and had agreed to the cut so as to help the unemployment problem. In his reply the President of the ECB stated that he did "not have that much difficulty" with the reporter's words (Duisenberg, 1999d, p. 6).

In this way, then, there is the potential for the Euro group to instil a heightened awareness of political sensitivities into the ECB's way of thinking without reforming the Maastricht/ Amsterdam treaties, without forcing a damaging public dispute between politicians and central bankers and, hence, without threatening the credibility of the ECB and the potential success of the EMU project as a whole. In other words, the Euro group has the opportunity to bring the preferences of the principal and the agent closer together.

Conclusion

The ECB is currently at the centre of a highly sensitive economic and political debate. Principal-agent theory helps to elucidate the foundations of this debate. Moreover, it also helps to propose realistic ways in which the Bank's operations could be democratised if this is considered to be necessary. However, what does this article tell us about principal-agent theory itself? After all, if the same logic can be used to support two completely contradictory arguments, then does this not suggest that the theory is in fact somehow deficient rather than enlightening?

The answer is 'no' and for two reasons. The first is that the principal-agent approach is useful for heuristic purposes. It establishes a framework with which to clarify particular issues. Moreover, it does so from a set of clearly identifiable first principles. In this way, there are no hidden assumptions and in the study of politics this is a definite advantage. The second reason is that the principal-agent approach is value-free. By focusing on the exercise of control within institutional arrangements, principal-agent theory forces attention to focus on positive rather than normative analysis. Any conclusions as to how relations should be structured can then be grounded in a clear understanding of how they actually work in practice.

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Notes

¹ For a politics-related overview with regard to the EU, see Doleys (2000).

² Ferejohn takes issue with this solution and focuses, instead, on the multiple opportunities available to principals that encourage agents “to compete with other options available to the principal in order to attract her support ...” (Ferejohn, 1999, p. 133).

³ For a measurement of the ECB’s independence, see Elgie (1998).

⁴ All translations are by the author.

⁵ The principal-agent approach has been applied to the economics of central banks by Walsh (1995) and Persson and Tabellini (1993).

⁶ Arguably, power was delegated to the ECB by multiple principals, namely the set of member-state governments. For simplicity’s sake, however, this article assumes that power was delegated by a single principal, the Council of Ministers as a whole.

⁷ A similar point is made by de Haan and Eijffinger (2000). They argue that governments should not have given the Bank itself the right to determine the operational definition of its primary objective. Indeed, this power, they believe, is one element in the Bank’s lack of accountability. However, they also argue that, given the Bank was granted this power, it cannot be blamed for using it (*ibid*, pp. 398-99).

⁸ Note that prior to the start of the 1999-2004 session the equivalent institution was the Sub-Committee on Monetary Affairs.

⁹ This position was adopted by the French during the Maastricht negotiations and immediately prior to the commencement of EMU. In this way, it might be argued that this proposal does not represent a shift in preferences. However, to the extent that it was not reflected in the delegation of power set out in the Maastricht Treaty and that the French government has very publicly reiterated this argument during its 2000 presidency, then it can be argued that it represents at least a new and significant manifestation of a more established position. In this respect, it can be

considered as a shift in preferences for the purposes of reconstructing the debate in principal-agent terms.

¹⁰ This point is emphasised by Taylor (2000, p. 197).

¹¹ There is some evidence to suggest that the Bank is now willing to state not just that there is a ceiling, but that there is also a floor to its definition of price stability. See, for example, the ECB's annual report for 1998 which states "the use of the word 'increase' in the definition [of price stability] clearly signals that deflation, i.e., prolonged declines in the level of the HICP index, would also not be deemed consistent with price stability" (European Central Bank, 1999, p. 49).

¹² This is a sub-group of ECOFIN comprising the Finance Ministers of all countries participating in EMU. It was formerly known as the Euro-11.

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