THE EUROPEAN CENTRAL BANK HOW ACCOUNTABLE? HOW DECENTRALIZED?

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ELLEN E. MEADE

ECONOMIC STUDIES PROGRAM
CONFERENCE REPORT NO. 4

American Institute for Contemporary German Studies
The Johns Hopkins University

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The American Institute for Contemporary German Studies (AICGS) is a center for advanced research, study and discussion on the politics, culture and society of the Federal Republic of Germany. Established in 1983 and affiliated with The Johns Hopkins University but governed by its own Board of Trustees, AICGS is a privately incorporated institute dedicated to independent, critical and comprehensive analysis and assessment of current German issues. Its goals are to help develop a new generation of American scholars with a thorough understanding of contemporary Germany, deepen American knowledge and understanding of current German developments, contribute to American policy analysis of problems relating to Germany, and promote interdisciplinary and comparative research on Germany.

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FOREWORD

The P.J. Hoenmans Program on Economic Policy Issues in Germany, Europe and Transatlantic Relations of the American Institute for Contemporary German Studies hosted a conference on May 28, 1998, to discuss Europe's new monetary institution, the European Central Bank (ECB). This conference was convened shortly after the historic first weekend in May during which eleven of the European Union's fifteen member states were selected to participate in monetary union from its commencement in 1999. The conference sought to examine the democratic accountability and decentralized structure of the new institution, and to invite comparison of that new institution with Germany's *Bundesbank* and America's Federal Reserve System.

At the time of the conference, the ECB was the subject of some controversy. Over the historic first weekend in May, a row had erupted over the selection of the president of the new central bank, as French officials attempted to split the eight-year term of office in order to permit a Frenchman to succeed the first president, Wim Duisenberg, after four years time. Although the controversy was resolved, its outbreak caused some to question the ECB's independence from political influence. In addition to the controversy over the presidency, hearings before the European Parliament of the six candidates selected to occupy the seats on the ECB's Executive Board focused attention on the democratic accountability and transparency of the institution. The candidates, including President-elect Duisenberg, saw little reason to publish minutes or summaries of meetings at which monetary policy decisions would be made.

This report contains the four papers that were presented at the AICGS conference. Christa Randzio-Plath, a member of the European Parliament from Germany who has been a leader in the Parliament's discussion about the ECB, provided insights into the debate over democratic accountability. In particular, Mrs. Randzio-Plath commented on the hearings that the Parliament had conducted with the candidates for the ECB's Executive Board, and on the key roles that openness and transparency of policy actions would play in establishing public accountability for the new institution.

Susanne Lohmann assessed Europe's new monetary authority from an institutional perspective. Professor Lohmann's offered a pessimistic outlook for the euro experiment, based upon the view that the formal design of the ECB would not permit it the flexibility necessary to react appropriately in a democratic society.

Adam Posen discussed the role that monetary targeting had played in *Bundesbank* policymaking and the lessons that could be drawn from this strategy

for the ECB. In Posen's view, the *Bundesbank* had pursued a masquerade, using an announced strategy of monetary targeting to pursue its actual strategy of inflation targeting. The transparency of ECB policy would be assured, Posen asserted, only if the ECB did not follow in the *Bundesbank*'s footsteps.

Ellen Meade and Nathan Sheets looked at the historical experience of the U.S. central bank and what implications the Fed's history might have for Europe's new institution. Decisionmaking authority in the Federal Reserve System is much more centralized than in the ECB system, and the decentralization in the new European arrangements raised questions about regional interests and their impact on voting patterns.

A final presentation, by Garry Schinasi, chief of the Capital Markets and Financial Studies Division in the Research Department at the International Monetary Fund (IMF), addressed some operational aspects of the introduction of the euro. Schinasi examined the role of the system to process and settle euro payments (known as the TARGET system) and questioned the efficiency of this system, with some focus on whether TARGET would pose an impediment to the rapid development of an integrated money market in euro. In addition, Schinasi presented his views on the potential for a deep and highly liquid market for European bonds to emerge, similar to what exists for U.S. securities. Although Schinasi's remarks are not included in this conference report, the IMF volume *International Capital Markets* published in September 1998 discusses many of these issues.

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February 1999

ABOUT THE AUTHORS

Christa Randzio-Plath, a lawyer by training, has been a member of the Social Democratic Party of Germany since 1964 and was elected to the European Parliament in 1989. Mrs. Randzio-Plath is a member of the European Parliament's Committee for Economic and Monetary Affairs and Industrial Policy and chairs its Subcommittee on Monetary Affairs. In that capacity, Mrs. Randzio-Plath has been very involved in the discussions concerning the European Central Bank and its democratic accountability.

Susanne Lohmann is 1998/1999 fellow at the Center for Advanced Study in the Behavioral Sciences at Stanford University as well as professor of Political Science at UCLA. Since receiving her Ph.D. in Economics and Political Economy from Carnegie Mellon University, Professor Lohmann has focused her research on collective action, international political economy and the political economy of central banking. Dr. Lohmann received the 1998 DAAD prize for Distinguished Scholarship in German Studies in the field of economics, presented at the AICGS Global Leadership Award Dinner.

Adam Posen is a senior fellow at the Institute for International Economics in Washington, D.C. From 1994-1997, he was an economist in International Research at the Federal Reserve Bank of New York. Dr. Posen received his Ph.D from Harvard University in Political Economy and Government, and has since focused his research on macroeconomic policy, monetary and financial systems, international political economy, and central bank independence and transparency.

Ellen E. Meade is a senior economist in the Division of International Finance at the Federal Reserve Board in Washington, D.C. In addition, Dr. Meade serves as director of EMU Studies for AICGS. She has worked extensively on European issues, particularly German monetary policy and the nascent European Monetary Union. In 1994-95, Dr. Meade served on President Clinton's Council of Economic Advisers.

D. Nathan Sheets is an economist in the Division of International Finance at the Federal Reserve Board in Washington, D.C. Since receiving his Ph.D. in economics from the Massachusetts Institute of Technology, Dr. Sheets has worked on the Russian and Japanese economies. In addition, during the academic year 1996-97, he was a visiting professor at Brigham Young University.

THE DEMOCRATIC ACCOUNTABILITY OF THE EUROPEAN CENTRAL BANK: CHALLENGES FOR THE ECB AND THE EUROPEAN DEMOCRATIC SYSTEM

Christa Randzio-Plath

INTRODUCTION

It is now beyond doubt that the single European currency, the euro, will come into existence on the planned date of January 1, 1999: that is, in thirty-two weeks. This will possibly come as something of a shock to quite a large number of pundits and politicians on both sides of the Atlantic, who were predicting until very recently that it couldn't be done. They badly underestimated the will to succeed that existed in the European Union (EU) and in the body that represents the people of the Union, the European Parliament (EP).

All the major decisions needed to establish monetary union have now been made. Eleven of the EU's fifteen member states have fully met the economic and institutional criteria for participation in the single currency, and these eleven countries will form the "first wave" to adopt the euro next year. The conversion rates at which their national currencies will be "irrevocably fixed" have been determined. The European System of Central Banks (ESCB), which consists of the European Central Bank (ECB) and the national central banks, is already coming into existence. It is also worth noting that Denmark, Sweden and the United Kingdom, which will remain outside the single currency area for the time being, nevertheless also fully met the inflation, interest-rate and fiscal tests, and that Greece will meet them in two or three years.

Attention has now shifted away from the issues of "when" and "with whom," to questions about the way in which the euro itself will develop. Let me turn first to the question of today, on the future ECB, and to the question of whether the euro will be "strong" or "weak." In some European countries, such as my own, there certainly have been fears that a single currency including countries with records of high inflation and high budget deficits (the most frequently-mentioned example is Italy) might be less stable than is desirable: that the euro, to be blunt, would not be "as good as the DM."

But those voicing such fears have not, I believe, taken account of the formidable battery of mechanisms that have been put in place to ensure the euro's stability. The euro will have at least three lines of defense against inflationary attack. First, the requirement that member states avoid "excessive budget deficits" is not merely a criterion for joining the single currency, but a continuing obligation. It has been reinforced by the Stability and Growth Pact, which effectively requires all participants to maintain balanced budgets over the economic cycle. No national budget deficit will ever, in normal circumstances, be allowed to rise above three percent of GDP.

Second, the Maastricht Treaty contains three "golden rules" governing the way in which any national budget deficit can be financed. These are: (1) a prohibition on the "monetary financing" of deficits—profligate governments will no longer be able to reduce their debts, and cheat those who lend them money, by inflating their currencies; (2) no "privileged access" to financial institutions—such governments will no longer be able to force their citizens to lend them money at lower than market rates of interest; and (3) no "bail out"—a government that gets into financial trouble will not be able to rely on the EU or its member states to come up with a rescue package.

Finally, and perhaps most important, full responsibility for the monetary policy of the euro area will reside with the ESCB, with the ECB itself at the core.

The Maastricht Treaty created the ESCB. From January 1, 1999, when the European Monetary Union (EMU) is launched, the ECB will decide a single monetary policy on behalf of all the countries participating in monetary union. The ECB is the first federal monetary authority in European history and will have unprecedented powers. The independence of the ECB is very far-reaching as it can only be altered by the means of a unanimous decision of the member states. The unprecedentedly high degree of independence calls for a correspondingly high level of democratic accountability, as real independence requires legitimacy and transparency in order to be credible and lastingly accepted. This is especially true for the ECB as a new institution.

INDEPENDENCE OF CENTRAL BANKS IN EUROPE

The independence of central banks is a relatively recent development in Europe. It is not an element in the tradition of European constitutional history, which has been marked by the principle of the division of powers in the

framework of the philosophy of Montesquieu and as a part of the check and balance powers in the United States. In Europe, the first independent central bank system was established in Germany after the First World War at the initiative of the Allies, but was stripped of its independence on the advent of the Third *Reich*. After the Second World War, the U.S. insisted on a federal independent central bank system in the Federal Republic of Germany. The independence of the central bank came up for debate in Europe at the beginning of the 1970s with the Werner Plan, and the concept of an independent European central bank arose and was incorporated into the Delors Report and the Maastricht Treaty.

In the nineteenth century, when central banks were set up modeled on the Bank of England (governed by the British Bank Charter Act of 1844), strict rules were laid down to limit the discretion of the central bank with regard to the issuing of banknotes. Initially, central banks were privately owned, but later they were nationalized and became subject to political control and political instructions. This inaugurated a period of reduced independence for central banks, but as it came to be recognized that low inflation could best be guaranteed by independent central banks, rules were altered in the 1880s and 1890s with the purpose of rendering central banks more independent again. Thus, the statutes of the European banks of issue mark a high point in the history of the independence of central banks.

In comparison with virtually all the other European banks of issue, Germany's *Bundesbank* enjoys the most independence, as it "shall be independent of instructions from the Federal Government in exercising the powers assigned to it by this Act." Since 1957, the *Bundesbank* has repeatedly demonstrated this independence. It is not accountable to the *Bundestag*. Central and eastern European states, as well as Sweden, Norway and Finland, while guaranteeing the independence of the central bank, involve their parliaments in monetary policy.

Legal convergence with regard to independence—institutional (in terms of staffing), operational and financial—of national banks of issue in the EU and other European countries too has reached an advanced stage. The legislative process will have to be completed in 1998. All EU central banks already have a duty to pursue the objective of monetary stability, and their independence has either been secured or will be guaranteed by legislation before the end of 1998. Transparency and compulsory reporting are provided for by some central bank

legislation or statutes. Monetary dialogue with national parliaments is provided for in France, Greece, Spain, Ireland, Sweden, Finland, Italy, Luxembourg, Portugal, and the United Kingdom. In addition, in Spain, the budget of the central bank must be submitted to Parliament for approval. Thus, as central banks have become increasingly independent of political instructions from the executive, the trend towards legitimation by means of the transparency of monetary decisions through monetary dialogue with parliaments has been accentuated.

The ESCB will have two key features. First, in the words of the Treaty itself, "[T]he primary objective of the ESCB shall be to maintain price stability." Even though it will also be required to "support the general economic policies in the Community," the Treaty makes it clear that this must be "without prejudice to the objective of price stability." Second, in order to pursue its primary objective, the ECB and the participating national central banks will enjoy "independence." This means, again in the words of the Treaty, that "neither the ECB, nor a national central bank, nor any member of their decisionmaking bodies shall seek or take instructions from Community institutions or bodies, from any government of a member state or from any other body." At the same time, to reinforce the point symmetrically, "Community institutions and bodies and the governments of the member states undertake to respect this principle and not to seek to influence the members of the decisionmaking bodies of the ECB or of the national central banks in the performance of their tasks." The Treaty also lays down that the ECB shall be independent not only in its actions, but also financially, organizationally, and in terms of staffing.

These basic provisions of the Treaty will result in a central bank which enjoys greater independence—that is, greater protection from interference by politicians—than any central bank in any political system in history. Even the position of the *Bundesbank*, widely considered the model for the ECB, has had to be modified in order to comply with the independence requirements of the Treaty.

It is also important to note that this independence is legally protected in a way that does not apply to even the most independent national central bank. The statute of a national central bank theoretically can be changed either by the simple passage of legislation or, at the most, by a change in the national constitution through prescribed procedures. To change the statute of the ECB in any way, however, it would be necessary to change the Maastricht Treaty

itself, requiring the unanimous decision of all fifteen EU member states (soon, perhaps, to be twenty or twenty-five after the enlargement of the EU), and the approval of any change by referendum in several of these states. Given that there is a demonstrable correlation between the degree of independence of national central banks and their record in preserving the value of the currency, the euro thus stands a good chance of being a very stable currency.

Such a degree of independence, however, raises certain political questions. First, it is important to be clear why independent central banks have a good record in maintaining price stability. Central bank independence limits short-run political influences on policy and thus achieves a monetary policy that corresponds better to the preferences of the democratic majority. The purpose of central bank independence, therefore, is to favor the long-term rather than the short-term. Second, in order to carry out its task of maintaining the value of the euro, the ECB will have at its disposal a number of monetary instruments, in particular the power to determine short-term interest rates. And, use of these instruments will inevitably have consequences for real economic aggregates such as economic growth, investment and employment. There is the risk that a central bank may seek to enhance its own reputation by breaking records for price stability, even if that entails high unemployment.

European monetary union has focused attention on a problem which has not yet been entirely resolved anywhere. That is, how to reconcile the need for central bank independence in order to control inflation with the requirement in a democracy that major choices of economic direction should be taken politically.

In sum, reconciling central bank independence with the requirements of democracy is not turning out to be an easy matter and both sides, the ECB as well as the EP, still have to learn. But both sides also need transparency of monetary decisionmaking. The EP needs it because democracy and transparency belong together. The ECB needs transparency in order to get credibility and confidence. It is for this reason that the EP has been paying special attention to that aspect of the ESCB which is the reverse side of the independence coin: accountability for decisions and actions.

ACCOUNTABILITY

The independence of the ECB and its democratic accountability are two sides of the same coin. The Maastricht Treaty and the Statute of the ECB provide for a monetary dialogue with the EP. Evidently, even at the time of the conclusion of the Treaty, the governments and central bank presidents assumed that the high degree of credibility and trustworthiness of the future ECB would be underpinned by a high degree of transparency of monetary policy decisions. For all institutions functioning within a democracy, the fundamental principle has to be that decisions taken must be transparent and accountable. It is crucial that the independence of the future ECB will meet with public acceptance. The ECB must enjoy a high degree of legitimacy.

The EP possesses competence in monetary affairs. The approval of the EP is required for the amendment of specific articles of the ESCB Statute and for specific tasks with regard to the supervision of credit issuance (assent procedure, Article 189b). The cooperation procedure (Article 189c) applies to detailed rules for the Stability and Growth Pact, the prohibition of privileged access by central government bodies to credit facilities, as well as the prohibition of liability for commitments of public authorities or for public debt. The consultation procedure applies to a wide range of aspects concerning the transition to the euro. Parliament's opinion must be obtained before a legislative proposal from the Commission is adopted by the Council. But, it is the Council that takes the final decision. The EP had to be consulted, for example, for the appointment of the president of the ECB and the members of its Executive Board. It will also be consulted when the fixed exchange rate between the euro and the other currencies will be set. Finally, the Maastricht Treaty provides for some instances where the EP has to be informed. One example is the submission of the ECB's annual report and general debates with or hearings of the president of the ECB. The ECB has therefore the duty to report to the EP.

Thus, the Maastricht Treaty and the Statute of the ECB give the ECB not only rights but also obligations. So, there are the rudiments of democratic accountability along the lines of that which exists in the United States, for example. The concept of accountability raises a number of separate issues. Full communication by the ECB will be absolutely essential. If accountability is to be real, it must be possible to establish a monetary dialogue on the questions of why and how the ECB is making its decisions.

Asking for transparency is a new thing in Europe, as central bankers were used to making their decisions behind closed doors and to deciding whether and how they wanted to explain their decisions. The ESCB and the ECB will conduct a single monetary policy for all the member states taking part in European monetary union. The ECB is the first federal monetary authority in European history. Democratic accountability must similarly be exercised at the European level. The EP, democratically elected by the people of Europe, is the appropriate institution to hold the ECB to account. The ECB will be conducting a Europe-wide monetary policy, and the EP represents the people of Europe as a whole. The presidents of the national central banks, however, should explain the single monetary policy to the national parliaments.

PRICE STABILITY AND THE RIGHT POLICY MIX

The primary objective of the ECB is to maintain price stability. However, the ECB has other duties to fulfill. The Maastricht Treaty recognizes the capacity of monetary policy to support the general economic policies of the Community and to contribute to the achievement of the objectives of the Community without prejudice to the objective of price stability. With a single monetary policy, Europe must gain a more appropriate and better balanced policy mix which is badly needed to stimulate investment, growth and employment.

One issue which has given rise to much discussion is the precise definition of "price stability," and how it is to be monitored. The Treaty itself contains no definition. In applying the convergence criteria for membership in the EMU, the Treaty does state in Article 109j1 that a high degree of price stability would be apparent "from a rate of inflation which is close to that of, at most, the three best performing member states in terms of price stability." "Close to" is defined as being within 1.5 percentage points. The best-performing countries achieved 1.2 percent inflation in the February 1997 to January 1998 reference period, with all countries except Greece not only comfortably below the reference figure of 2.7 percent, but also below 2 percent. These Treaty requirements, however, are not much help in reaching long-term definitions. They were primarily designed to ensure nominal convergence between EU member states and would have been fulfilled equally well if the inflation rates had been between 11.2 and 12.7 percent.

A clear definition of price stability is nevertheless needed. For the purpose of holding the ECB accountable for its actions, specific numerical inflation targets are required. It is clear that the task of defining price stability will now fall to the ECB according to Article 12 of its Statute. The EP calls on the future ECB to make clear the definitions and its use of operational targets to reach the price stability target.

In preparation for the ratification of appointments to the ECB's Executive Board, the EP sent a questionnaire to all six candidates. This questionnaire formed the basis for our detailed examination of the candidates when they appeared before Parliament's Economic and Monetary Committee on May 7-8, 1998. One of our key questions was: "Which definition of price stability and which monetary concepts, targets and instruments do you favor for the monetary policy of the future ECB?" The reply of the nominated ECB president, Wim Duisenberg, was essentially that of all the candidates: "Concerning the definition of price stability, there is a broad consensus among central banks that this can be characterized as a rate of change of the consumer price level comprised in a range between zero and two percent. Such a range enables us to take into account the, on balance positive, measurement errors and the changes over time in consumption habits that affect the basket of representative goods on the basis of which the index is measured."

This definition is a reasonable starting point for the development of an accountability procedure. The starting point would be the specific inflation targets, together with inflation forecasts, evaluations of inflation trends, and intermediate money supply targets, as well as the underlying forecasts for GDP growth. Then, if rates of inflation are particularly high or low, the EP should call for a specific explanation from the ECB. Parliament and the ECB, it seems, are agreed that there will have to be both inflation targets and intermediate targets. Mr. Duisenberg told the Committee hearing that he was not in favor "of putting all the eggs into one basket" and believed in a "mixed targeting strategy."

ECONOMIC AND MONETARY DIALOGUE

The Bank is also required, under the Treaty, to support the general economic policies in the Community. The procedures by which these general policies come into existence are still under development. Key elements are the annual economic report by the Commission, on which Parliament holds an

annual debate, and the procedures for determining the broad guidelines of the economic policies of the member states and of the Community under Article 103 of the Treaty, in which Parliament participates. The EP therefore hopes that the ECB's annual reports will contain appraisals of the extent to which monetary policy has in fact supported these general economic policies. The ECB president will be invited to participate not only in Parliament's debate of the ECB annual report, but also in the debate of the Commission's annual economic report. The incoming president, Wim Duisenberg, has given us to understand that he will be willing to do so.

Once price stability has been achieved and can be maintained, the ECB has to take into account the need to support the economic policies of the EU and, pursuant to Article 105 of the Maastricht Treaty, to support the goals of the Community of Articles 2 and 3 concerning economic growth and a high level of employment. These provisions have to be explored further. Certainly, controlling inflation fosters growth and employment. But there is not only the risk of overshooting the inflation target but also that of undershooting it. This will have a negative impact on growth and employment.

ECB decisions will typically entail two dimensions: first, a technical dimension, concerning the forecast of future inflation and the assessment of the current and future state of economic activity; and second, a political dimension, concerning the appropriate policy response to shocks when a tradeoff between alternative goals is required. Accountability should be exercised over both dimensions. This requires having access to central bank information, to its forecasts, and to its assessment of the current economic situation. Otherwise, it will be much more difficult to hold the ECB accountable if we cannot understand the motivation behind its policy decisions.

ACCOUNTABILITY MEANS: REPORTING TO THE EP

The establishment of the ECB is attended by many uncertainties. It will be in the ECB's own interests if its decisions on monetary policy and the thinking behind them are announced publicly, because its independence will be enhanced in the same measure as it succeeds in pursuing a convincing monetary policy. It must be possible to establish why and how the ECB is taking its decisions. In addition to the presentation of the ECB annual report foreseen in Article 109b3, quarterly meetings on recent monetary and economic

developments with the president and/or other members of the Executive Board should take place. In this way, greater certainty could be attained concerning monetary policy under EMU than would be possible just by publishing reports, as the substance of the reports would be determined solely by the ECB.

A continuing monetary dialogue between the EP and the ECB is needed in order to avoid any misunderstanding which might have an adverse effect on the markets and speculation. Past experience of a dialogue between the EP, the presidents of the European Monetary Institute (EMI) and national central banks, and the Subcommittee on Monetary Affairs has shown that democratic accountability is perfectly feasible in the form of reports and dialogue. The Maastricht Treaty and the Statute of the ESCB and ECB stress the importance of this dialogue, which may at any time be initiated at the request of the president of the ECB or the EP. Four additional dialogues each year with the responsible committee would be sufficient and desirable. In addition, the EP has the intention to invite the ECB president to take part in the general debate on monetary and economic developments over the previous and the current year, on the basis of the annual report of the ECB and the European Commission's (EC) annual economic report as well as the broad economic guidelines which are proposed by the Commission and later on decided by the Council of Ministers. The dialogue between the EP and the ECB will concentrate on the definition of price stability, the targets, and the monetary instruments used in pursuing price stability.

Wim Duisenberg, the president of the future ECB, takes the problem of openness and transparency seriously. In the hearing, he underlined the necessity for a monetary dialogue with the EP and giving public evidence not only about the definitions of price stability and monetary goals and decisions, but also the background underlying the decisions. He committed himself to report to the EP at least four times per year and to comment on both the EC annual economic report and the broad economic guidelines.

ACCOUNTABILITY MEANS: PUBLICATIONS

The ECB has to publish annual reports. First, the EP urges the ECB to include in its annual reports a description and an evaluation of recent inflation trends. The ECB should explain its past monetary policy decisions in the light of these trends and how they comply with the established price stability target.

In addition, the ECB should explain its inflation forecasts and compare them with the established price stability target, as well as discuss the forecasts for real GDP growth upon which the price stability target is based. Second, the annual reports should give information concerning the use of intermediate monetary targets. Third, the EP calls on the ECB to include a description of how the ECB intends to support the general economic policies in the Community with its monetary policy, as well as its appraisal of the extent to which monetary policy has in fact supported these general economic policies.

This publication requirement makes the ECB democratically accountable. Admittedly, the quarterly reports do not necessarily have to be debated in the EP. A reading of Article 15 in conjunction with Article 12 shows that reporting is expected to cover monetary policy definitions, approaches, objectives, and instruments.

ACCOUNTABILITY MEANS: PUBLICATION OF MINUTES

The EP calls for the minutes of the ECB Council meetings to be published in the form of summaries. These should include the decisions made and the reasoning behind them. The summaries should also explain how the decisions are linked to and affect other policies. The minutes should be published at the latest by the day after the ECB's next meeting, and full detailed minutes should be published at the latest five years after the meeting.

In order for the monetary decisionmaking process to be described as open, it is not enough that reports should be published. Monetary decisions must be publicly announced and justified on the same day as they are made. An important aspect of this is the publication of the ECB's minutes of decisions made at its meetings. The U.S. Federal Reserve has adopted a practice which reconciles the need for the bank to be independent with the need for openness of decisionmaking. Never once has the fact that minutes recording decisions are published caused any turbulence on the markets or concern among investors. Nor has the independence of the Federal Reserve been called into question either by the markets or by the chairman or other members of the Fed's policymaking body.

Although publication of the voting conduct of members of the respective central bank boards in some countries is perfectly customary, for example in the United States, this should not be required during the first phase of the third stage

of EMU. The new supranational authority has no precedent. True, it has its place in the tradition of European central banks and can draw on the achievements of the national central banks. However, it will be difficult enough to formulate and implement a uniform monetary policy. This Europeanization process should not be disturbed by speculation about voting. The ECB's Executive Board and Governing Council must be given every opportunity to reach agreement.

The future ECB Board members take a different view on the publication of the minutes. Wim Duisenberg, for example, wants any minutes to be published only after "a reasonable period of time," after members have completed their terms on the Board, about sixteen years. By these means, he wants to assure that no member can be influenced at an earlier stage. Especially after a comparison with the U.S. system, the EP finds this unacceptable. The publication of minutes does not have any adverse effect on financial markets, nor do the members of the Fed's policymaking body consider themselves to be less independent. The publication of minutes will therefore be subject to further discussions.

ACCOUNTABILITY MEANS: CONSULTATION IN NOMINATION AND ASSENT PROCEDURES

The EP had to be consulted on the appointment of the six members of the ECB's Executive Board by the governments of the member states (Article 106). Therefore, on May 7-8, 1998, we held hearings with Wim Duisenberg and the other candidates for the Board in the appropriate committee of the EP, the Committee on Economic and Monetary Affairs and Industrial Policy. These hearings—held in public, along the lines of those in the American Senate—allowed for forming an impression of the candidates' personal integrity, professional competence, and views on monetary and economic policy. Unlike in the United States, the nomination process does not comprise a ratification procedure. The EP has no power to enforce its decision. It cannot even legally prevent a nomination. This means that the EP has only the political power to assess nominees, and through its hearing procedure, it may help to guide public opinion in promoting the credibility, trustworthiness and legitimacy of the ECB. The ECB will gain in credibility and legitimacy if the members of the Executive Board make a convincing impression in public. This will further enhance the

position of the Board members, particularly bearing in mind that they are being called upon to serve on the board of a supranational bank of issue since public monetary dialogue does not yet exist at the European level.

Finally, it must be said that certain governments have questioned the independence of candidates and of the ECB during the discussions about the ECB's first president. This form of public controversy was counterproductive and fueled public mistrust concerning the independence of ECB presidents. The EP has expressed the hope that the first president would be nominated early and that the term of office would not have to be divided between candidates, because only this would comply with the Maastricht Treaty and respect the principle of independence. In the case of Wim Duisenberg, however, we approved his appointment as he convinced us he would be fully independent. During his hearing with the EP, Wim Duisenberg dispelled any doubt that he was merely a puppet on the string of national governments. He has proved to be an independent central banker.

CONCLUSION: RECONCILING DIFFERING VIEWS

The EP, fortunately, does not come to the task of creating a working system of accountability for the ESCB entirely "cold." Over the past four or five years, Parliament's Monetary Subcommittee has held many detailed discussions both with the two successive EMI presidents—Mr. Lamfalussy and Mr. Duisenberg—and also with most of the national central bank governors. These discussions have revealed that certain differences of view clearly exist as to how monetary policy should be conducted, and not just between politicians on the one hand and central bankers on the other. Some I have already touched upon.

For example, there has clearly been a division of opinion between those central banks that have favored inflation targeting (such as the Bank of England) and those that have preferred to operate through targets for monetary aggregates (such as the *Bundesbank*). The initial practice of the ECB, as we have seen, is likely to be a combination of these traditions.

In the past, there have also been differences in the technical instruments used in monetary management, with a greater or lesser reliance upon open market operations as opposed to minimum reserve requirements. As a detailed analysis published by the EMI in 1997 made clear, the ECB will not follow any one tradition, but is likely to make use of a wide range of available instruments.

This could include, so we learned at the hearing of ECB candidates, active intervention in the secondary markets for public debt.

There are also, as we have seen, very clear-cut differences on the issue of transparency. Here the division is between what has been called the "German-Dutch culture of confidentiality" and the "Anglo-Saxon-Scandinavian culture of openness." A compromise here is going to prove more difficult.

Finally, differences of opinion clearly exist on the balance between the pursuit of price stability and the pursuit of wider economic goals. Though it is possible to maintain, theoretically, that there is no conflict, the differences are apparent from the desire of certain governments and parliaments—notably that of France—for some kind of "economic government" to act as a "counterweight" to the independent central bank.

One issue that must be addressed in any case is the need to coordinate monetary policy, which will be conducted as a single policy for the whole euro area, with fiscal policy, which will remain the devolved responsibility of the separate national governments and parliaments, subject to the limits on budget deficits. Most urgent of all is the need to reduce the high levels of unemployment in most European countries. Monetary policy must clearly contribute to this objective.

The European Parliament is fully ready and prepared to play its part in resolving these issues.

THE DARK SIDE OF EUROPEAN MONETARY UNION

Susanne Lohmann

"The euro will deliver an electroshock to the European system."
Niall Fitzgerald, Unilever (Dahlburg, 1998)

INTRODUCTION

European Monetary Union (EMU) will further the process of European integration and allow the welfare gains from comparative advantage and economies of scale to be realized. The common currency will sweep away state-sponsored market inefficiencies and rigidities, break up entitlements that threaten to bust government budgets, and lift the fog of depression that has settled on the old world. A newly discovered sense of economic dynamism will bring jobs to regions devastated by enduringly high unemployment rates. Europe will find peace at last: the common currency, along with common political institutions, will forge a European people out of disparate nationalities who once killed each other in two world wars. This, at least, was the vision of German Chancellor Helmut Kohl and other Europhiles in government and business.

But European monetary integration has its dark sides. On the economic side, the future member states of EMU do not meet the criteria for an optimal currency area, despite the Maastricht-induced convergence of budget deficits and inflation rates. Their economies react very differently to changes in interest rates, implying that the pain of a tight monetary policy will be distributed unevenly across countries (Ramaswamy and Sloek, 1977; Dornbusch, Favero, and Giavazzi, 1998). If some states experience a recession while others grow, the constraints implied by a common currency will inevitably mean sacrificing the needs of some countries on the altar of a stable euro—or sacrificing the stability of the euro to accommodate troubled economies.

Consider the plight of Finland's economy, which has historically suffered from extreme economic volatility, in part because it cycles with world demand for pulp and paper (Warner and Peterson, 1998). A slump in the paper market would cause a recession in Finland with little, if any, impact on other European countries. It is doubtful that the European Central Bank (ECB) would lower interest rates to help the Finnish economy, which accounts for only 1.5 percent

of the euro zone's total gross domestic product (GDP). Finland could, of course, spend its way out of a recession. Indeed, in its last downturn in 1991-92, Finland's budget deficit soared to 12 percent of GDP. But as a member of EMU, it risks penalties if its deficit exceeds 3 percent of GDP. Then again, the ECB could look the other way, but it then risks creating a precedent that would undermine the expectations EMU is built on (namely, that fiscal practices inconsistent with the demands of a common currency will be punished).

On the political side, EMU—having been negotiated by political elites with little voter input and voter support—has a "democracy deficit." Many European voters remain unconvinced that EMU is desirable. Two-fifths of the German respondents to a public opinion poll expected to suffer disadvantages from the euro's introduction; just over one-third expected their personal situation to remain unchanged; only 7 percent expected to benefit (Pötzl, 1988). French voters are even more fearful: two-thirds expect to be worse off under EMU (Graham, 1997). In many countries, voters support EMU not because they believe EMU will be beneficial *per se*, but because they care about affiliated benefits—European integration providing an external disciplining force for an "irresponsible" government (Italy) or monetary integration "leading" trade integration (Austria).

The economic and political weaknesses of EMU stimulate crisis scenarios (Feldstein, 1997; Didzoleit, 1998). The ECB will follow an excessively tight monetary policy to establish credibility with the markets. Unemployment rates will remain stubbornly high even in good economic times. Workers will become dissatisfied and restless as the common currency makes transparent the differences in wages and benefits from one country to the next. Italian government debt will spiral out of control. International capital will move out of the euro into the dollar and the yen. Several European countries will experience severe recessions. The long-suffering electorates of the member states of EMU will take an envious look at dynamic Britain, which is doing exceptionally well outside of EMU, thank you very much. Violent protests will break out in France. The extreme right in France and the former Communists in eastern Germany will gain votes. The French government will insist on changes to the Stability and Growth Pact, but Germany will refuse. In the end, EMU will unravel, with long-lasting collateral damage to the larger effort of European integration.

The political analysis in this paper provides a theoretical underpinning for such crisis scenarios. It is argued here that EMU builds on a naive view of political institutions. It is designed to disappoint and, ultimately, to fail.

Well designed institutions have built-in mechanisms of political accountability that allow monetary policy to be shaped by both credibility and flexibility concerns. Lacking flexibility, EMU has a brittle "make it or break it" quality. Earlier, I discussed the case of Finland, an economic and political lightweight. If heavyweights like Germany or France experience an economic recession and the ECB proves to be inflexible, EMU will fall apart. Of course, it is possible, and indeed likely, that the ECB will transcend its rigid design and turn into the political animal it was never meant to be, in which case it will accommodate the heavyweights and lower interest rates—or look the other way when troubled economies seek fiscal relief.

But my argument is concerned with the formal design of EMU, which is built on the attitude that monetary decisionmaking is—and should be—isolated from the messy and counterproductive pressures of democratic politics. I suggest instead that an apolitical ECB is both impossible and undesirable.

It is impossible to keep politics out of monetary policy because institutional design does not "map" into policy outcomes in a mechanical and deterministic fashion. In practice, policy outcomes depend on the policy preferences of political agents who control the decision points of the institution in question and on informal (non-institutionalized) interactions between these agents and their political principals. Policy preferences and informal interactions are not perfectly controllable; the potential for political slippage cannot be "designed away."

More important, the notion that politics necessarily weakens a monetary institution, rather than being a source of strength, is untenable. Powerful institutions like the *Bundesbank* derive their independence not from the letter of the law or from formal appointment procedures. Instead, they are embedded in a larger political system, supported by powerful political stakeholders (Posen, 1993, 1995) or competing political veto players operating in a system of checks and balances (Lohmann, 1998a). By depoliticizing the ECB, its designers make it difficult for the ECB to attract political stakeholders who have the ability and incentives to protect the integrity of the institution when it comes under political attack.

Finally, the wide range of predictions about the consequences of EMU for Europe—eternal peace versus riots and war, economic boom versus economic disaster—underscores the extreme and ill-defined uncertainty societies face when they undertake large-scale institutional changes that are off the charts of human experience. We would like to see voters, and not political elites, make choices that have huge potential upsides and downsides in shaping the destiny of large numbers of people. But EMU has a "democracy deficit" in that it lacks voter input in some member states and voter support in many others. As a result, EMU does not have the political legitimacy to withstand the serious crises it will inevitably encounter, given the hard economic choices ahead.

"QUIS CUSTODIET IPSOS CUSTODES?" (WHO WILL GUARD THE GUARDIANS?)

Roman satirist Juvenal (Courtney, 1984)

In a democracy, the power lies with elected politicians who shape public policy and affect the wealth and well-being of large numbers of people. Monetary policy and monetary institutions are anomalous. Monetary policy is often isolated from electoral politics, set by independent central banks staffed with "conservative" technocrats (Rogoff, 1985). To the extent that an all-party consensus keeps monetary policy off the electoral agenda, voters who are unhappy with its effect on employment and output, or on their pocketbooks, have nowhere to go.

One reason for the anomalous political treatment of monetary policy is the fact that discretionary monetary policy is beset by a time-consistency problem that results in an inflation bias. This problem arises when economic agents in the private sector, expecting the central bank to inflate, write an inflation markup into their nominal contracts, which the central bank is then forced to accommodate to avoid depressing employment and output (Kydland and Prescott, 1977; Barro and Gordon, 1983). In an open economy, a time-consistency problem also arises in the presence of a balance-of-payments objective. One country inflates in order to depreciate its exchange rate and improve the competitiveness of its exporting industries. But if several countries simultaneously follow a beggar-thy-neighbor policy, their real exchange rates and relative competitiveness are unaffected, and all they have to show for their efforts is excess inflation (Cukierman, 1992).

Another reason for the anomalous political treatment of monetary policy lies in its political vulnerability. Democratic policymakers have incentives to manipulate the money supply for electoral or partisan purposes. An opportunistic political business cycle arises when incumbent policymakers have incentives to expand the money supply before elections to stimulate the economy and thereby increase their chances of reelection (Nordhaus, 1975; Rogoff and Sibert, 1988; Persson and Tabellini, 1990; Lohmann, 1998b, 1999). Inflation and unemployment then vary over time as a function of the electoral cycle. A partisan political business cycle arises when one political party caters to a constituency with preferences for low inflation and its competitor represents a constituency that is better off with a high rate of inflation (Hibbs, 1977; Alesina, 1987). Inflation and unemployment then vary over time as a function of the party in power. Either way, the political incentives to use monetary policy for electoral or partisan gain lead to excessive variability in aggregate economic outcomes.

Credible commitment is the solution to the time-consistency problem and the political vulnerability of monetary policy. Rational expectations imply that systematic attempts to stimulate output are futile in equilibrium and only create an inflationary cost. As a result, policymakers are better off credibly committing in advance not to inflate or to create pre-election monetary surges. Policymakers in open economies are better off committing not to follow competitive beggar-thy-neighbor policies at each other's expense. Political parties who take a long-run view and know they may be in power today, out of power tomorrow, are better off cooperating to avoid opportunistic or partisan swings in monetary policy.

Credible commitments about the future path of monetary policy often take on institutional form. Instead of committing directly to the optimal monetary policy path, elected politicians commit to an institution that will follow the optimal path, or at least some second-best path that is preferable to a monetary policy beset by inflation biases, pre-election monetary surges, and partisan swings. Examples of such institutional commitments are independent central banks staffed with conservative central bankers, monetary and inflation targets, currency boards, and fixed exchange rate arrangements such as the gold standard and the European Monetary System (EMS). EMU, which provides for a common currency, is of course the ultimate example of a regime that fixes exchange rates about as close to irrevocably as possible.

Elsewhere, I have considered two questions about monetary institutions (Lohmann, 1992, 1996, 1998c). First, why do credible, or at least partially credible, commitments take on institutional form? Specifically, why would a policymaker choose to set up a monetary institution rather than simply promise to follow a steady, non-inflationary monetary policy? Second, how should monetary institutions optimally be designed? Specifically, how can a policymaker design a monetary institution so as to achieve credibility while retaining some flexibility to deal with real shocks and unforeseen contingencies?

A monetary institution draws a "line in the sand" that allows the audience of the policymaker's institutional commitment—voters, wage setters, financial markets, and other policymakers—to monitor whether the policymaker is keeping his promise and to execute trigger-strategy punishments if he reneges. An **institutional defection**—the dismissal of a central banker, a devaluation or exit from the EMS, the failure to achieve a monetary target—generates an **audience cost**. This cost can take on many different forms: voters may vote the policymaker out of office; wage setters may write high inflation mark-ups into nominal wage contracts; financial markets may engage in destabilizing speculation or shift investment capital to other countries; cooperative agreements with other policymakers on other dimensions of public policy may break down. It is this audience cost, or the threat of a trigger-strategy punishment, that makes the policymaker's commitment to the institution credible.

A well designed institution not only is credible (in the sense that institutional defections trigger an audience cost), but it also has a built-in capacity for responding flexibly to extreme shocks and unforeseen contingencies. For example, a conservative central banker (Rogoff, 1985) who is only partially independent (Lohmann, 1992) will respond to real shocks to some degree and accommodate the policymaker's demands in extreme circumstances. This institution provides both credibility (in "normal times," the conservative central banker sets monetary policy independently and thus follows her preferences for low inflation) and flexibility (in "extreme situations," the central banker is forced to accommodate the more inflationary preferences of her political principal). The institution of a partially independent conservative central banker comes with the added benefit that it does not break down in equilibrium (the central banker accommodates up to the point where her political principal is indifferent between accepting the central banker's decision, on the one hand, and paying

the political cost of overriding or dismissing the central banker, on the other). As a result, the trigger-strategy punishment protecting the central banker's partial independence is not executed in equilibrium. Avoiding the audience cost promotes welfare especially when the cost is borne not only by the political principal but also by the people (as is the case, for example, when the audience of the policymaker's promise punishes him, and themselves, when it revises its inflation expectations upwards).

In many cases, the institutional promise is directed at an audience that is capable of executing state-contingent trigger-strategy punishments. Such an audience can observe or verify the "state of the world"; that is, it can recognize extreme shocks and unforeseen contingencies when they occur and excuse "legitimate" defections. Flexibility then comes at low cost: the credible threat of an audience cost provides credibility, but this cost is waived when flexibility is called for.

Audiences differ in their ability to execute state-contingent punishments. For example, voters would be well informed about the dismissal of a central banker if it makes front-page news. Voters in small open economies know all about devaluations. Voters also observe inflation, which they experience as rising prices in the supermarket. But they cannot usually monitor the fulfillment of a monetary target like the *Bundesbank*'s *Zentralbankgeldmenge* (central bank money stock). By and large, voters are blissfully unaware that such a monetary target exists in the first place. Even if they knew of the target, they would not have the expertise to understand its economic implications, nor would they have an interest in checking whether the central bank is on track. On the other hand, trade union and employer organizations who negotiate wage contracts, along with big players in financial markets, are an ideal audience for a monetary targeting procedure. Not only do they have incentives to monitor the fulfillment of the target, but they are also well informed and can observe economic and political developments that would justify a deviation from the target, in which case they can waive the punishment.

Economists often discuss the pros and cons of monetary institutions on narrow technocratic grounds and neglect a more important distinguishing characteristic: different institutions invoke different audiences. It is argued here that a large part of optimal design consists of setting up a monetary institution so as to invoke the ideal, or close-to-ideal, audience. The "guardians of the guardians" should have the ability and incentives to inflict an audience cost on

the policymaker in the event that he reneges, thereby generating credibility; but they should also have the ability and incentives to excuse defections when extreme shocks or unforeseen contingencies are realized so as to allow for flexible policy responses while minimizing the probability and cost of institutional breakdown.

It is along this dimension—the credibility versus flexibility tradeoff—that the ECB and EMU compare unfavorably to the *Bundesbank* and the EMS. The latter two come with a complex schedule of audience costs and a capacity for excused defections. They have built-in mechanisms of accountability that generate partially credible commitment while retaining some degree of flexibility to respond to extreme shocks and unforeseen contingencies.

By design, the *Bundesbank* has some surface similarity to the ECB, but it is questionable whether the performance of the *Bundesbank*-anchored EMS will carry over to EMU. To illustrate, let me describe several audiences and compare their ability and incentives to monitor the *Bundesbank* and the EMS, on the one hand, with the ECB and EMU on the other.

The Electoral Connection

Voters can impose the ultimate audience cost: they can vote the government out of office. But the mass of voters tends to be ill-informed. As noted above, voters can monitor highly salient events that make front-page news or trends they experience personally. But they do not usually have the information, expertise, and incentives to execute state-contingent trigger-strategy punishments.

Worse, voters themselves face a time-consistency problem in executing trigger-strategy punishments. After all, a policymaker who inflates to stimulate the economy typically does so to please voters, who care not only about inflation but also about employment and output. It is not obvious that voters would have incentives to vote out of office a policymaker who is "doing good." This time-consistency problem is avoided when voters punish for "emotional" reasons—national pride, national trauma, a national inferiority complex. They are then willing to execute a punishment even if the punishment is not, as an economist would say, "renegotiation-proof" (Fudenberg and Tirole, 1991, pp. 174-176).

Older German voters experienced the traumatic consequences of two hyperinflations. Middle-aged voters take pride in the *Wirtschaftswunder* (the

postwar economic miracle), which is perceived as having been built upon the stable *Deutsche Mark*. Voters of all ages regularly take vacations outside of Germany, and the ever-improving rate at which they can exchange the *Deutsche Mark* for foreign currency is also a source of national pride ("every year I add another three zeros to the lira"). All voter groups are suspicious of inflation and supportive of the *Deutsche Mark*, and a majority of voters is hostile toward the euro. German politicians know that high inflation rates, let alone hyperinflation, would endanger their political survival. In this sense, the *Bundesbank*'s low-inflation monetary policy is emotionally "anchored" by national trauma and national pride.

German voters are not good, however, at monitoring inflationary threats that come in subtle form. Consider, for example, the response of the German people (or rather, the lack thereof) to two major institutional modifications of the postwar German central banking system, the 1957 replacement of the *Bank deutscher Länder* by the *Bundesbank* and the 1992 integration of the eastern *Länder* (regional states) into the *Bundesbank* institution. To the extent that German monetary institutions are crucial in guaranteeing low inflation, one would expect German voters to have followed with bated breath the public debates over the design of the *Bundesbank* in the late 1950s and the early 1990s. In fact, these debates raged at the elite level, between and within the political parties, between the central government and the *Länder*, in the *Bundestag* and the *Bundesrat* (the lower and upper houses of parliament), but the issue never gained salience in the minds of the general public (Lohmann, 1994, 1998a).

In the EMS, governments fear losing popularity when they devalue or even exit. Devaluations and exits are front-page news; they are politically salient in part because they affect national pride. A devaluation or exit, with its implication that "my country's currency can't keep up with the *Deutsche Mark*," provides a convenient emotional reference point for voters, but it also plays an informational role. When a government pegs its currency to another, more stable, currency, it thereby allows voters to monitor in a simple and straightforward way whether the government is keeping its promise not to inflate. By way of analogy, there is evidence that voters in federal systems take informational cues from the relative economic performance of their local economies and the national economy to judge local politicians, who get voted

out of office if they preside over **relatively** bad economic performance (Lowry, Alt, and Ferree, 1998).

In short, we can think of the policy of low inflation in Germany and other member states of the EMS as being anchored by voter trigger-strategy punishments: history provides a powerful emotional reason for German voters to punish their politicians for high inflation, and devaluations and exits in the EMS serve as a useful emotional and informational device for voters in other countries to punish their elected representatives for inflating relative to the *Deutsche Mark*.

In comparison, the ECB and EMU are not designed to rely on voter-imposed audience costs. If EMU goes bad, it is not clear whom voters should hold politically accountable. Voters will end up helpless and frustrated because bad things are happening to them and they cannot do anything to improve their situation. Unhappy citizens will flock to extremist parties. Political entrepreneurs will emerge within existing parties or form new parties, associating themselves with a newly popular alternative: exit EMU. Incumbent governments will then jump on the exit bandwagon to avoid losing power—or else they will get voted out of office and replaced by anti-EMU forces.

To make matters worse, voter judgment can exhibit a volatility that can lead to political instability and sudden political change. Voters in one country might think, "if everybody joins EMU except for my country, then something must be wrong with my government if we are not allowed to join." This kind of thinking puts pressure on elected policymakers to join the herd. But sometime in the future, when a recession, along with the constraints implied by a common monetary policy, generates mass unemployment in some EMU member states while Britain booms, voters will make their governments responsible for joining EMU and getting them into a mess. Such a sudden reversal is all the more likely for voters who never had the chance to express their support for (or objection to) EMU in an election or a referendum. If EMU goes bad, its democracy deficit, or its perceived lack of electoral legitimacy, will hurt. Exacerbating this problem, many policymakers have used EMU as a stick to force voters to accept "politically unacceptable" economic reforms; if the reform efforts backfire, voters will come back with a vengeance.

Wage Setters and Financial Markets

If a policymaker makes a promise vis-à-vis wage setters and financial markets to follow a policy of low inflation, he thereby invokes two kinds of audience costs in the event that he later reneges. First, wage setters and financial markets can bring about negative economic outcomes (wage inflation, capital flight) that hurt voters and thus reduce the policymaker's reelection prospects. Second, bad economic outcomes can be informational cues for voter trigger-strategy punishments. For example, the large mass of voters cannot directly observe a deviation from a monetary target, but it can read front-page news about a crisis in the foreign exchange markets caused by capital flight following a deviation from a monetary target.

Trade union and employer organizations, as well as "large" participants in financial markets, tend to be well-informed about economic and political events that have the potential to affect real wages and profits. Because they can observe or verify the state of the world that would justify an "excused" defection, they have the ability to execute sophisticated state-contingent trigger-strategy punishments. For example, wage setters and financial markets are the audience for the *Bundesbank*'s monetary targeting procedure. The *Bundesbank* has missed its targets about one-half of the time over the last few decades, but its reputation has not suffered—an indicator of excused defection. In the EMS, financial markets generate audience costs in the form of destabilizing speculation and capital flight.

Once again, the ECB and EMU compare unfavorably. In the future, financial markets will lose their function of communicating to voters that the government in one country or another is following "irresponsible" economic policies: capital can move out of the euro and into the dollar and the yen, but such movements are at best a signal that the euro zone as a whole is doing badly—it does not assign responsibility to specific elected politicians. Even if wage setters or financial markets bring about negative economic consequences or generate negative signals about the performance of the ECB or EMU as a whole, voters can respond only if they are offered alternatives (e.g., a political party stands for election on an "exit EMU" platform). In countries that have an elite consensus about EMU, the electoral connection is broken.

Political Veto Players

Countries are not governed by a single "unitary actor" policymaker, as is often assumed in theory, but by multiple policymakers who are spread over multiple parties, houses of parliament, and layers of government, supplemented by a multitude of ministries, bureaucracies, commissions, and committees. In a complex system of checks and balances, political veto players can prevent policymakers from reneging on monetary policy promises (Tsebelis, 1995; Lohmann, 1998a; Moser, forthcoming). Veto players can also delay an institutional defection to the point where the defection does not pay off because private agents have time to adjust their behavior in anticipation of a defection.

The *Bundesbank* is a powerful institution in part because of the way it is backed up by federalist veto players. The German government's leverage over the *Bundesbank* is limited for two reasons. First, the central government does not control a majority of the members of the *Bundesbank* Council, as it appoints only a minority (the Directorate), whereas the *Länder* appoint a majority (the *Land* central bank presidents). Second, the central government cannot unilaterally change the *Bundesbank* Law. Such a change is subject to a veto of the *Bundesrat*, which is controlled by the *Länder*. Twice, in 1957 and 1992, the central government attempted to centralize the German central banking system. Each time, it succeeded partially—after a fierce fight with the *Länder*, which, in a vigorous attempt to protect their turf, delayed and partly foiled the government's plans (Lohmann, 1994, 1998a).

The ECB is designed to steer clear of messy politics, and yet the ECB will be operating in an environment that offers nothing but hard economic choices. It will inevitably end up stepping on the toes of one political heavyweight or another. Because of its apolitical design, the ECB will have difficulties attracting political protection. It would be preferable by far for the designers of the ECB to accept the idea that a central bank, with its vast powers over the wealth and well-being of millions of voters, is fundamentally a political animal. The central bank could then be set up as part of a system of political checks and balances, in which counteracting interests keep inflation down while forcing the central bank to be partially responsive to extreme shocks and unforeseen contingencies. Economists and central bank technocrats tend to believe that political pressures are necessarily counterproductive. In fact, political pressures can reflect economic pain that a central bank can and should legitimately respond to.

Linkage Politics

Elsewhere, I have argued that policymakers who interact with each other in more than one policy dimension can make credible commitments via "issue linkages" (Lohmann, 1997). If a policymaker defects on one dimension, cooperation breaks down on other, possibly functionally unrelated, issue dimensions. Because such links increase the punishment incurred in the event of a defection, they make defection less likely in the first place. The downside of linkage politics is that a breakdown in one policy dimension brings with it a costly breakdown in other dimensions.

Both the EMS and EMU make use of issue linkage: Britain notwithstanding, a shared understanding exists that countries failing to participate in monetary integration will be left out, at least to some degree, of other dimensions of European integration. The EMS, however, has a built-in escape valve—politically negotiated devaluations—that does not trigger punishments in other policy dimensions. In contrast, the trigger-strategy punishments that come "attached" to EMU are rigid; they do not allow for excused defection. A country can unilaterally decide to quit, but doing so will undermine the larger effort of European integration. Alternatively, the member states of EMU can look the other way if one country does not meet its obligations, but doing so will tear at the fabric of the expectations that define EMU.

The ECB does not fit the definition of a well-designed institution; it is not meant to bring about a favorable credibility-versus-flexibility tradeoff. Its design is rigid, implying that EMU will do poorly while it lasts; it will not last long; and when it breaks down, its breakdown will damage the cause of European integration.

"THE STATUTES OF THE ECB ARE MODELED ON THOSE OF THE *BUNDESBANK*, WHICH MEANS THAT IT WILL BE FULLY INDEPENDENT." Yves Thibault de Silguy, European Commissioner for Economic and Monetary Affairs (Rees-Mogg, 1995)

One view in the literature on monetary institutions and credible commitment is that legal statutes, or formal institutions more generally, can solve commitment problems; that is, the mere passing of a law creates commitment where none existed before. This view is implicit in the "statute reading methodology"

scholars employ when they infer causality from the negative cross-country correlation between (legal) central bank independence and low inflation (Forder, 1996, p. 39). It is also present when scholars propose that the political vulnerability of monetary policy can be effectively reduced by the simple means of writing central bank independence into the constitution or making changes to the independent status of the central bank subject to a two-thirds majority in Parliament.

This view is inconsistent with time-series and cross-country evidence suggesting that formal independence does not map into behavioral independence in a straightforward way. For example, the *Bundesbank*'s formal statute remained unchanged from 1957 to 1992. Yet the degree to which German monetary policy was vulnerable to political pressures fluctuated considerably over this period (Lohmann, 1998a). Similarly, we find that measures of legal central bank independence are negatively correlated with the depreciation in the real value of money for **industrial** countries, whereas the correlation is effectively zero for **developing** countries.

The divergence between the letter of the law and actual practice is substantially larger in developing than in industrial countries. This may be due to a general norm of greater adherence to the law in industrial countries (Cukierman, 1992, p. 421). To understand the constraining role of legal statutes, or formal institutions more generally, there is no serious alternative to examining the way they are embedded in a larger political system that creates political costs for violating or changing the law and political costs for institutional corruption, change, or breakdown. In short, "reading statutes does not measure independence, passing them does not create it" (Forder, 1996, p. 50). As noted earlier, the *Bundesbank*'s independence is guaranteed not by virtue of the letter of the law, but because the *Bundesbank* is embedded in a larger political system where powerful players have stakes in the institution and are willing to fight when the institution comes under attack (Lohmann, 1998a).

The *Bundesbank*'s record also suggests that institutional design does not translate into policy outcomes in a mechanical and deterministic way. First, the letter of the law is often ambiguous. Powerful political interests will then interpret it as suits their interests. Even when the intent of the law is clear, it may not be implemented in practice. Powerful political players can play a game of "mutually agreed excused defection," whereby everybody interprets the law in a way that is inconsistent with the intent of the law, and flouting the law is not

punished because there is no audience that has the ability or incentive to impose significant political costs.

More important, policy outcomes depend not only on institutional constraints, but also on the policy preferences of political agents who control the institution and on informal (noninstitutionalized) interactions between these agents and the stakeholders of the institution. Policy preferences and informal interactions are not precisely predictable or controllable.

By way of illustration, consider German monetary policy. The *Bundesbank* Council makes its decisions by simple majority rule. To predict German monetary policy outcomes, we would need to know the monetary policy preferences of the *Land* central bank presidents who form a majority on the central bank council. The *Land* central bank presidents are formally nominated by the *Bundesrat* and formally appointed by the president of the Republic; *de facto* they are selected by their respective *Land* governments. The formal appointment process along with the informal selection procedure allows us to make some educated guesses about the voting behavior of the *Land* central bank presidents on the *Bundesbank* Council. A *Land* central bank president might represent the economic interests of her *Land*, or she might seek to further the electoral and party-political goals of the *Land* government that appointed her. In the event of a change in government, the central bank president might pander to the new government to improve her chances of reappointment. She might accommodate external interest groups who control her future career path after she retires from the *Bundesbank*. Then again, she might succumb to *Bundesbank*-internal peer group pressures and turn into a "nonpartisan" technocrat (the Thomas à Becket effect). Because she identifies with the *Bundesbank*, she might accommodate elected politicians who can credibly threaten the legal status, structure, or very existence of the institution.

The *Bundesbank* has an empirical record that can be used to discriminate between these competing hypotheses, at least to some degree (Lohmann, 1998a). But it is impossible to predict in the abstract how formal appointment procedures will affect the voting behavior of the *Land* central bank presidents. There are simply too many overlapping concerns—ideology, internal peer group pressures, external political pressures. The relative strength of these concerns fluctuates over time and among individuals in a way that cannot be absolutely predicted or controlled.

The ECB mimics a "thin simplification" (Scott, 1998) of the *Bundesbank*—it builds on the idea that German monetary policy is sound because of the legal guarantees and formal appointment procedures laid out in the *Bundesbank* Law. The *Bundesbank*'s institutional features carry over to the European level, but its behavioral rules and political embeddedness do not necessarily travel well.

Of course, we can make some educated guesses about the factors that will influence the voting behavior of the national central bank presidents on the ECB Council. For example, *Bundesbank* watchers agree that the *Land* central bank presidents do not tend to vote along "*Land*-egoistical" lines. In contrast, ECB watchers are concerned that the national central bank presidents on the ECB council will vote the interests of their respective countries rather than the interests of the euro zone. But who knows? National central bank presidents who retire from the ECB Council only to follow a career path in the country they came from will presumably have a "perspective" different from that of *Land* Central Bank presidents who accept high-level bureaucratic positions in the European Union or are so old that they retire altogether. Nothing in the formal appointment procedures tells us what will happen. All we can do is wait and see.

"ES IST EINE SACHE DES GLAUBENS: ES KANN SO, ES MAG ABER AUCH ANDERS KOMMEN."
(IT IS A MATTER OF FAITH: IT MAY TURN OUT THIS WAY, OR IT MAY TURN OUT DIFFERENTLY.)
***Der Spiegel* journalist Wolfram Bickerich (Bickerich, 1998)**

Disagreements about EMU arise because interested parties have different material interests or different political and bureaucratic goals. There is nothing surprising about "big business" coming out for EMU, with trade unions against. It does not take a rocket scientist to understand why the European Parliament is enthusiastic about EMU ("more Europe is better"), whereas the *Bundesbank* is as gloomy as it can afford to be without openly contradicting its Europhile government.

But the heterogeneity of interests and goals does not explain why a large part of the disagreement about EMU centers on predicting its consequences. Earlier, I presented two competing visions of EMU. More generally, we find

that interested parties on all sides of the debate love or hate EMU for reasons that are incompatible. For example, the Germans are against EMU because they fear the euro will be too **soft** (the ECB will cave in to the irresponsible French and Italians), while the French are against EMU because they fear the euro will be too **hard** (the ECB will be dominated by German bullies). They cannot both be right.

Within the confines of economic theory, there is no theoretical framework that would allow us to understand why people have different "models" of the policy effects of large-scale interventions in the economy. The rationality assumption of economic theory implies that people have a shared understanding of the way the world works; that is, they agree on the efficiency and distributional effects of various policy alternatives, even when they disagree about which policy alternative is best because they are differentially affected by various policy alternatives. Modern game theory provides theoretical underpinnings for "why we can't agree to disagree forever" (Geanakoplos and Polemarchakis, 1982; see Fudenberg and Tirole, 1991, chapter 14, for a survey). To the extent that differences in beliefs reflect some underlying objective information, a player who knows that another player has beliefs different from his own should revise his beliefs, taking into account the information implied by the fact that the other player disagrees with him. As the two players interact, engaging each other in policy debates and making policy decisions, their beliefs should converge.

Happily, outside of the boundaries of mainstream economics there exists scholarship that sheds light on the role of mental models in driving political debate and policy decisions (DeNardo, 1997; see also Denzau and North, 1994). The debate over EMU has all the hallmarks of an **ideological** debate:[1] (1) not only do ordinary people disagree with each other, but so do experts; (2) until we get more empirical feedback about "The Way the World Actually Works," there is no obvious way to discriminate empirically between the competing views; and (3) even as empirical feedback accumulates, the debate shows no sign of converging—if a particular claim turns out to be empirically untenable, the debate simply moves on and polarizes over another unsettled question, with new arguments and new evidence chasing the same old conclusions.

Policy debates tend to be ideological when the underlying objective reality is complex. Ordinary human beings do not have the cognitive capacity for

contemplating a full-scale model of a complex political and economic system and working out the implications of a policy intervention in the full-scale model. Instead, human beings form simple models in their heads and work out the implications of a policy intervention in these simple models.

A complex system can be represented by any number of simple models, each of which spells out the workings of some dimension in detail while ignoring the "action" in many other dimensions (enter the infamous *ceteris paribus* of economic theory). Because different simple models keep constant different factors, they generate different implications about the effects of a policy intervention as it works its way through the system. If the underlying objective reality is complex, or if it changes in a poorly understood way, then the empirical record that unfolds disallows empirical discrimination. People, including experts, will continue to claim that their simple models are correct, and there is no way to discriminate among their competing and incompatible claims. They will disagree forever.

In contrast to rational players in the "we can't agree to disagree forever" literature, real-world players have "sticky" beliefs and display a remarkable lack of self-awareness about the heterogeneity of models people hold in their heads. When people find out in the course of a policy debate that other people have different beliefs, they simply discount the other beliefs as stupid and misguided, instead of "rationally" updating their own beliefs. Academic economists themselves are the penultimate example of irrational players—discounting the intuitions of real-world economic agents that contradict mainstream economic theory ("if only everybody took Econ101 in college, the world would be a better place") and ignoring the first-hand experience of economic agents that might tell them something about the way the economy actually works.

Evolution has not prepared us (that is, hard-wired the cognitive and decision-making apparatus in our heads) for survival in a complex world. Dörner (1996) reports some experiments in which ordinary people play the role of a benevolent dictator in a complex artificial (computer-simulated) society. The participants in his experiments had a tendency to run their societies into the ground. Their decision making demonstrated cognitive limitations and biases. They did not understand budget constraints and nonlinear relationships, and they reacted in counterproductive ways when they encountered unforeseen side-effects or crises.

As a practical matter, we have to live with our limitations and biases. If we cannot contemplate a full-scale model of objective reality, we must use simple models to work out the consequences of various policy interventions. But being human beings, we can also step back and understand that in the face of a complex reality our simple models may be wrong, implying that policies coming out of such simple models can have adverse side-effects unforeseen by our models.

Understanding our limitations allows us to refine our idea of optimal institutional design. The notion of an optimally designed institution is itself ill-defined in that an institution may be optimal in the context of a particular model, but it may well be suboptimal in reality. A truly well-designed institution is open to the idea that the model that originally motivated the institution may turn out to be wrong. This institution has mechanisms in place by which it can gather and make use of empirical evidence suggesting that the model may be wrong. Such mechanisms typically require open and decentralized modes of decision making that grant access to local and practical knowledge; they respect the creative capacity of human beings for circumventing counterproductive formal rules and structures and developing informal interactions that fill in the gaps between the rules and allow for exceptions and flexible responses; they allow for spontaneity, adaptability, informal coordination, and disorganization; they are messy, malleable, and (partially!) corruptible.

By definition, unforeseen contingencies are unforeseen, but it is foreseeable that at some point in the future some unforeseen contingency will trigger institutional breakdown: no institution lasts forever. For this reason, a well designed institution includes a *Sollbruchstelle*. This German engineering term translates literally as "spot that is meant to break." It stands for the part of a machine that is deliberately constructed to be weaker than other parts so that it takes a hit when that the machine comes under stress. It then breaks down with little collateral damage and is repaired or replaced at low cost. The ECB and EMU could fail disastrously because so many of the features that define a truly well-designed political institution were deliberately "designed away:" the driving force behind the apolitical design of EMU is fear of and contempt for democratic politics.

But politicians have a way of reasserting their primacy over technocrats. In the end, the real question is whether the ECB will overcome its rigid design and bend with the political winds, or break down because it becomes politically

unsustainable. There will be political and economic costs of accommodation or breakdown—costs that could have been lower if the designers of EMU had showed some understanding of and appreciation for democratic politics.

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ENDNOTES

1. The subsequent discussion draws on conversations with James DeNardo.

NO MONETARY MASQUERADES FOR THE ECB

Adam S. Posen

INTRODUCTION

Almost overnight, transparency has become the central banker's watchword. From a world in which we used to hear about "Secrets of the Temple," we have moved to a world where transparency is explicitly one of the criteria listed by the European Monetary Institute (EMI) for evaluating the future strategy of the European Central Bank (ECB) (EMI, 1997, p. 2). As members of democratic societies, we have a certain gut-level sense that important policies should be open to scrutiny. As economists, we either believe that efforts at keeping monetary policy secret cannot succeed, or, more realistically, add to short-run uncertainty for no real gain. So that is settled, right?

Apparently not. It remains unclear what transparency means in operational terms for central banks. On a case-by-case basis, we can determine whether certain changes are in the direction of more or less transparent policymaking. The U.S. Federal Open Market Committee (FOMC) releasing explanations of its interest rate moves is a step towards greater transparency; the German *Bundesbank* publicly resetting its "rate of normative price increase," its *de facto* inflation target, as EMU approaches is another. Yet, for a fresh institution like the ECB, how should transparency be embodied and institutionalized? There is no general consensus advocating public meetings of its Governing Council, committing the ECB to publish explicit forecasts of inflation and other variables, or even to specify an exact set of priorities for monetary policy in practice.

Clouding matters further is the announcement by the recently appointed ECB Council that, initially, it will follow a hybrid strategy of monetary and inflation targeting, and after a certain transition period, revert to strict monetary targeting. Leaving aside the patent absurdity of finding stable and informative monetary aggregates for this new currency zone, this is a move to decrease transparency. The ECB's ultimate goal is sustained low inflation, and it should be up front about the fact that one achieves low inflation by contracting the economy, or at least credit, when the inflation forecast rises above the goal. The only way to reduce inflation without doing so is to convince wage- and price-

setters ahead of time that the central bank will react to such forecasts, and to credibly notify them when this is happening.

Monetary targets are at best a diversionary tactic from this reality. We saw the Volcker Fed mischievously masquerade its disinflation of 1979-82 as adherence to monetary targets, and this had two lasting effects: one, convincing people of the Fed's counter-inflationary will once the inflation rate was lowered (not because monetary targets were met); and two, forcing the Fed chairmen into the early 1990s to engage in a costuming of monetary policy in front of elected officials and the public. As summarized by Alan Blinder (Blinder, 1998, p. 29):

> Monetarist rhetoric provided the Fed with a political heat shield as it raised interest rates to excruciating heights. In any case, the Fed began the gradual process of backing away from M targets in 1982. The target growth range for M1 was formally dropped in 1987, but growth targets for M3 and, especially, M2 retained some subsidiary role in monetary policy formulation into 1992—at least putatively. Finally, in February 1993, Fed Chairman Alan Greenspan announced with magnificent understatement that the Fed was giving "less weight to monetary aggregates as guides to policy." Less? How about zero? Greenspan's proclamation was greeted with yawns in both academia and the financial markets because it was considered old news . . . a 1978 law which is still on the books, requires the Federal Reserve to report its target ranges for money growth to Congress twice a year. This the Fed dutifully does. But it is an empty ritual. The relevance to policy eludes all concerned.

It is my argument that all monetary targeting, even as practiced by the *Bundesbank*, is such a masquerading of inflation targeting. The important lesson for the ECB is that it cannot get away with such mischief, and following monetary targets is a mistaken removal of transparency.

WHAT IS TRANSPARENCY?

Monetary policy's effects may be thought of as the result of three factors: the preferences of the central bank, the transmission of the central bank's policy

(usually interest rate) decisions into the economy, and the development of the economy in the interim until that policy takes effect (which I term forecast transparency). Leave aside shocks which we assume the central bank would not know about or else they would not be shocking. This means there are three potentially hidden aspects—changes in what the central bank wants, in what the central bank can do, and in what the central bank is doing. Both the central bank and the private sector have to look backward at the sum of these changes in order to build a model with which to look forward and predict what happens next. Thinking of it that way, it is pretty easy to discern when total transparency changes—we can tell who is doing what in the current economy, and whether that is different from what would have been expected before given initial conditions and the central bank's policy instrument.

We should realize, however, that forecast transparency is the least important source of confusion. If the forecast of the economy is uncertain due to changes which are structural and lasting—and not induced by a temporary shift—we will find out pretty quickly. Both the public and policy will catch up. In any event, there is also little a central bank can do about this kind of uncertainty beyond collecting more data. The most dangerous aspect for monetary policy to lack transparency is the second aspect, the monetary transmission mechanism, that is what the central bank is capable of doing. Because the primary means of transmission of monetary policy in any developed economy is through the financial system, what we're really talking about concerning this aspect are changes in financial technologies and regulations. Fortunately, these are pretty observable, although their implications are not always clear, and they are something over which the central bank usually can exert some influence. This is a matter about which the ECB will have to become more concerned, especially if the euro does prompt financial reform.

That being said, lack of transmission transparency is the source of occasions where monetary policy truly can do damage. When people speak about monetary crises what they usually have in mind are occasions where monetary policy moves (or does not move in the infamous case of the 1929 stock market crash) are amplified in unexpected ways by financial fragility. Thankfully, finding anyone to disagree with the statement "financial fragility is bad" is a bit difficult, so I will not belabor the point. Most importantly for today's discussion, dealing with financial fragility is something that must be done

irrespective of the development of the central bank and which is transparent so long as specific policy initiatives are taken.

That leaves us with one remaining aspect of monetary policymaking to make transparent: the question of the central bank's own preferences, the specific goals of policy. Clearly, the central bank has no willing uncertainty of its own in this regard. It is also the easiest uncertainty to remove—the central bank just has to tell the truth about what it wants and have its deeds match its stated intent. Sounds simple, does it not? You will notice, however, that in the real world central banks disclose their goals to varying degrees, with varying explicitness in that disclosure. If we all agreed on the forecast, or at least to the broad outlines of the forecasting model to the extent we are ever able to, then a monetary policy move gives some, though not all, information about where the central bank wants to go **whether or not** the bank tells us explicitly what it is after. Most people making economic decisions get the same signals and these are consistent with what the central bank is expecting, and the central bank's actions in turn become better expected.

If, on the other hand, we are again planning for the future by reasoning backwards from the policy decision and the current state of the economy without **either** an explicit knowledge of the central bank's intent **or** a largely agreed upon model of the economy, we do not know what to think. If the ECB raises interest rates at its first council meeting, what should we take it to mean? Does it mean that the ECB is confirming or denying one particular side in the debate over whether loose interpretation of the Maastricht fiscal criterion was dangerous? Does it give us an insight into what the forecast of the European economy should be? Does it merely signal an effort to establish credibility and independence in the public mind? If different economic decision-makers see different possible motivations implied by the ECB's move they will logically make different forecasts and different decisions. I want to emphasize that these scenarios are very much the stuff of reality rather than thought exercises.

What can a central bank do to remove this uncertainty about its preferences? It can make its goals, and therefore its policies, more transparent. The primary way central banks do this is to publicly announce a numerically-defined measurable target for policy, with a specified time horizon for that target. In recent years, this has taken the form of multi-year inflation targets. What I want to emphasize today, however, is that many countries which in the past were supposedly targeting money—including the *Bundesbank*—were

actually publicly targeting inflation. The framework of explicitly stating an inflation goal and noting deviations from it conferred advantages, although the emphasis on monetary growth targets actually detracted from this success.

BEHIND THE GERMAN MONETARY MASK[1]

It is commonplace in current discussions of Europe's new central bank to hear that not only has the ECB been modeled on the *Bundesbank* institutionally, but that the monetary targeting strategy which the *Bundesbank* has pursued is a viable model for the ECB's strategy. Last year, then EMI President Wim Duisenberg said that he has "... a certain preference for monetary targeting. The success of the *Bundesbank* shows that this strategy underpins the competence of the central bank, thus offering an optimum safeguard for its independence" (Duisenberg, 1997). Recent statements by members of the ECB Governing Council upon their and Duisenberg's confirmation went further, calling for the ECB to adhere to monetary targets. While the record of success of the *Bundesbank*'s targeting strategy (and of the similar strategy pursued by the Swiss National Bank) since the collapse of the Bretton Woods regime is indeed impressive, it was not the money which mattered.

The primary benefits gained from announced monetary targets in Germany are from the transparency which this framework conferred on the exercise of discretionary policy—strict adherence to monetary aggregate growth as a formal intermediate target, and the rule-like constraint on policy that would imply, has not played a role in their success. Accordingly, interpretations of monetary targeting which imply that the future ECB would need to blindly follow the *Bundesbank*'s stated procedures in order to maintain its credibility are mistaken. In fact, to do so would be exactly the same type of one-time distraction that declaration of monetary targets by the Fed in 1979-82 was, leading to an open disregard of its own statements which a new central bank can ill afford.

It is well known that annual target ranges for monetary growth were missed around fifty percent of the time in Germany in the 1980s and 1990s. Far more significantly, the *Bundesbank* has, by its own admission and as seen in the historical record, taken into account a much broader range of information variables than just money when setting policy, and has pursued in the short-run a number of goals beyond minimizing inflation. As documented in Laubach and

Posen (1997) and Bernanke and Mishkin (1992), post-Bretton Woods monetary history is replete with examples of *Bundesbank* actions to manage the external value of the DM, to disinflate gradually in order to take into account real-side goals like unemployment, and even to make counter-inflationary policy moves when the monetary aggregates indicated no need. Bernanke and Mihov (1997), Clarida and Gertler (1996), and von Hagen (1995) all demonstrate econometrically that money does not predict *Bundesbank* policy when inflation and other factors are taken into account.

Instead, the primary gains from announced monetary targets have been through their use as a framework for transparent indication of monetary policy stance and intentions with reference to an underlying but public numerical inflation target. The ability to have a standard and a goal for forward-looking policy to point to amid the chaos of present day decisions seems to anchor public expectations. Not only does this give wage- and price-setters a better awareness of monetary policy's stance at any given time, it allows the central bank to distinguish in the public's mind between one-time price-level shifts and other shocks which would require a response irrespective of pass-through. We saw this flexibility tied to transparency exercised by the *Bundesbank* following both oil shocks and German reunification, when the initial inflationary impulse was accommodated partially, but a specific time-frame for bringing inflation back down also was given.

This explains why the German monetary framework, for all the *Bundesbank*'s prestige and independence, includes institutionalized structures for providing explanations of policy in an explicit and informative manner on a regular basis. Just the announcement of monetary target and interest rate numbers, or even inflation goal levels, was sufficient. In such a framework, changes in target levels and even target misses have not only proved to have only limited fallout, but they also have served an educational function. When the *Bundesbank* moved its "unavoidable inflation" target to four percent in 1980, it informed the public that supply shocks do require a different response than demand shocks, and that there is room for gradualism in disinflation. When the *Bundesbank* renamed its inflation target of two percent the "normative rate of price increase" in 1986, it indicated what level of inflation could function as an operational definition of price stability (and why that was not zero) as well as its likely future stance. There appears to be a positive synergy between having to occasionally break in the short-run or put into perspective the long-term

commitment to price stability, and public support for and understanding of said commitment.

Seen in this light, the distinction between inflation targeting and monetary targeting as practiced in Germany is even smaller than that acknowledged in the EMI's *The Single Monetary Policy in Stage Three*.[2] Inflation targeting as practiced in Canada, New Zealand, the United Kingdom, and other countries, shares its basic components with monetary targeting in Germany: a publicly announced goal for the medium term of a greater-than-zero measured inflation rate; the use of a wide range of information variables rather than reliance on a single specific indicator in the setting of monetary policy in pursuit of that goal; flexibility for the central bank to respond to other economic needs in the short-term; and a commitment to transparent discussion of progress towards the inflation goal and explanations of short-term deviations from it in pursuit of other goals. Of course, one cannot set a monetary target without specifying an inflation goal in the quantity equation that generates the monetary target. Apparently, one cannot pursue a monetary target strictly without contradicting ultimate policy goals either (Estrella and Mishkin, 1997 and Friedman and Kuttner, 1996 are examples in a literature documenting that monetary aggregates are insufficiently tied to inflation to be useful as more than indicators, even in Germany).

THE ECB'S TARGET SHOULD SHOW ITS TRUE FACE

The EMI has stated that transparency is one of the six criteria to be used in evaluation of any proposed monetary strategy for the ECB.[3] Nonetheless, the ability of properly designed transparency to discipline discretionary monetary policy without locking it into an inappropriate rule has been underappreciated. Although the *Bundesbank* has been subject to little formal accountability to the electorate or to elected officials in the explicit manner of the Federal Reserve, let alone of the Reserve Bank of New Zealand, it has issued a constant stream of statements delineating its decisions, its reasoning, its responsibilities, and its performance. Such accounting may not be enough to fully close the perceived democratic deficit of the Maastricht Treaty protected ECB, but it does indicate that even where explicit oversight does not exist, central banks can and will respond to the underlying threat of institutional change and build political support.[4] The key lesson is that such efforts at public

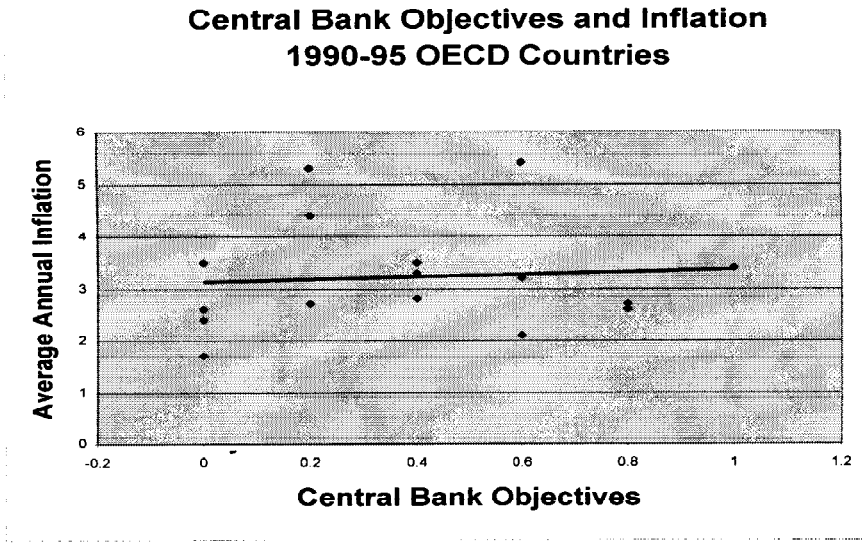
outreach and explanation not only increase legitimacy but also aid rather than compromise monetary policy performance, and so should be given priority in design of the ECB's strategic framework on two grounds.

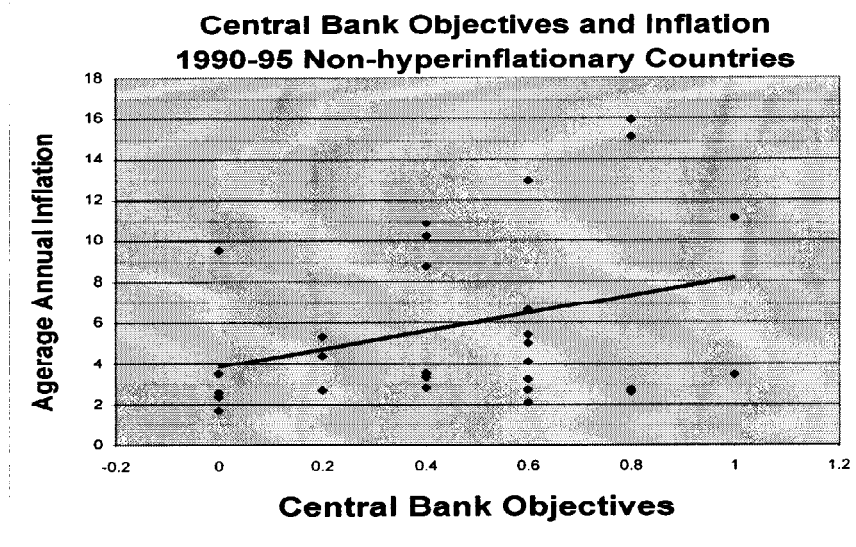
Transparency about goals has additional advantages. While the *Bundesbank* does not have an explicit numerical "escape clause" with legal standing (*a la* New Zealand) to allow flexibility in the face of severe financial or supply shocks, it has exercised that flexibility as though it were there. This flexibility should not come as a surprise to careful observers of the *Bundesbank*, but it is worth reemphasizing that even the supposedly tight monetary targeting frameworks allow for such responsiveness when so many seem to fear that the ECB will need to be inflexible in order to fulfill its mandate for price stability. Binding a central bank's hands extremely tightly does not seem to be a necessary condition for sustained low inflation. When disciplined by transparency, discretion succeeds.

I will demonstrate the lack of association between true transparency and rule-like interpretation of stated goals in a reasonably direct manner. In Figure 1, I plot the average inflation rates in the 1990s against written central bank charter objectives for a group of sixteen OECD countries and then for a wider set of OECD and non-hyperinflationary developing countries. Central bank charters are coded 1 if their only stated goal is price stability and it is said to be overriding, 0.8 if the only goal listed is price stability but with no mention of its precedence, 0.6 if many goals are listed along with price stability, 0.4 if the many goals listed contradict price stability, and 0.2 if price stability is ranked below other goals. The code drops to 0 if price stability is not listed as a goal (data from Cukierman, 1992). The ECB, of course, would get a 1.0 rating on this scale. If what central banks are required to do in the long-run actually constrains their ability to behave flexibly in the short-run—or equivalently, if the charter mandate provides sufficient transparency about central bank goals—the countries with the narrow central bank mandates solely for price stability should have lower average inflation rates because they loosened less in response to intervening events and saw greater resilience of low-inflation expectations.

We can see on these charts that there is no statistical association between a central bank's charter and its country's average level of inflation (if any pattern exists, it goes the opposite way). The same pattern or lack thereof would appear if one were to plot different decades or different but still representative samples of countries. Remember, the Federal Reserve currently operates

Figure 1





Source: International Monetary Fund, Interntional Financial Statistics; and Cuklerman (1992)

under a mandate to pursue both "full employment" and "stable prices," which would earn it a 0.4 on this scale, and the Swiss National Bank has a charter listing several goals but not price stability, earning it a 0 score. Yet both of these central banks have produced long-run average inflation rates comparable to the single-goal mandated "safeguard the currency" *Bundesbank*.

Let me be very clear about what I am and what I am not saying. I am not saying that central bank laws are meaningless and are ignored by their central banks. I am saying that a variety of evidence shows that all credible central banks exercise policy flexibility in the short-run regardless of their legally mandated goals. Flexibility is inevitable because truly rule-based monetary policy is so inherently untenable that it is only undertaken in the most dire circumstances, when the central bank has so little credibility that no alternative is available. Thus, there is no reason to believe that in low-inflation economies announcement of either a legal commitment or a previous central bank's mantle masquerading as a target provides the needed transparency.

Monetary transparency—that is, the public announcement of a numerically-defined goal for inflation (or other normal quantity) over a meaningful time-horizon—is the institutional framework of German monetary targeting without the money. It removes unnecessary uncertainty about the stance of present and future monetary policy in a way that a velocity-shocked monetary aggregate never could. In a time of structural change, likely at least in euro financial markets, it is an anchor for business and individual beliefs about the structure of the economy, as well as a guidepost for the course of the economy over the long run, even as the economy and monetary policy vary in the short-run. By talking about long-run goals, rather than inappropriate targets, monetary transparency would allow the ECB the necessary flexibility to respond to short-run developments in the economy. And in a democracy, transparency is the only appropriate monetary response to political pressures which are put on an independent central bank.

I would argue that an increase in transparency about the ECB's monetary goals now might serve to lock in low inflation expectations. As Benjamin Friedman has observed, from the late 1960s until recently, the reasonable presumption about the goal of U.S. monetary policy has been that any practical reduction in inflation was desirable. In the Europe of the Maastricht-defined race to EMU membership, this was at least as much the case. We did not need to discuss Europe's inflation goal and the costs and benefits of achieving it in

specific terms because the goal almost always was something lower than the current level. I would assert that we have been somewhat fortunate as well in recent years, and until last summer have not been confronted by any major negative macroeconomic shocks. This extended the period during which the fact that the likely direction of policy was no longer self-evident had little implication.

When another negative shock comes, however (and one will, even if Asia rebounds, Russia remains stable, and U.S. equities are not in a bubble), the question will be whether the difficult choices made by the ECB at that time will be properly understood. Remember my scenarios about transparency and monetary policy. Will a needed discretionary move in interest rates be seen as such, or as a change in goals or in the structural forecast? In particular, what happens if that negative shock hits after the ECB announces a first year or two of monetary targets which are only good for the sake of show to unsophisticated audiences? Will the markets and the public have enough trust in those target-ignoring policymakers that uncertainty and inflation expectations will not rise even if the long-run goal of policy has not been publicly announced ahead of that shock?

I do not by any means claim that monetary transparency in general, or inflation targeting in particular, is a cure-all for whatever ails an economy. Certainly, as far as monetary policy goes, it would always help to have better understanding of the structural changes in the economy and better forecasts. Yet, a central bank that has transparent goals can point to them as a guide to long-run expectations in a world of shocks and uncertainty. In fact, a transparent goal for monetary policy prevents some of the worst potential effects of structural change from occurring, either a dispersion of private-sector expectations about the course of monetary policy and inflation, or worse, a widespread locking-in of a mistaken model of the economy thought to be validated by central bank actions.

Therefore, the future ECB and other central banks interested in emulating the German *Bundesbank*'s performance—both in terms of sustained low inflation and of consistent support for the central bank's policies—might best turn their attention to the manner in which policies are operationally implemented and conveyed to the public. It was transparency, rather than more abstract concerns about "credibility," which made the *Bundesbank* a success. In fact, with the spread of inflation targeting as a monetary framework, there

seems to be an emerging operational best practice along these lines. The role of communication in what I have previously termed the "disciplined discretion" of German monetary targeting is not to put a rule-like coat of rationalization on *ad hoc* policies, but to create the proper balance between flexibility and transparency in the operation of monetary policy. That is why I advocate that the ECB adopt the entire transparency effort of the inflation targeting framework without a monetary masquerade.[5]

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ENDNOTES

1. This section draws on Laubach and Posen, 1997.

2. According to the EMI (1997, p. 2), "While pure forms of monetary and direct inflation targeting can clearly be distinguished at a theoretical level, their application in different countries has shown that several variants integrating elements of both strategies exist."

3. The six "guiding principles" enumerated are "effectiveness, accountability, transparency, medium-term orientation, continuity, and consistency with the ESCB's independence." EMI, 1997, p. 2.

4. Kenen (1995, pp. 191-3) discusses whether such accounting would provide sufficient accountability for the ECB and advocates additional measures. Posen (1993, 1995) argues that central bank independence over the long run is impossible without political support, and even independent central banks will act in line with this reality.

5. A proposal for an inflation targeting strategy for the ECB is spelled out in detail in Bernanke, Laubach, Mishkin, and Posen, 1998, chapter 12.

CENTRALIZATION VS. DECENTRALIZATION IN THE FEDERAL RESERVE SYSTEM: LESSONS FOR THE EUROPEAN CENTRAL BANK

Ellen E. Meade and D. Nathan Sheets

> There is little evidence . . . to suggest that regional interests lead to the formation of sectional coalitions of influence within the FOMC or between the bank Presidents and the board. The divisive issues of monetary and credit policy are national or international in scope and run rather along ideological than sectional lines. (from "The Structure of the Federal Reserve System," in hearings on The Federal Reserve System After Fifty Years, U.S. House of Representatives, 1964, p. 1977).

INTRODUCTION

The European System of Central Banks (ESCB) that is slated to take control of monetary policy for the eleven European countries that will make up the euro area beginning in 1999 will be composed of the European Central Bank (ECB) and the existing national central banks (NCBs). Although the decisions regarding monetary policy will be taken at the ECB in Frankfurt by members of the ECB's Executive Board and the presidents of the NCBs, operational aspects of policy will be performed to a large extent by the NCBs in accordance with the principle of subsidiarity in the Maastricht Treaty. However, the specific roles of the Executive Board and the NCBs—how powerful and influential the center is relative to its branches—will evolve only over time. Moreover, to what extent national economic concerns dominate decision-making for the entire euro area will only be revealed over time.

This paper reports early results on our on going examination of centralization and decentralization in the context of the Federal Reserve System. First, we review the historical debate about the role of the Federal Reserve Board in Washington relative to that of the twelve regional Reserve Banks. The formation of the Federal Open Market Committee (FOMC) as the body to determine monetary policy and the New York Federal Reserve Bank as the most important of the regional banks was not part of the 1913 Federal Reserve Act; these crucial aspects of the Federal Reserve's structure and

functioning were determined later. Second, we examine the votes cast at FOMC meetings by the governors and the Reserve Bank presidents since 1968. The voting behavior offers some information on the weight of each Federal Reserve district in the decisionmaking process and the likelihood of each district to dissent from the majority. Next, we look at unemployment statistics for the fifty U.S. states in order to assess whether concerns about regional economic developments appear to have been related to the votes cast by FOMC members. At each stage of our analysis, we draw implications from the Federal Reserve's experience for the ESCB. In future work, we plan to examine the transcripts of FOMC meetings from periods that were characterized by significant diversity in regional conditions to determine whether regional disparities appear to have influenced voting behavior.

HISTORY OF THE FOMC

When the Federal Reserve Act was signed in 1913, the periphery of what is now the Federal Reserve System was much more powerful than the center. The creation of a central bank was motivated by the desire for an "elastic currency," which would guarantee the requisite liquidity in the banking system to coincide with the seasonal economic cycle. Much of the debate over the creation of the central bank reflected a struggle between the powerful financial community and the greater populace—between Wall Street and Main Street. While very interesting and important, the struggle over the creation of the U.S. central bank is not the subject of this paper; rather, we are interested in the evolution of the Fed's structure from its creation in 1913 to the Banking Act of 1935, which formally established the FOMC as we know it today as the Fed's monetary policymaking body.

Upon its establishment in 1913, the Board of Governors of the Federal Reserve System in Washington was constituted with five members who were appointed by the president and confirmed by the Senate to terms of ten years; these five members sat alongside the secretary of the treasury and the comptroller of the currency who were also voting members of the Board. The "Governors" of the twelve Reserve Banks were appointed by the board of directors of the Reserve Bank, subject to the approval of the Board in Washington. Thus, the original structure of the Federal Reserve combined a purely public sector element (the Board members) with a quasi-public element

(the Reserve Bank "Governors"); this remains a feature of the Federal Reserve System today.

The principal tool of monetary policy was intended to be the discount rate, which was set and operated independently by each Reserve Bank, although the Board was invested with some authority to review discount policy. Thus, at the time of the creation of our central bank, the coordination of policymaking was not envisioned. Moreover, with the discount rate as the instrument of monetary policy, the importance of purchases and sales of government securities on the liquidity of the banking system (that is, open market operations) was not recognized.

The individual Reserve Banks began, during the 1920s, to engage actively in sales and purchases of government securities. This activity was uncoordinated and, in particular instances, disrupted the market for government securities. Over time, a few of the Reserve Banks began to coordinate their purchases and sales. The Banking Act of 1933 formalized the FOMC as an entity, consisting of the twelve Reserve Bank Governors and the members of the Board in Washington. The FOMC could "initiate and recommend" policies, but final decisionmaking power rested with the Board. However, a Board decision was nonbinding in that Reserve Banks could refuse to participate.

The Banking Act of 1935 amended the structure of policymaking further, giving decisionmaking power to the FOMC and transferring authority from the periphery to the center. The 1935 FOMC included the seven Board members and five representatives of the twelve Reserve Banks; the Board was given decisionmaking power to which the Reserve Banks were subject. The Board members were given the title of "Governor," with the Reserve Bank heads renamed as "Presidents." The treasury and comptroller were removed from the Board. All seven Governors were to be appointed by the president with the approval of the Senate to terms of fourteen years. These changes served to strengthen the independence of the Board from the government and its power relative to the Reserve Banks.

What lessons might we draw from the Fed's history for the ESCB? It took nearly one-quarter century in the United States for the center to gain control from the periphery and to solidify the institutional features of the central bank. Based on our experience, centralized control has been better at delivering policy that is appropriate for the nation as a whole. The seven Board members

have majority voting power on the FOMC, with the regional interests (as represented by the Reserve Bank presidents) rotating across the twelve Reserve districts. This is in sharp contrast to the ESCB, with only six members of the Executive Board at the center and eleven heads of the national central banks at the periphery, all with voting power.

VOTING BEHAVIOR OF THE FOMC

In order to get a better handle on the role of the center relative to the periphery in monetary policy decisionmaking, we have examined the voting behavior of the FOMC. We have amassed the voting records of Board Governors and Bank presidents from 1968 to 1997—a total of 288 FOMC meetings.

Table 1
Representation of Federal Reserve Districts

	Number of votes cast (average for 288 meetings)	Percent of total Reserve Bank assets, 1996
1 - Boston	0.97	5.7
2 - New York	1.94	33.3
3 - Philadelphia	1.05	3.4
4 - Cleveland	0.50	6.6
5 - Richmond	1.20	8.7
6 - Atlanta	0.59	6.5
7 - Chicago	1.37	10.4
8 - St. Louis	0.59	3.8
9 - Minneapolis	0.40	1.5
10 - Kansas City	1.06	2.9
11 - Dallas	1.00	3.8
12 - San Francisco	0.99	13.4
Total	11.65	100.0

There are many interesting aspects of voting behavior that one could study; two of these appear to be particularly relevant for Europe's new central bank. First is what we term the "effective representation" of each district on the FOMC (shown in the first column of table 1). Effective representation reflects the share of the FOMC votes—assents and dissents—registered by the twelve

Federal Reserve districts over the period of 288 FOMC meetings. Take New York as an example. New York, the second Federal Reserve district, has accounted for 1.9 of the total 11.7 votes cast on average over the 1968-97 period. The president of the Federal Reserve Bank of New York has a permanent seat on the FOMC and it is typical for one of the members of the Board to represent the New York district.[1] Thus, 2 votes. The 1.9 is slightly less than 2, and the 11.7 is less than the 12 FOMC votes, because on occasion vacated positions have not been filled immediately.

Looking at other entries in the first column, Boston, Philadelphia, Kansas City, Dallas, and San Francisco have had on average about one vote, while Richmond and Chicago have had somewhat more influence and the others somewhat less. The second column reports the share in total assets of each district bank as a measure of economic size of the region. If New York's FOMC vote were to correspond to its one-third share of total assets, it would have four (rather than two) votes. The asset share of San Francisco would suggest an FOMC vote above one and one-half. Clearly, the importance of each Federal Reserve district in the voting pattern of the FOMC differs from the economic weight of the regions, at least as measured by bank assets.

How will this compare with the ECB? Germany, France, and Italy combined represent about three-fourths of total nominal GDP for the eleven countries that will make-up Euroland, yet they will have six of the seventeen seats—or 35 percent—on the ECB's Governing Council, the equivalent body to the FOMC. Finland, with less than two percent of the economic mass in Euroland, will cast 12 percent of the vote.

Does this matter? In the European context, it will only matter if Finland and other smaller countries that have a voting share that is disproportionately larger than economic size, vote with an eye to developments in their individual countries than in the euro region as a whole. While it is difficult to predict what will happen in Europe, we have examined the FOMC's voting record for evidence of this sort of behavior.

In this context, it is interesting to recount an exchange (taken from the FOMC transcripts) between Chairman Greenspan and Robert Parry, the president of the Federal Reserve Bank of San Francisco, from the meeting in December 1992:

> Chairman Greenspan. Do you have a question, Bob?
> Mr. Parry. Yes. I just want to comment on . . . regional disparities. I mentioned in my report on California the decline of about 155,000 [jobs] in the last six months. If we back out California from the statistics, we get almost a completely different picture of what is happening: We see an employment picture in terms of nonfarm employment where the rest of the country is up 300,000 in the last six months. That's not robust but it is increasing. If we back out California from the civilian employment numbers, we get an unemployment rate of 6.8 percent . . .
> Chairman Greenspan. Are you about to suggest something?
> Mr. Parry. We are not seceding . . . yet! What I'm suggesting is that a majority of people in the country are experiencing something very significantly different from what a group of people in one state, or maybe even half a state, are.
>
> [Later in the meeting.]
> Mr. Parry. Mr. Chairman, recent developments suggest that a moderate expansion is underway, and we are seeing numbers in the inflation area that certainly are encouraging. . . . since the economy is picking up, I believe we probably should give somewhat less weight to the risk of stagnant real economic activity and more weight to the possibility that it may accelerate more sharply . . .

There were no dissents cast at the meeting in December 1992, or at several meetings prior to that meeting, although monetary policy had been eased somewhat earlier in the year.

FOMC dissents are relatively rare, with the greatest number of dissents (five) having been registered only once during the period examined in 1983. On average, Board members dissent about six percent of the time, while Reserve Bank presidents dissent slightly more often, nearly nine percent of the time. With the center more likely to agree to a common view than the periphery, this raises another question. Is the structure of the ECB's Governing Council, with a larger portion of the vote cast by the periphery (eleven votes as compared with the six cast by the center) more likely to lead to disagreements over the appropriate policy?

REGIONAL ECONOMIC DIFFERENCES

To understand whether regional economic conditions have influenced the voting behavior of FOMC members, it is useful to examine statistics from the U.S. states or Federal Reserve districts for evidence of such influence. Unfortunately, most U.S. data are not available on a state-by-state basis, leaving us with little statistical information with which to investigate the hypothesis. In this paper, we have used state unemployment rates, one readily-available measure of state-by-state variation. Analysis of this sort has direct implications for Europe. To the extent that the votes of FOMC members are consistent with regional concerns, we would expect similar patterns to arise in ECB voting, given the strong affiliation of ECB members with their respective countries. If FOMC votes appear to reflect only national conditions, it might be appropriate to ask what institutional characteristics of the Federal Reserve System have facilitated this result.

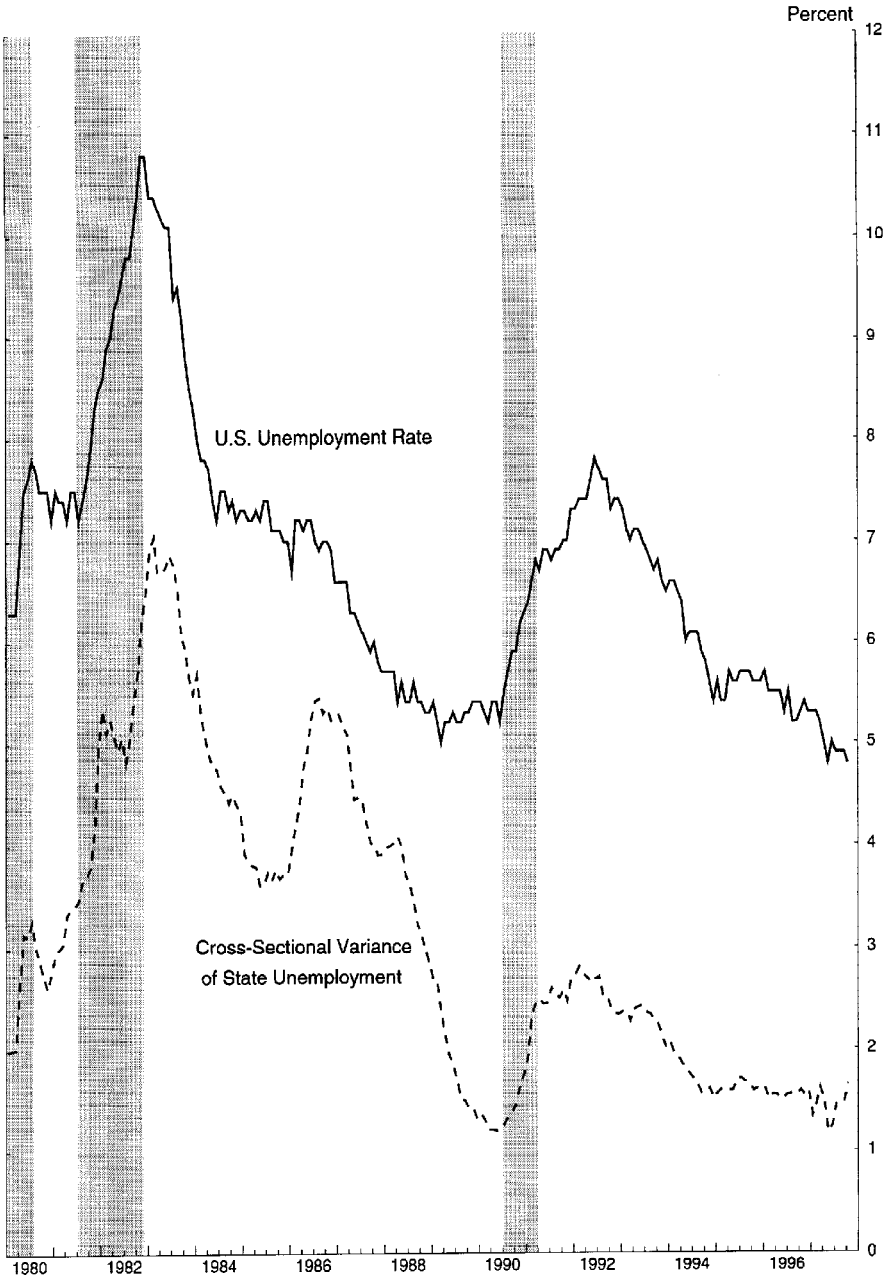
Chart 1 plots the national unemployment rate against the cross-section variance of individual state unemployment rates for the January 1980-October 1997 period. Notably, the cross-section variance of state unemployment rises during recessions (the shaded areas of the chart) and falls during expansions. This is particularly conspicuous during the 1981-82 recession, when the U.S. unemployment rate increased to almost eleven percent and the cross-section variance more than doubled. Conversely, since 1992, the U.S. unemployment rate has fallen sharply and the dispersion of state unemployment rates has declined.

However, there is one exception. The decline in oil prices during 1986 was a beneficial shock for most regions. The U.S. unemployment rate declined from 7 percent at end-1985 to 6-1/4 percent in mid-1987. The decline in oil prices was an adverse development for oil-producing states, notably Texas. The unemployment rate in Texas surged from 7.2 percent at end-1985 to 9.4 percent in October 1986 and remained at 8-1/2 percent in mid-1987. Accordingly, the overall U.S. unemployment rate declines during this period, but the cross-section variance of state unemployment rises.

Periods of high cross-section variance in state unemployment rates may be times when a divergence of views among FOMC members is likely to emerge. In other words, we might expect a positive relationship between the dispersion of state unemployment rates and the number of

Chart 1

Variability of Unemployment across U.S. States



dissents at FOMC meetings. Chart 1a illustrates this point, with the number of FOMC dissenting votes (the solid line) plotted against the cross-section variance of the state unemployment rates. While the number of dissents rises with the increase in the cross-section variance in the 1982-83 period, the evidence does not appear to be overwhelming. Furthermore, this analysis does not take into account the direction of the dissent (that is, whether the dissents registered were consistent with the unemployment data in the region).

Another measure of the dispersion of unemployment rates across states is the spread between the maximum and minimum unemployment rates, shown in chart 2. This spread reached its peak in early 1983 at 13.4 percentage points and was at its smallest in June 1997 at only 4-1/2 percentage points. The average spread over the sample period was 8.3 percentage points. There is a large degree of persistence over the sample period in the particular U.S. state that registers the maximum and minimum unemployment rates. For example, West Virginia recorded the maximum unemployment rate slightly less than one-half of the period, while Nebraska recorded the minimum unemployment rate about one-third of the period.

The implications of this analysis for Europe are tentative at best. Charts 3 and 4 represent an attempt to replicate charts 1 and 2 for Euroland. Chart 3 plots data for nine of the eleven countries in the European Union that will join monetary union next January (the graph excludes Austria and Luxembourg where the necessary data are not available). The Euroland unemployment rate was computed by weighting national unemployment rates by each country's share in the total labor force (over the 1992-94 period). Due to data availability, the sample begins only in 1992. As the unemployment data used are published national statistics, some differences in definitions across countries remain.

Although data constraints are severely binding, chart 3 seems broadly consistent with chart 1. In particular, during the European recession of 1992-93, the unemployment rate increased from just under 10 percent to about 12-1/2 percent. Although the aggregate unemployment rate remained constant in subsequent years, the cross-section variance declined as countries recovered.

Chart 4 highlights the dispersion in unemployment rates across the nine euro-area countries. While the largest spread between the maximum and minimum unemployment rates across the U.S. states was 13.4

Chart 1A

U.S. Unemployment and FOMC Dissents

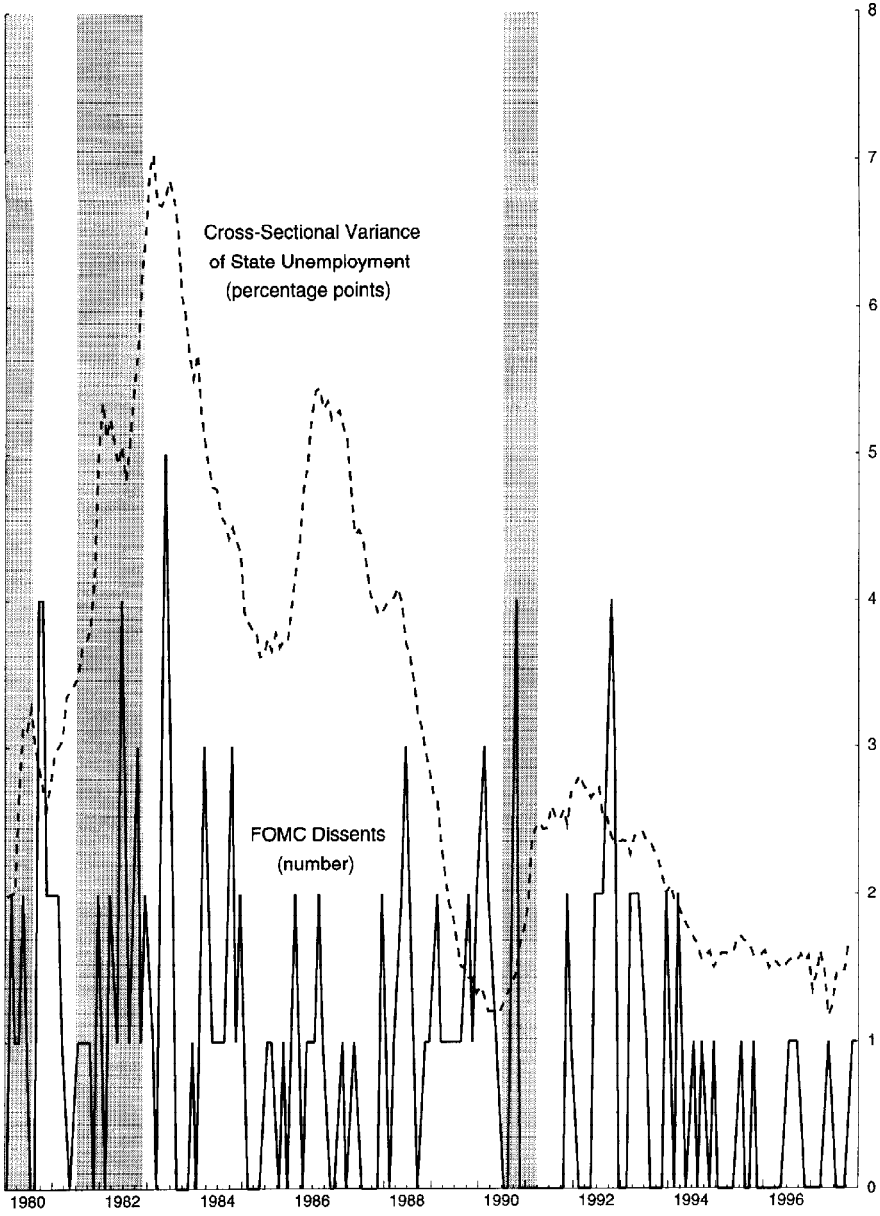


Chart 2

Maximum and Minimum Unemployment Rates

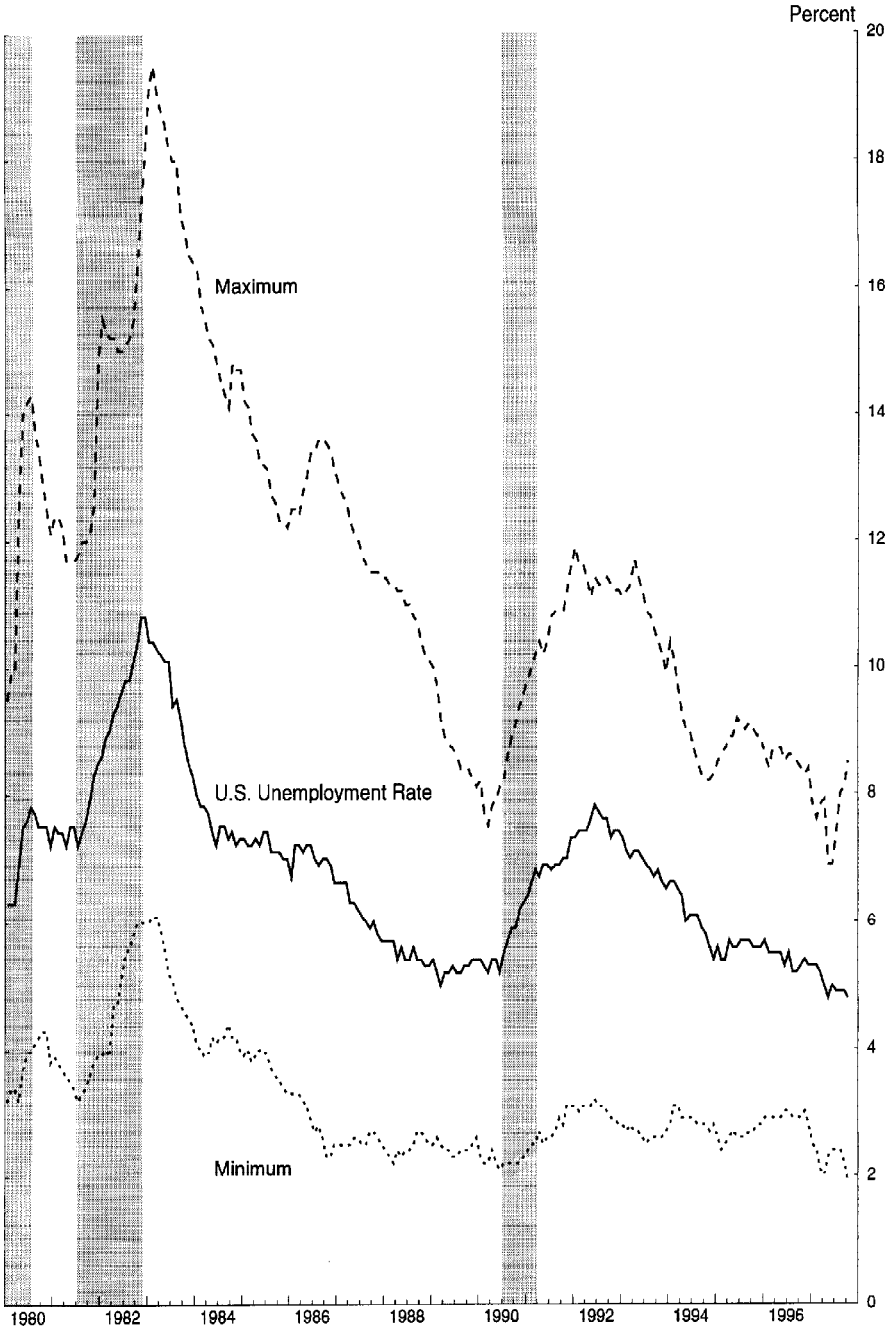
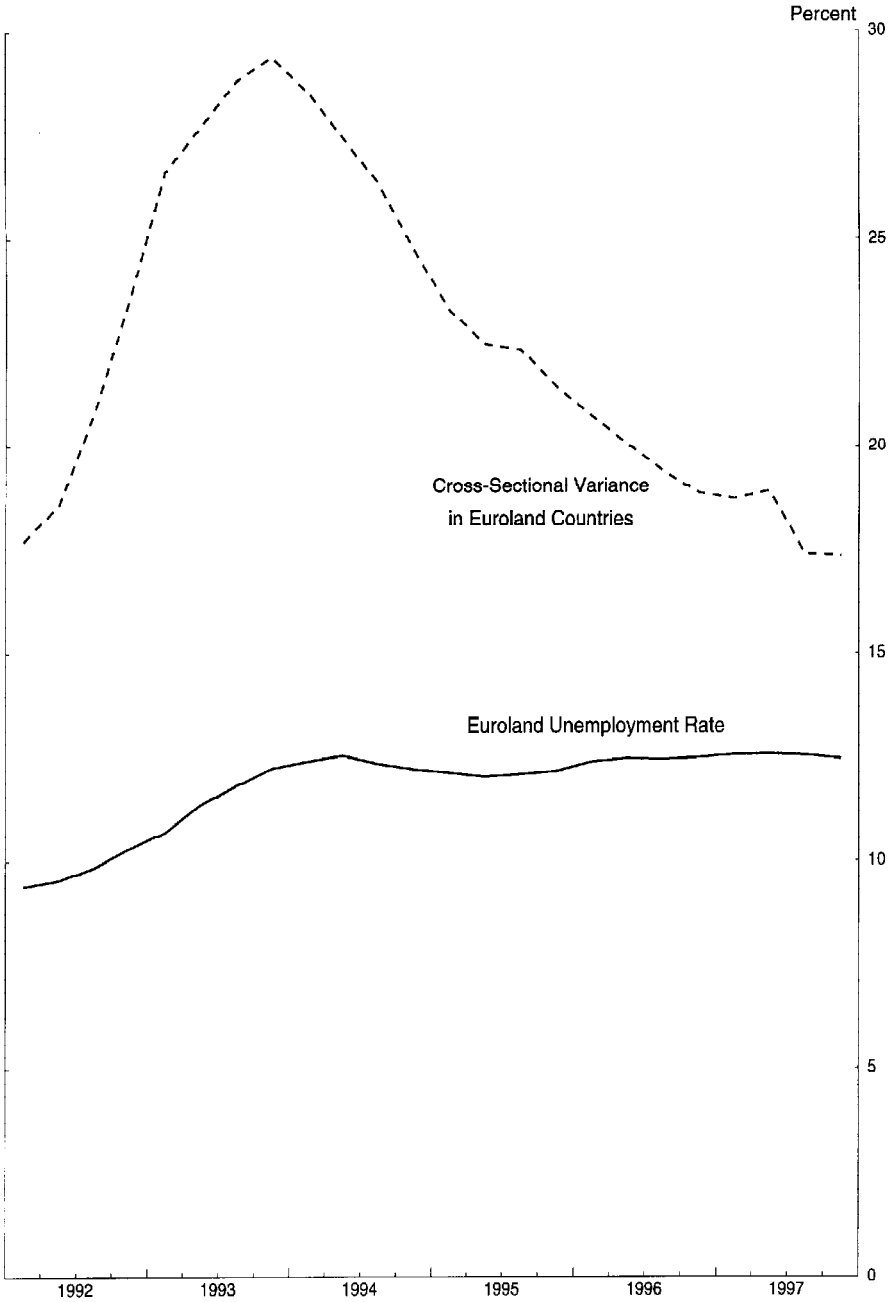


Chart 3

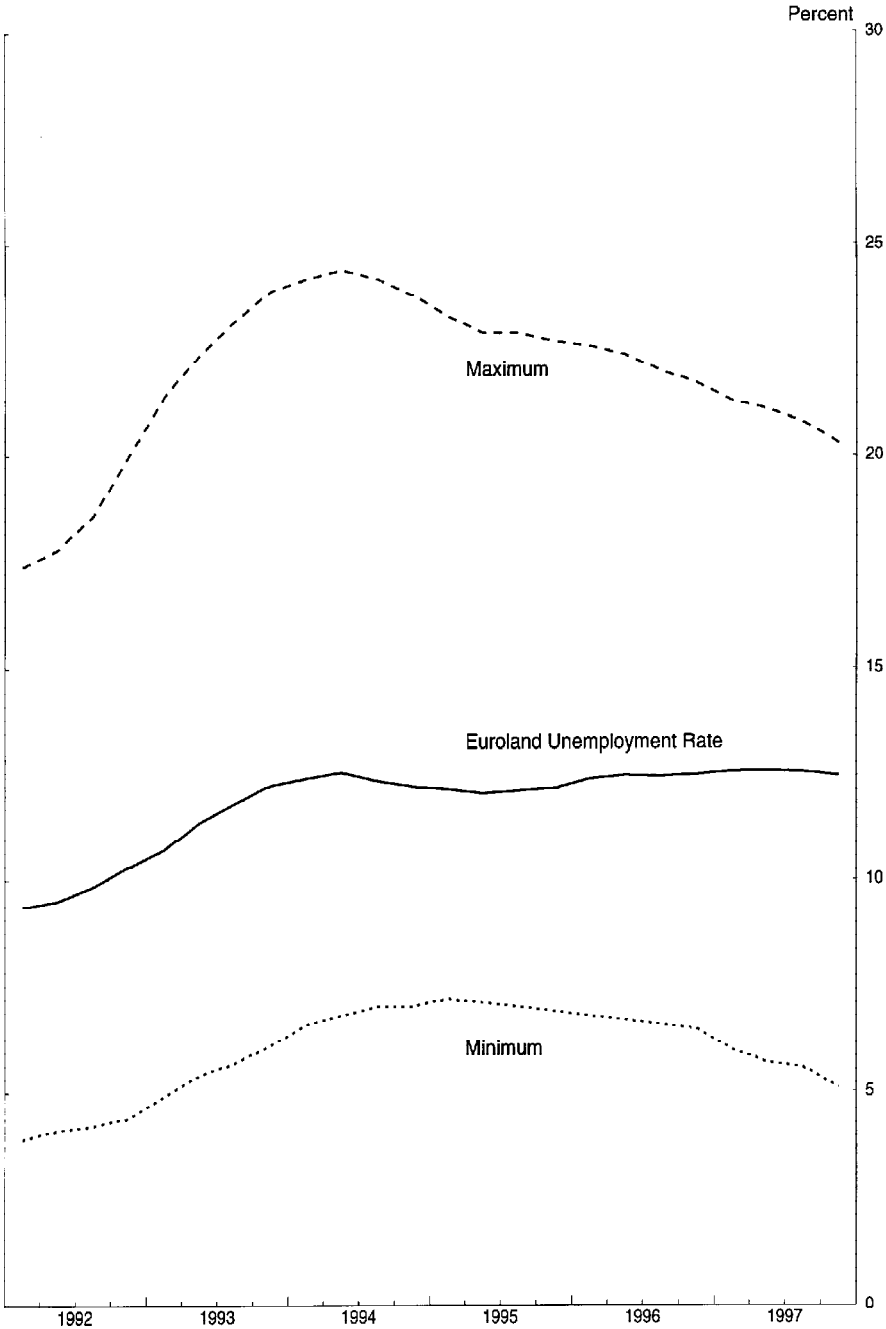
Variability of Unemployment in Euroland*



* Excludes Austria and Luxembourg.

Chart 4

Maximum and Minimum Euroland Unemployment Rates



percentage points from 1980-97, there is a persistent 15 point spread in Euroland from 1992-97. Taken at face value, this would suggest that regional divergences in Europe are far more pronounced than in the United States and might imply that regional cleavages may be more pronounced in ECB voting than they have been in FOMC voting.

CONCLUSION

In this paper, we have explored some possible lessons from the Federal Reserve's experience for Europe's nascent central bank. The Federal Reserve System is much more centralized than the ESCB, having achieved its centralization over a twenty-five year period during which the Fed's decision making structure was not well-defined. While dissenting votes are more common among the Reserve Bank presidents on the Fed's FOMC than among Board members, the frequency of dissents is generally very low. The paucity of regional economic indicators makes it difficult to ascertain whether regional economic developments have influenced the voting patterns of FOMC members. In future research, we hope to explore further the voting records of FOMC members and to look for evidence of regional influences in the published transcripts of FOMC meetings.

Europe may do well to heed the Fed's history. Much more decentralized in structure and in operational responsibilities than the Fed, the ESCB must avoid any tendency to promote the national economic situation or national financial market at the expense of the area as a whole. Ironically, the plethora of national statistics may make the pressures on Governing Council members more difficult, as regional economic differences will be highlighted by such statistics. And finally, as voting records and transcripts from Governing Council meetings will not be published, it will not be possible to investigate in any systematic way whether regional or national influences have played any role in voting patterns!

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ENDNOTES

1. Each of the seven Governors of the Federal Reserve Board nominally represents one of the Federal Reserve districts and no more than one Governor may be appointed from each district.

Conference Agenda

The European Central Bank
How Accountable? How Decentralized?
Lessons from the *Bundesbank* and the Federal Reserve System

Welcome: Carl Lankowski, AICGS

Moderator: Stanley Black, University of North Carolina

The Democratic Accountability of the European Central Bank: Challenges for the ECB and the European Democratic System
Speaker: Christa Randzio-Plath, European Parliament

Guarding the Guardians of the Currency: To Whom are the *Deutsche Bundesbank* and the European Central Bank Accountable?
Speaker: Susanne Lohmann, University of California at Los Angeles

No Monetary Masquerade for the ECB
Speaker: Adam Posen, Institute for International Economics

Centralization vs. Decentralization in the Federal Reserve System: Lessons for the European Central Bank
Speakers: Ellen E. Meade, Federal Reserve Board
D. Nathan Sheets, Federal Reserve Board

The Creation of an Integrated Euro Money Market
Speaker: Gary Schinasi, International Monetary Fund