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Legitimacy and efficiency: Revitalizing EMU ahead of enlargement

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Legitimacy and efficiency: Revitalizing EMU ahead of enlargement

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ABSTRACT

Eight years after the launch of its third stage, and on the brink of its expansion, the European Union's (EU) Economic and Monetary Union (EMU) has proven to be successful. However, EMU has also highlighted the diversity of its members economic performance, and their need to run larger public deficits than they initially committed to. This special issue attempts to find out what can be done to relieve the tensions in EMU. The source of EMU's difficulty seems to lie in its weak legitimacy, ambiguous gevernance, and asymmetric institutional design. The EU needs to improve its fiscal rules and streamline decision making in the European Central Bank without eroding legitimacy.

KEYWORDS

Efficiency; EMU; enlargement; EU; legitimacy.

Eight years after the launch of its third stage, the European Union's (EU) Economic and Monetary Union (EMU) has proven to be both successful and complicated. It has eliminated exchange rate instability across much of Europe, lowered interest rates, made comparing prices easier, in so doing facilitating trade, travel and tourism, and deepened the European financial area. Recently, economic growth has also been accelerating among its member states after years of near-stagnation, although some argue that this is merely a cyclical development. The differences between those inside versus those outside EMU are declining. Although in the earlier years the EU member states that chose to stay out of the euro area were growing faster than those in EMU, recently the performance of the 'ins' has closely

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approximated those of the 'outs' (Commission, 2006: 133). Furthermore, EMU is on the brink of expansion. In January 2007 Slovenia became the first transition economy to join the euro area, Cyprus and Malta are scheduled to join in January 2008, and in the coming years more new members are due to join.

Nevertheless, EMU has highlighted the diversity of its members' economic performance, in particular how member states deal with public spending and the ageing population and related costs. This diversity was reflected especially in the member states' need to run larger public deficits than EU member states committed to run in the Treaty Establishing the European Community. The political–economic backdrop in Europe over the past few years is not helpful either: social tensions in France, the 2005 rejection of the European Constitutional Treaty by French and Dutch voters, difficulties in completing the single market, and strong disagreements among member states in issues ranging from energy and security to agriculture and the EU budget. In addition, the enlargement of the euro area to the east if not to the north–west, is expected to exacerbate these challenges for EMU.

As new administrations set in office in France and the UK and as the Baltic countries prepare for the single currency, this special issue attempts to find out what can be done to relieve the tensions in EMU. The contributions below portray a troubled currency union though not one in crisis. The source of EMU's difficulty lies in its weak legitimacy, which complicates efforts to resolve ambiguities in its governance. EMU's asymmetric institutional design leaves the project's legitimacy vulnerable to fluctuations in the perceived advantages and disadvantages of the euro. The euro-zone's enlargement to the UK (and perhaps to Denmark and Sweden too) can only be expected under severe crisis there.

What to do? The EU needs to continue to improve upon the fiscal rules agreed on in the Maastricht Treaty. A properly reformed Stability and Growth Pact (SGP) must allow for politically achievable budgetary goals, which reward national political leaders for the difficult decisions that they are required to take. Efficiency in the decision making processes of the European Central Bank (ECB) is important but it must not come at the expense of legitimacy. Thus, equal voting rights must be maintained in its General Council – the body responsible for setting monetary policy of the ECB. Furthermore, some 'democratic override' must be built into EMU, allowing for effective external review of the ECB and of the finance ministers of participating countries (the Eurogroup), as well as potential sanctions for extreme cases of departing from the preferences of a broad set of societal interests.

In his article on *Enlargement and the International Role of the Euro* Benjamin Cohen asks how enlargement of the EU will affect prospects for the euro as an international currency. He has long argued that Europe's joint currency is fated to remain a distant second to America's greenback because of

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three structural factors: (1) relatively high transactions costs, due to inefficiencies in Europe's financial markets; (2) an anti-growth bias built into the institutions of EMU; and (3) ambiguities at the heart of the monetary union's governance structure. On top of these concerns progress in building a global role for the euro has been underwhelming to date also because of the well documented inertia that is inherent in all monetary behavior, arising from stickiness in currency preferences.

In this issue Cohen extends his earlier analysis, focusing in particular on the impact of enlargement on the governance structure of EMU. From the start, internationalization of the euro has been retarded by a lack of clarity about the delegation of monetary authority among governments and EU institutions. The addition of a diverse collection of new members, with significantly different interests and priorities, will exacerbate ambiguity at the expense of transparency and accountability and make the challenge of governance worse. In fact, enlargement will aggravate the negative impact of all three factors that constrain the euro's international role. Bringing accession countries into EMU will prolong the segmentation of Europe's financial markets, and delay any significant reduction of the cost of doing business in euros. By adding to inflationary and budgetary pressures, enlargement will reinforce the anti-growth bias built into the institutional structure of EMU.

Of course, as the euro area is enlarged its economic base broadens and its potential for network externalities increases. Nevertheless, Cohen argues that enlargement will diminish, not expand, the euro's attractiveness as a rival to the greenback. Furthermore, though unlikely, the possibility that EMU could founder under the weight of enlargement cannot be dismissed.

The greatest challenge for the functioning of EMU has so far come from its beleaguered fiscal regime. Ever since 1996 the SGP has sought to tighten the discipline among the member states so that they comply with the Maastricht Treaty criteria. However, by late 2003 the EU's regime of fiscal constraint verged on the brink of collapse. The reform of the SGP adopted in March 2005 by the Council of Ministers on Economic and Financial Affairs (ECOFIN) emphasized the role of cyclically adjusted deficit calculations, expanded the conditions under which the member states could deviate from the budgetary targets, but retained the SGP's target of 3 percent deficit level and 60 percent debt level (in proportion to GDP). These reforms did not prevent one-third of the original 15 member states from running deficits in excess of 3 percent of GDP in 2005, despite the upswing in the economic cycle.

The troubles of the SGP and the prospect of the Euro-zone's enlargement underscore the need for reforms that would resolve the anti-growth bias and the governance ambiguities that Benjamin Cohen foresaw. Two articles in this special issue deal with reforms in EMU, one with the SGP, the other with reform of the ECB.

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In their article on *Reforming Europe's Stability and Growth Pact: Lessons from the American Experience in Macrobudgeting* James Savage and Amy Verdun argue that the continued reliance on the SGP's targets explains the failure of member states to comply with the EU's macrobudgetary rules. A properly reformed SGP must allow for politically achievable budgetary goals, which reward national political leaders for the difficult decisions that they are required to take. National politicians must be able to claim credit for their actions.

Savage and Verdun explore the American experience since 1985 with three macrobudgetary laws aimed at promoting fiscal stability: Gramm–Rudman–Hollings, the Budget Enforcement Act, and Balanced Budget Act. Macrobudgetary rules that rely upon deficit criteria produce budgetary targets that are often beyond the control of political actors. Thus, after several futile years of trying to control their deficits with the first of these laws, the Americans changed the goal to controlling spending in the latter two. The authors offer the EU a number of lessons from US experience. These include substituting spending targets for deficit targets, creating politically realistic and administratively manageable fiscal sanctions rather than draconian measures, and applying nominal spending caps rather than using a GDP basis.

In addition to these challenges to fiscal policy in the Euro-zone, future enlargement of the single currency potentially threatens the efficiency of its monetary policy making. Especially, extending the principle of equal representation of National Central Banks (NCBs) on the ECB's Governing Council to the new member states might stifle its decision making. In his article on *Running an Enlarged Euro-zone; Reforming the European Central Bank: Efficiency, Legitimacy and National Economic Interest* David Howarth argues that the reform that the Governing Council adopted in December 2002 distorts the guiding principles of ECB decision making: equality ('one governor, one vote'), representativeness (all the Euro-zone is represented) and *ad personam* participation (each governor votes in an independent and personal capacity).

The reform eliminates equal voting rights. Instead it emphasizes member state macroeconomic interest in determining their bargaining power and prioritizes the size of national economies and financial markets over population size. This distortion reflects the interests of the largest member states in maintaining disproportionate representation in the Governing Council, as well as the preferences of mid-size member states (notably The Netherlands). The reform thus weakens the future representation of NCBs of Central and East European EU member states, in order to diminish a structural bias in favor of higher interest rates. In fact, Howarth shows that the pre-reform bargaining power of individual Governing Council members already reflects the size of their home economies, the interests of which they defend.

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The proposed reform contributes to the suspicion that the ECB is particularly preoccupied with the effect of its policy on the largest economies, despite the official requirement that it target Euro-zone wide inflation. Worse still, this damage to the principles of ECB decision making is not compensated for by improved efficiency in ECB decision making, because of opposition from the smaller member states, and legitimacy concerns, which ensure a large and 'decentralized' Governing Council.

Howarth's article pits efficiency against legitimacy in the process of reform. This dilemma arises, at least in part, from the gap between monetary integration and political integration in Europe, which gives rise to questions about the democratic accountability and legitimacy of the Eurozone. In his article on *Democratic Accountability and the Exchange-Rate Policy of the Euro Area* Randall Henning examines the consequences of the political 'incompleteness' of the monetary union for the democratic accountability of its external monetary policy, comparing the euro area to the US.

Henning notes that accountability in exchange rate policy is weak compared to other policy areas in almost every country. Exchange-rate policymaking is often delegated to the finance ministry and central bank – two institutions over which other domestic actors have little oversight. Although the rationale for delegation is compelling, he maintains that oversight and accountability by outsiders, especially the legislature, are still desirable, feasible, and appropriate in democratic systems. Moreover, the democratic accountability of exchange rate policy is important to maintaining political support for economic openness in general. According to Henning, in the US the Congress provides the possibility for 'democratic override' when policy diverges substantially from the preferences of a broad set of societal interests. In the euro area, the ECB and Eurogroup operate without effective external review or potential sanctions for departing even in the extreme from such preferences.

Henning supports his argument by contrasting the responses of the US and the euro area toward Chinese foreign exchange intervention during 2002–2006. He finds that the weakness of accountability within the euro area has two negative potential effects. First, it tends to bias remedies for undervaluation of third currencies toward trade measures and away from exchange-rate measures and could thereby erode political support for economic openness more broadly. Second, if exchange rate policy deviates from societal preferences repeatedly, the weakness of accountability could leave the euro area at risk for an erosion of legitimacy over time. Until the political project of the European Union is completed, Henning suggests that policy makers should compensate for the weakness of accountability by providing greater transparency, soliciting the views of societal groups, the Parliament and the Commission on external monetary policy, and developing a more robust inter-institutional dialogue.

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Political economists have long raised concerns that EMU's asymmetric institutional design, which is built around a single independent supranational central bank and decentralized system of fiscal governance with 13 (soon 15) national authorities, leaves the project's legitimacy vulnerable to fluctuations in the perceived advantages and disadvantages of the euro. The difficulty is exacerbated by the confusion over the way in which the public should evaluate EMU. Should it be judged on its ability to deliver economic growth, macroeconomic stability, or job creation?

In their article on *The Legitimation of EMU: Lessons from the Early Years of the Euro,* Servaas Deroose, Dermot Hodson and Joost Kuhlmann suggest that although popular support for EMU remains strong after seven years of the single currency, it has varied at the member state level. Support for EMU appears to have been closely related to popular attitudes about the euro's utility and perceived – rather than actual – economic performance. In particular, the perception that the euro currency changeover raised prices, though not supported by the data, appears to have weighed heavily on EMU's legitimacy. This effect is pronounced in Germany, the Netherlands and Portugal, and to an even greater extent in Greece, Italy and Spain. Survey data suggests that those viewing the euro as advantageous tend to focus on the single currency's benefits for travel and trade and on its political advantages for Europe rather than its contribution to greater macroeconomic stability and historically-low interest rates.

The implications of these findings are three-fold. First, economic and monetary authorities need to pay due regard to the legitimacy of policy making as well as to its efficiency and credibility. Second, the gap between EMU's perceived and actual economic impact reinforces the role of euro area economic governance in promoting greater understanding of the single currency's benefits and allaying concerns over its perceived costs. Third, EMU's legitimacy depends on more broad-based mechanisms rather than elite-driven and technocratic approaches to monetary integration.

Nowhere else among EU member states is EMU's legitimacy more challenged than in the UK. The only large member state that has opted out of the euro area Britain's possible future entry feeds much speculation. Will Britain ever adopt the euro, and if so when? The conventional view holds that British entry into monetary union is impeded by: opposition from large fractions of public opinion, business leaders, and the Conservative party; by insufficient synchronization of its economic cycle with the that of the euro area; by the sensitivity of Britain's foreign trade and investment to the single currency; and by the peculiarities of British political institutions. Because most of these influences change only slowly, many are very skeptical that Britain will join the single currency in the foreseeable future.

In his article on *How and Why Britain Might Join the Single Currency,* James Walsh argues that policy failure is a more important influence on British economic policy than is often recognized. Policy failure endangers the

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career prospects of politicians, and leads them to search for and consider alternative policy ideas. In turn, these ideas determine the goals for policy and frame expectations about the effects of different policies. Politicians select and seek to implement a rival idea, *ceteris paribus*, that identifies causal mechanisms that explain recent failure and offers an intellectually coherent and politically attractive set of policy prescriptions. Thus, major changes occur when an existing policy fails and new ideas are available to shape a replacement.

Walsh argues that a sharp deterioration in British economic performance, blamed on the current British policy framework (central bank independence and a floating exchange rate), combined with a perception that euro membership would address this failure, could improve the attractiveness of euro membership. This combination could in a short period of time lead many politicians, business leaders, and voters to see the advantages of euro membership and encourage a British government to advocate euro membership. Potential examples for such a combination include a sustained depreciation of the British pound, higher inflation or unemployment in the UK compared with the Euro-zone, or slower growth. Walsh supports his argument by analyzing British policy failures since the 1970s, including the failure of demand management in the 1970s, the Medium Term Financial Strategy in the 1980s, and the EMS in the 1990s. Thus, Walsh seems to imply that legitimacy is a relative concept and in times of crisis the single currency may suddenly re-emerge as a legitimate alternative. However, if an economic meltdown in the UK is unlikely, EMU's 'relative legitimacy' still depends on reforms that will successfully resolve the challenges of ambiguous governance, legitimacy and accountability.

This special issue originated in a panel held at the Ninth Biennial International Conference of European Union Studies Association (EUSA), which took place in Austin, Texas in Spring 2005. A workshop, organized by the editors of this special issue, followed in December 2005 at the SAIS Bologna Center of the Johns Hopkins University. The editors are grateful to the SAIS Bologna Center for hosting and sponsoring the workshop and to the Parachini family for generously providing the financial support. Some of the participants in the workshop later dropped out or their articles were rejected during the refereeing process at *RIPE*; we thank both them, and the contributors to this special issue, for having delivered punctually their original and thought-provoking articles. Most of the logistical side of the editorial work was carried out by the Bologna Center's staff, particularly Sarah Bignami. *RIPE's* editors were forthcoming and supportive of the idea of this special issue from the start. We thank them all.

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Enlargement and the international role of the euro

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Enlargement and the international role of the euro[1]

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ABSTRACT

How will enlargement of the European Union (EU) affect prospects for the euro as an international currency? Previously, I have argued that Europe's joint currency is fated to remain a distant second to America's greenback long into the foreseeable future because of three structural factors – relatively high transactions costs, due to inefficiencies in Europe's financial markets; a serious anti-growth bias built into the institutions of Economic and Monetary Union (EMU); and, most importantly, ambiguities at the heart of the monetary union's governance structure. In this essay I extend my earlier analysis, focusing in particular on the impact of enlargement on the governance structure of EMU. From the start, internationalization of the euro has been retarded by a lack of clarity about the delegation of monetary authority among governments and EU institutions. The addition of a diverse collection of new members, with significantly different interests and priorities, can only make the challenge of governance worse, exacerbating ambiguity at the expense of transparency and accountability. Enlargement will diminish, not expand, the euro's attractiveness as a rival to the greenback.

KEYWORDS

EMU; the euro; monetary governance; currency internationalization; EU enlargement.

I. INTRODUCTION

How will enlargement of the European Union (EU) affect prospects for the euro as an international currency? Will the addition of a dozen or possibly even more new members to the Economic and Monetary Union (EMU) enhance the euro's ability to challenge the US dollar for global monetary supremacy? Previously, I have argued that Europe's joint currency

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is fated to remain a distant second to America's greenback long into the foreseeable future (Cohen, 2003). In this essay I extend my earlier analysis to consider the impact of enlargement on the euro's international role. My conclusion now is, if anything, even more skeptical than before. Enlargement, I submit, will diminish, not expand, the euro's attractiveness as a rival to the greenback. The dollar will remain the only truly global currency.

To date, progress in building a global role for the euro has been underwhelming. To some extent, this might be due simply to the inertia that is inherent in all monetary behavior – a well documented stickiness in currency preferences. Since the adoption of a new money is costly, involving an expensive process of adaptation, an already popular currency like the dollar enjoys a certain natural advantage of incumbency. My previous work, however, suggests that there are also more fundamental forces at work. Three factors, all structural in character, have been largely responsible for the euro's slow start as an international currency: relatively high transactions costs, due to inefficiencies in Europe's financial markets; a serious anti-growth bias built into the institutions of EMU; and, most importantly, ambiguities at the heart of the monetary union's governance structure. The analysis offered here suggests that adding new members to EMU will, if anything, simply make matters worse. Larger numbers will aggravate the negative impact of all three factors.

Of particular salience is the impact of enlargement on the governance structure of EMU. I am hardly alone in stressing the degree to which prospects for internationalization of the euro are dimmed by EMU's institutional inadequacies. The theme has featured in the work of economists (e.g. Eichengreen, 1998) and political scientists (e.g. Bieling, 2006) alike. From the start, it should have been clear that widespread acceptance of Europe's new currency would be retarded by a lack of clarity about the delegation of monetary authority among governments and EU institutions. My argument here is that the addition of a diverse collection of new members, with significantly different interests and priorities, can only make the challenge of governance worse, exacerbating ambiguity at the expense of transparency and accountability.

The organization of the essay is as follows. The first two sections set the stage for analysis. The first section reviews the story of the euro's internationalization to date, while the second outlines prospects for enlargement of EMU and what the addition of new members could mean for the currency's future. The main analysis then follows in three subsequent sections, addressing in turn the impact of enlargement on each of the three structural factors identified in my previous work. The results and implications of the analysis are summarized in a concluding section.

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II. DREAM DELAYED

At its birth, the euro's future as an international currency seemed assured. Yet since the new money's introduction in 1999, acceptance beyond EMU itself has actually been quite slow, limited mainly to the euro's natural hinterland in and around Europe – 'the euro's turf', as economist Charles Wyplosz (1999: 89) calls the nearby region. In many respects, Europe's monetary union has been a resounding success. But in terms of its anticipated challenge to the dollar, performance to date can only be described as disappointing. Beyond the European region, in the global marketplace, the greenback remains as dominant as ever.

Grand ambitions

Europe's ambitions for the euro have always been grand. First and foremost, the joint currency was expected to help promote the EU's long-standing goal of an 'ever closer union among the peoples of Europe'. The benefits would be both practical and psychological. Not only would exchange risk within the group be eliminated, reducing transactions costs that hampered the construction of a single European market. One money for Europe would also provide a powerful new symbol of European identity, enhancing the sense that all Europeans belong to the same emerging community.

But that was never all. For many in the EU, there was an external ambition as well. On the broader world stage, EMU was meant to enhance Europe's role by creating a potent rival to the dollar, the leading international money of our era. Resentment has long simmered among Europeans sensitive to the inordinate power that the greenback's popularity gives to the United States – America's 'exorbitant privilege', in Charles De Gaulle's memorable phrase. Europe is the equal of the United States in output and trade. Why should it not be America's equal in monetary matters, too? Though the 'old dream of enthusiasts' (Zimmermann, 2004: 235) was never formally articulated as such, it was evident from the start. EMU was supposed to challenge the dollar for global supremacy. Wyplosz (1999: 76), an informed insider, calls this 'the hidden agenda of Europe's long-planned adoption of a single currency'.

The stakes were clear. Four distinct benefits are derived from widespread international circulation of a currency, supplementing internal gains: (1) a potential for seigniorage (the implicit transfer of resources, equivalent to subsidized or interest-free loan, that goes to the issuer of a money that is used and held abroad); (2) an increase of flexibility in macroeconomic policy, afforded by the privilege of being able to rely on one's own currency to help finance foreign deficits; (3) the gain of status and prestige that goes with market dominance, a form of 'soft' power; and (4) a gain of

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influence derived from the monetary dependence of others, a form of 'hard' power. America had long enjoyed all four benefits. It is understandable that Europeans might desire a piece of the action, too.

Faith in the euro's potential was widespread. Fundamentally, international currency choice is shaped by three essential attributes. First, at least during the initial stages of a money's cross-border adoption, is widespread confidence in its future value backed by political stability in the economy of origin. No one is apt to be attracted to a currency that does not offer a reasonable promise of stable purchasing power. Second are the qualities of 'exchange convenience' and 'capital certainty' – a high degree of liquidity and reasonable predictability of asset prices – both of which are essential to minimizing transactions costs. The key to each quality is a set of broad and efficient financial markets, exhibiting both depth and resiliency.

Third, a money must promise a broad transactional network, since nothing enhances a currency's acceptability more than the prospect of acceptability by others. Historically, this factor has usually meant an economy that is large in absolute size and well integrated into world markets. The greater the volume of transactions conducted in or with an economy, the greater will be the economies of scale to be derived from use of its currency. Economists describe these gains as a money's 'network externalities'. Network externalities may be understood as a form of interdependence in which the behavior of one actor depends strategically on the practices adopted by others in the same network of interactions.

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Europe's new currency was set to begin life with many of the attributes necessary for competitive success. Together, prospective members would provide an economic base roughly comparable to that of the United States, enjoying extensive trade relations around the world. The potential for network externalities, therefore, was considerable. Likewise, EMU would start with both unquestioned political stability and an enviably low rate of inflation, backed by a joint monetary authority, the European Central Bank (ECB), that was fully committed to preserving confidence in the euro's future value. Much room existed for a successful challenge to the dollar, as frequently predicted. Typical was the view of Robert Mundell (2000: 57), a Nobel laureate in economics, who expressed no doubt that the euro 'will challenge the status of the dollar and alter the power configuration of the system'. The conventional wisdom was unambiguous. The markets would ultimately elevate the euro to a top rank alongside the greenback. In the oft-quoted words of Jacques Delors, when he was head of the European Commission, *'le petit euro deviendra grand'*.

In fact, the only question seemed to be: How soon? Most analysts understood that the process would take time, owing to the natural advantage of incumbency. It took the dollar, for example, more than a half century to surpass sterling as an international currency, long after America emerged as the world's richest economy. However long it might take, though, the

process was expected to start quickly. Not everyone agreed with the optimistic forecast of Fred Bergsten (1997), a former US Treasury official, who predicted that Europe's new currency would achieve 'full parity' with the dollar in as little as 5–10 years. But few doubted that within such a time frame, significant signs of a shift toward the euro would become evident. By now, nearly a decade after the euro's introduction, the displacement of the dollar should clearly have begun.

The story so far

So what is the story so far? Viewed purely in exchange-rate terms, the euro's record of performance has been mixed. From an opening value of $1.17 the currency initially drifted downward, sinking to a low near $0.83 by mid-2000 and subsequently languishing at well below par for upwards of 2 years. In mid-2002, however, the euro began an impressive recovery, climbing decisively to a high above $1.35 in 2004 before drifting down again in 2005, then up again in 2006. By mid-2007, the euro was once again above $1.35.

Exchange rates, however, are not the issue. A currency's price is at best an imperfect indicator of its international status. What really matters is not price but *use*: the extent to which a money is voluntarily chosen by market actors outside EMU for the standard functions of medium of exchange, unit of account, and store of value. Central banks, of course, may also adopt the euro, as an intervention medium, currency anchor, or as part of their foreign reserves. But currency use by state actors understandably tends, for efficiency reasons, to reflect prevailing market practice. In the absence of political pressures, central banks prefer to use a currency that will be most helpful to them in managing their exchange rates and monetary policy. The key issue, therefore, is what happens to the preferences of *private* actors. If the euro is ever truly to challenge the dollar, it will be by displacing the popular greenback for any or all of the traditional roles of money in the broad global marketplace.

Viewed in these terms, there is little evidence yet of any significant progress. The expected fast start has not occurred. As of January 2008 the euro zone, as it is commonly known, will comprise 15 EU members. A look at the available data suggests that in most categories of international use (adjusting for the elimination of intra-EMU transactions) the euro has managed to hold its own as compared with the past aggregate shares of EMU's 'legacy' currencies. Hence, Europe's new money has easily taken its place as successor to Germany's old Deutschmark (DM), which among international currencies had already attained a rank second only to the dollar. But that is about all. As economist Hèlène Rey (2005: 114) concludes, the euro 'has established itself immediately as the second most important currency in the world . . . It has not, however, displaced in any significant

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way the dollar as the currency of choice for most international transactions'. Indeed, after an initial spurt of enthusiasm, use in most market segments has actually leveled off or even declined in recent years (ECB, 2007). Worse, the only significant gains to date have been in the European Union's immediate neighborhood, including the EU's newest members before they joined, as well as other actual or potential candidate countries. In the words of the European Central Bank (2007: 7), a 'strong institutional and regional pattern continues to characterise the internationalisation of the euro'. Globally, Europe's new currency remains in the dollar's shadow.

The clearest indicator of a money's international status is the amplitude of its use as a medium of exchange in the foreign-exchange market, where average daily turnover now exceeds some $2 trillion worldwide. Top currencies are bought and sold not only for direct use in trade and investment but also as a low-cost intermediary – a 'vehicle' – for the trading of other currencies. A vehicle role is a direct consequence of high market turnover, which yields substantial economies of scale. Typically, it will be less expensive for a market agent to sell a local money for a vehicle currency and then use the vehicle currency to buy the needed foreign money than it would be to exchange one infrequently traded money directly for another.

No currency has more market turnover than the dollar, reflecting the large size of the US economy and its leading role in world trade. The low transactions costs that result from high market volume explain why the greenback has long been the most favored vehicle for global currency exchanges, appearing on one side or the other of some 93 percent of all transactions in 2005–2006 (ECB, 2007). The euro, by contrast, entered on one side of just 39 percent of all transactions. That was higher than the share of the Deutschmark, which had appeared in 30 percent of transactions in 1998 (its last year of existence) but lower than that of all euro's legacy currencies taken together (53 percent) and actually down from a high of 41 percent in 2004–2005 (ECB, 2007). Only in trading in the Nordic countries and East-Central Europe, where commercial ties are largely concentrated on the EU, is the euro clearly the favored vehicle.

The greenback also remains the most favored vehicle for the invoicing of global trade, which adds the role of unit of account (currency of denomination) to that of medium of exchange (currency of settlement) for international contracts. Overall, the dollar is estimated to account for nearly half of all world exports – more than double the US share of world exports. The DM's share of trade invoicing in its last years, prior to its replacement by the euro, was 15 percent, roughly equivalent to Germany's proportion of world exports. Evidence from the International Monetary Fund (Bertuch-Samuels and Ramlogan, 2007) suggests that this share was maintained by the euro after its introduction in 1999 but has not yet shown any sign of increase except in neighboring European countries.

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Likewise, the dollar remains the most favored store of value in global capital markets, where the euro has yet to catch on significantly as an investment medium for international portfolio managers. There has been some increased use of the euro as a financing currency (a vehicle for borrowing). Non-European borrowers have been attracted by the opportunity to tap into the much broader pool of savings created by the consolidation of EMU. Overall, the share of the euro in the stock of international debt securities rose strongly, from roughly a fifth in 1999 to nearly half by the end of 2005, before falling back by a few percentage points in 2006 (ECB, 2007). But again, most of the increase came from immediate neighbors (mainly recent or prospective EU members). Borrowers in Asia and Latin America continue primarily to use the dollar. Moreover, these developments represent growth only in the *supply* of euro-denominated assets. On the demand side, foreign investors so far have been slower than anticipated to add to their holdings of euro-denominated assets, despite the greater depth and liquidity on offer. Most issues have been taken up by European investors, making them in effect 'domestic'. Outside EMU, the euro's overall share of portfolios has changed little from the previous aggregate of legacy currencies. Similar patterns have also prevailed in international banking markets (ECB, 2007).

So far, therefore, the story is unencouraging – certainly not the happy outcome that so many had predicted. The old dream has been delayed. Other than within the European region itself, use of Europe's new currency has shown little sign of growth and may indeed have already begun to settle down. All this is a far cry from attaining full parity with the dollar in as little as 5–10 years.

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III. DREAM REVIVED?

Yet despite the euro's disappointing performance to date, hope lives on, now buoyed by the prospect of a significant increase of membership. Enlargement of the EU will mean, in time, an expanded EMU, too. Bigger, it is said, will also be better. Greater numbers will enhance the currency's power and prestige, increasing its attractiveness as a rival to the dollar. Europe's grand dream has been revived.

Enlargement

The European Union's enlargement in May 2004 added ten new 'accession countries', bringing total membership of the EU to 25. Two more neighbors, Bulgaria and Romania, joined in January 2007; and yet others, including more successor states of the former Yugoslavia and even Turkey, hope to follow in the more or less distant future. All are legally obligated, sooner or later, to adopt the euro. The only question is when.

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Upon entering the EU, each accession country is automatically enrolled in EMU with a 'derogation'. Simply put, derogation means that adoption of the euro is mandatory but only when the country is deemed ready. Several critical conditions must be satisfied first – the same so-called convergence criteria that were demanded of present participants before they could join EMU. The convergence criteria were first spelled out in the 1992 Maastricht Treaty (Article 109j), which brought the euro into existence. The four familiar conditions are:

1. Relative price stability – in practical terms, an average rate of consumer price inflation, observed over a 1-year period, that does not exceed by more than 1/2 percentage points the average rate of inflation in the 'three best performing Member States in terms of price stability';
2. interest-rate stability – in practical terms, a year-average nominal interest rate on a 10-year benchmark government bond no more than two percentage points above the average in the three best performing member states;
3. fiscal stability – specifically, a fiscal deficit below 3 percent of GDP and public debt totaling less than 60 percent of GDP; and
4. exchange-rate stability – specifically, participation in the pegging arrangement known as the Exchange Rate Mechanism (ERM) for at least 2 years while the country's currency trades against the euro without severe tensions, within 'normal fluctuation margins'. Because the present Exchange Rate Mechanism is a successor to an earlier arrangement that existed before 1999, it is usually referred to as ERM2 to distinguish it from its predecessor.

It is not expected that all accession countries will manage to satisfy the necessary conditions at the same pace. Key is the exchange-rate criterion. To date, only eight of the 12 new members admitted in 2004 and 2007 have even tried to commit formally to ERM2. These are Bulgaria, Estonia and Lithuania, which carried over their long-standing currency boards anchored on the euro; Cyprus, which already had a firm euro peg; Latvia and Malta, which converted basket pegs to the euro; and Slovakia and Slovenia, which moved from managed flexibility to stable euro pegs. The largest accession countries – the Czech Republic, Hungary, Poland, and Romania – so far have opted to preserve a higher degree of exchange-rate flexibility.

Accordingly, target dates for adoption of the euro vary considerably. The first to make the move were Slovenia, which joined the zone in January 2007, and Cyprus and Malta, which will enter in January 2008. Estonia, Latvia, and Lithuania had all hoped to join in 2007 or 2008 but have been forced to postpone because of excessively high inflation rates. Slovakia has tentatively penciled in January 2009 but may also postpone, while Bulgaria and the Czech Republic have in mind 2010 at the earliest. Hungary has

abandoned its target of 2010 without rescheduling. Poland and Romania have not even tried yet to set a timetable for joining.

Goals have slipped because disillusionment with the euro is on the rise, especially in the larger accession countries. Adoption of the euro was once viewed as a badge of honor. But policy makers have come to understand, as one recent study puts it, that while 'membership has its benefits . . . these benefits are not free. Being part of a currency union requires discipline, and the loss of the exchange rate as an instrument for coping with economic shocks can be costly' (Ahearne and Pisani-Ferry, 2006: 1). The convergence criteria are proving a very tough hurdle. Moreover, resistance is spurred by concerns over the prospective loss of monetary autonomy. In some instances, adoption could be delayed for years.

Much, obviously, remains uncertain. All we know for sure is that, sooner or later, the number of economies in the euro zone is supposed to be a lot bigger than it is now.

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Size matters, but . . .

But will bigger really be better? The case for such a presumption seems clear. Larger numbers will mean an even broader transactional network, increasing exponentially the potential for network externalities. Hence, conclude many, the euro is bound to grow even more attractive as a rival to America's greenback. That is the logic of Mundell (2000: 60), for example, who has argued that 'the outlook for the euro is very favorable [because] as the EU expands into the rest of Central Europe, the euro will have a substantially larger transactional domain than the dollar'. Likewise, it is the logic of Jacques de Larosière (2002: 15–6), former managing director of the International Monetary Fund (IMF). 'The euro's position as a reserve currency will progress in the future', de Larossière asserts, because 'with the monetary integration of candidate countries to the European Union, we see the geographic reach of the euro is likely to expand considerably'. Prospects for Europe's money as an international currency are assumed to depend directly on the absolute size of its economic base.

Nowhere is the logic clearer than in the writing of Fred Bergsten, long one of the euro's biggest boosters. What qualifies a currency for international status? 'There is good reason', Bergsten (1997: 25, 27) contends, 'to believe that the relative size of key currency countries' economies and trade flows is of central salience. . . . The sharp increase in the size of the economy and trading unit underlying the European key currency could produce a quantum leap in the international role of that asset'. The old DM had first gained widespread acceptance when Germany accounted for no more than 9 percent of world output and 12 percent of world trade. The 12 original members of EMU would more than double both ratios; enlargement is adding even more. A dramatic rise in euro use, therefore, should

be expected as well. In Bergsten's (1997: 27) words: 'In the eventual steady state, a rise of 65–250 percent in the size of the relevant economic base could be expected, which would expand the potential size of the currency's role by 30–335 percent'.

Arguments like these, however, are far too simplistic to be taken seriously. As economist Barry Eichengreen (1997: 50, 52) has noted in a comment on Bergsten: 'This argument allows no role for other determinants. ... One cannot forecast the international role of the euro simply by replacing a Germany that accounts for 9 percent of world output with an EU that accounts for 31 percent'. Size no doubt matters. Economies as small as, say, Norway or Sweden could never realistically hope to see their currency compete for global status. Patently, the network externalities would be too limited. But while a large economic base may be necessary, it is hardly sufficient. For a period in the 1980s, Italy's GDP surpassed that of Britain. No one, however, rushed to substitute lire for sterling as a vehicle for trade or investment. Clearly other factors matter, too.

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IV. TRANSACTIONS COSTS

What are these factors? As indicated, my previous work suggests that three factors, in particular, have played a crucial role in the euro's story so far – transactions costs, an anti-growth bias, and issues of governance. The question is: How will enlargement affect each of the three? In each instance, my answer is unequivocal: Larger numbers will simply make matters worse. Enlargement will delay even more Europe's grand dream for the euro.

Market segmentation ...

Begin first with transactions costs – the cost of doing business in euros. Transactions costs directly affect a currency's attractiveness as a vehicle for exchange transactions or international trade. At its birth, Europe's new money obviously offered a large and expanding transactional network, thus promising substantial network externalities. But even so, it was clear that the dollar would be favored by the natural advantage of incumbency unless euro transactions costs, which began high relative to the widely traded greenback, could be lowered to a more competitive level. The same scale economies that encourage use of a currency in the first place are also responsible for what specialists call 'hysteresis' or 'ratchet effects'. Adoption of a new currency tends to be resisted unless the money can be expected to be truly cost-effective.

From the start it was understood that the cost of doing business in euros would depend directly on what could be done to improve the structural efficiency of Europe's financial markets. The point was put most cogently

by economists Richard Portes and Hélène Rey (1998: 308): 'The key determinant of the extent and speed of internationalization of the euro will be transactions costs in foreign exchange and securities markets'.

On the face of it, prospects for euro transactions costs looked good. In purely quantitative terms, introduction of the new currency promised to create the largest single-currency capital market in the world. That expansion, in turn, was expected to trigger major qualitative improvements in depth and liquidity, knitting previously segmented national markets together into an integrated whole. As matters have turned out, however, Europe's reach has fallen considerably short of its grasp.

In practical terms, admittedly, much has been accomplished despite some foot-dragging by member governments. Integration at the retail level – the realm of bank accounts, mortgages, insurance policies, and the like – continues to be impeded by a plethora of interconnected barriers, including a diversity of settlement systems that fragment liquidity and reduce transactional convenience (Berglöf *et al.*, 2005). But change clearly has been significant at the wholesale level where, in the words of *The Economist* 'financial markets in Europe became much more integrated and more interesting' (*The Economist*, 2005: 10). The elimination of exchange risk inside the euro zone has intensified competition among financial institutions, encouraging cost-cutting, innovation, and consolidation. Progress has been particularly impressive in short-term money markets, syndicated bank lending, credit derivatives, and the corporate bond sector.

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Nonetheless, it is evident that the dollar's cost advantage will persist so long as the EU is unable to offer a universal financial instrument that can match the US Treasury bill for international investor liquidity and convenience. This is a deficiency that will be difficult, if not impossible, to rectify so long as Europe, with its separate national governments, lacks a counterpart to the Federal government in Washington. Under the circumstances, the best the Europeans could do was to encourage establishment of selected benchmark securities for the public debt market. Gradually three euro benchmarks have emerged: the German Bund at 10 years, the French bond at 5 years, and the Italian bond at 2 years (Rey, 2005: 112). But such a piecemeal approach falls far short of creating a single market as large and liquid as that for US government securities. Full consolidation of the public debt market remains stymied by variations in legal traditions, procedures, issuance calendars, and primary dealer systems.

Notably, yield differentials in the public debt market have shrunk significantly since the euro was born, suggesting that interchangeability among national issues has increased somewhat. But the convergence of yields is far from complete. Investors continue to treat the debts of EMU governments as imperfect substitutes, mostly owing to differences in perceived default risk (Codogno *et al.*, 2003). And these differences of perception could eventually be compounded as a result of a decision by the ECB in

November 2005 to limit the collateral it will accept in refinancing ('repo') operations with European commercial banks. Previously, the ECB had accepted all euro-zone government bonds indiscriminately, as if the debts of EMU member states were all equally creditworthy. Now, however, the Bank intends to be more selective. Bonds must have a single A-rating or better from at least one of the three main rating agencies (Moody's, Standard and Poor's, and Fitch). Observers expect that this decision will lead commercial banks, over time, to be much more selective in their choice of issues, accentuating yield spreads (*Financial Times,* 9 November 2005).

On balance, therefore, segmentation of the public debt market has proved difficult to overcome; and that, in turn, means that the cost of doing business in euros remains a drag on the currency's attractiveness. Though efficiency gains in financial markets have been substantial, they clearly are insufficient on their own to significantly improve the euro's cost-effectiveness relative to the dollar. Owing to the greater liquidity and convenience of the US Treasury bill, America's greenback continues to benefit from the advantages of incumbency.

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... Prolonged

None of this will be improved by enlargement. Indeed, the reverse is more likely to be true. Larger numbers, obviously, will make it even more difficult to overcome the segmentation of Europe's public debt market. The variety of securities, procedures, and dealer systems will become even more pronounced. Likewise, spreads are likely to diverge even more as compared with yields on the issues of present EMU members. The euro zone will be even further from creation of a universal instrument comparable to the US Treasury bill.

Indeed, larger numbers could even slow the pace of financial-market integration generally. The main reason is the more primitive level of development of institutions and regulatory arrangements in accession countries, as compared with EMU's original members. Banking systems, exceptionally, are relatively advanced due to widespread foreign ownership. In the 1990s, banks in the Baltic states and East Central Europe were largely privatized. Most ended up in foreign hands, bringing immediate benefits in terms of fresh capital and innovation. Other sectors, however, have lagged behind, especially markets for equities and derivatives. Regulatory and supervisory systems, despite efforts at modernization, are still largely deficient in such key areas as the assessment of credit risk (Schadler *et al.*, 2005: 41–2). Weaknesses like these are likely to encourage foot dragging by new members even more pronounced than that of existing EMU members, for two reasons.

First is the sheer cost of the adjustments that will be required to knit new entrants into the euro zone's nascent capital market. Since they start from

a lower level of development, they will need even more extensive reforms at both the retail and wholesale levels in order to get up to speed. But since these are by no means rich economies, governments could prove to be even more stubborn in their resistance to further market-opening measures.

Second is the higher risk of financial crisis in accession countries as they move into the euro zone. Most of these economies offer relatively high rates of return on capital, making them attractive targets for investment. Analysts generally expect that with the elimination of exchange risk, there will be even greater incentives for capital inflows, which eventually could generate overheating, asset price bubbles, and unsustainable increases of indebtedness. The risk is concisely summarized by a recent IMF study (Schadler *et al.*, 2005: 56, 65–6): 'Rapid credit growth looms on the horizon for each [accession country] . . . A critical concern with rapid credit expansion is the risk of banking distress or even a banking crisis . . . Adjustment in the aftermath of overheating or asset price bubbles may well be difficult without an exchange-rate instrument to effect needed changes of relative prices'. Worries about such vulnerabilities could make governments even less willing to rush into the process of financial integration.

For both reasons, the path to efficiency gains in financial markets could be even more obstructed than in the present EMU. If anything, enlargement will prolong the segmentation of most financial markets in the euro zone, not just the public debt market. Significant reductions in the cost of doing business in euros, therefore, will long remain beyond Europe's grasp.

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V. ANTI-GROWTH BIAS

A second critical factor inhibiting the internationalization of the euro is a serious anti-growth bias that appears to be built into the institutional structure of EMU. By impacting negatively on yields on euro-denominated assets, this bias directly affects the currency's attractiveness as a long-term investment medium.

When EMU first came into existence, eliminating exchange risk within the European region, a massive shift was predicted in the allocation of global savings as compared with holdings of European assets in the past. Yet as the ECB (2007) has ruefully noted, international portfolio managers have been slow to move into the euro. Liquid funds have been attracted when there was prospect of short-term appreciation. But underlying investor preferences have barely budged, in good part because of doubts about prospects for longer-term economic growth in the euro zone. In turn, one of the main causes for such doubts seems to lie in the core institutional provisions of EMU governing monetary and fiscal policy, the key determinants of macroeconomic performance. In neither policy domain is priority attached to promoting real output. Rather, in each, the main emphasis is on other considerations that tend to tilt policy toward restraint, imparting

a distinct anti-growth bias to the euro zone as a whole. As *The Economist* (29 April 2006: 38) laments, the euro 'has provided currency stability but has done little to promote growth'. Opportunities for future investment returns are therefore more limited than they might be otherwise.

Here too there is reason to believe that enlargement will simply make matters worse. Overall, the economies of accession countries may be small as compared with older members. Together, the EU's newest members have added no more than 10 percent to the GDP of the economic union as a whole. Nonetheless, the entrance of new members into the euro zone can be expected to tilt monetary and fiscal policy even more toward restraint, further dampening investment returns.

Monetary policy

On the monetary policy side, the European Central Bank, unlike many other monetary authorities, was created with just one policy mandate – to maintain price stability. Moreover, the ECB is formally endowed with absolute independence, largely insulating it from political influence. Legally, the ECB is free to focus exclusively on fighting inflation, even if over time this might be at the cost of stunting real growth. In practice, naturally, the ECB is not wholly insensitive to growth concerns. Nonetheless, the overall orientation of ECB priorities is clear. Summarizes Hannes Androsch (2007: 48), formerly finance minister of Austria: 'The ECB is obliged to focus on fighting inflation, not promoting general economic development, and they are overdoing it. . . . We are not fully using the growth potential I think Europe has'.

With enlargement, the ECB's restrictive bias may be expected to become even more pronounced owing to an inherent tendency toward higher inflation in the EU's new member economies. All of the accession countries are relatively poor as compared with the older partners. All will be seeking to catch up to the income levels of the more advanced economies by promoting productivity gains in key sectors. Generally, in such situations, productivity gains tend to be more rapid for tradable goods (exports and import-competing production) than for nontradables, since tradables face the most competition and tend to attract the largest share of technology-intensive foreign direct investment. However, as wages in the tradables sectors rise with productivity, they also bid up wages in nontradables production, which in turn forces up the prices of nontradables relative to those of tradables. The result is an increase of aggregate inflation even though tradables prices are held down by competition from abroad – a process known as the Balassa–Samuelson effect.

The pressures of the Balassa–Samuelson effect are already evident in many of the accession countries, including most notably the three Baltic states, all of which have been forced to postpone entry into the euro zone

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because of high inflation. Only a few, such as the Czech Republic and Slovenia, have come even close to matching the low inflation experience of the EU's best performing economies. True, all the new members are making a determined effort to keep prices under control. With luck, most eventually may even be able to compress their inflation rates long enough to meet the first of the Maastricht Treaty's four convergence criteria (relative price stability). Once inside EMU, however, they almost certainly will find it difficult to suppress sustained price increases for long.

Over time, higher inflation in the accession countries could be avoided only by allowing an appreciation of their nominal exchange rate. But once they become part of the euro zone, that option is ruled out *ex hypothesi*. Hence, the average inflation rate for the EMU as a whole will be subject to systematic upward pressure, inducing an even more restrictive monetary policy than has prevailed until now. The ECB can be expected to get even tougher in fighting inflation. That in turn will lower even more prospects for growth of returns on euro-denominated assets.

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Fiscal policy

The story is much the same on the fiscal policy side, where euro-zone governments have formally tied their hands with their controversial Stability and Growth Pact (SGP). The SGP, first set up in 1997, was intended to implement the 'excessive deficit procedure' called for by the Maastricht Treaty (Article 104c). In effect, it extrapolates from the third of the Treaty's four convergence criteria (fiscal stability) to the period after countries join the euro zone. The key provision is a strict cap on national budget deficits at 3 percent of GDP. The tight restraint makes it difficult for elected officials to use budgetary policy for contracyclical purposes, to offset the anti-growth bias of monetary policy.

Here also, we know, practice has increasingly diverged from principle, with a number of EMU's original members – including, most notably, France and Germany – repeatedly missing the SGP's 3 percent target. We also know that little has been accomplished to make the Pact more effective, apart from some limited reforms in 2005. To some, these facts mean that the SGP has no 'bite'. Empirical evidence, however, suggests that for most of EMU's smaller members the Pact has in fact exercised a significant discipline (Annett, 2006). Moreover, can anyone doubt that deficits might be even larger yet in the absence of the SGP? Historically, many EMU governments routinely ran deficits in excess of 3 percent; most had to struggle to qualify for membership in the first place. De facto, therefore, if not de jure, the SGP straitjacket remains a constraint on euro-zone countries, perpetuating an anti-growth bias in fiscal policy, too. And here also the restrictive impact is likely to become even more pronounced as EMU grows in size.

The reason is simple. EU membership imposes a heavy burden on government budgets. Once they join the club, new members must begin contributing to the central EU budget. They must also conform to all of the requirements of EU legislation, the *acquis communautaire*, which will compel them to increase spending on such vital needs as infrastructure, social services, and environmental quality. Though most will find some of the pressure alleviated by financial assistance from EU institutions, net benefits will be limited by cofinancing requirements. Overall, therefore, there is no doubt that fiscal policy in accession countries will be severely tested. Membership could raise budget deficits by amounts as large as 3 or 4 percent of GDP unless offset by higher taxes or parallel expenditure cuts (Kenen and Meade, 2003: 5–7).

Accordingly, most new members can be expected to be persistently preoccupied with deficit reduction, leaving little leeway for the use of budgetary policy to counterbalance a restrictive monetary policy. Apart from the three countries that have already been admitted to the euro zone (Cyprus, Malta, and Slovenia), only the Baltic states today seem able to live comfortably under the SGP's 3 percent cap. Elsewhere, substantial deficit problems are the rule, particularly in the largest accession countries. Almost certainly, austerity measures will be called for that could have the effect of retarding real growth.

The net impact will be considerable. It may be an exaggeration to claim, as has the president of the Czech Republic, that the rigidities of the SGP will create weak and dependent 'transfer economies' like East Germany after reunification (Klaus, 2004: 176). The outlook need not be that dismal. But for many of the accession countries, budget constraints clearly will be tight. It does not seem unreasonable, therefore, to expect that for entering countries budgetary policy will on balance be tilted even more toward restraint. Overall, the extra fiscal pressures will add substantially to EMU's anti-growth bias, again lowering prospects for improvement of returns on euro-denominated assets.

VI. GOVERNANCE

Finally, there is the governance structure of EMU, which for the euro's prospects as an international currency may be the biggest obstacle of all. The basic question is: Who is in charge? The answer, regrettably, has never been easy. From the start, uncertainty has reigned concerning the delegation of monetary authority among governments and EU institutions. In principle, the distribution of responsibilities is clear. In practice, however, the Maastricht Treaty – being the product of a complex political negotiation – naturally embodies a variety of artful compromises and deliberate obfuscations, resulting in a strikingly high degree of ambiguity about just how the euro zone is actually to be managed. Jurisdictional lines are anything

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but transparent; the details of accountability are equivocal and obscure. None of this is apt to cultivate a comfortable trust in the euro. Indeed, market actors outside EMU may be excused for hesitating to commit themselves to what looks rather like a pig in a poke – even if transactions costs could be lowered to competitive levels and even if returns on European assets could be significantly improved.

Three key provisions may be cited. First is the governance of EMU's core institution, the European Central Bank. Second is the delegation of responsibility for ensuring financial stability across the euro zone as a whole. And third is the issue of external representation: Who speaks for the euro on the broader world stage?

The European Central Bank

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Practical operational control of monetary policy lies in the hands of the ECB's Executive Board, made up of the President, Vice-President, and four other members. Overall managerial authority, however, is formally lodged in the Governing Council, which in addition to the six-member Executive Board include the heads of the central banks of all participating states, each with the same voting rights. From the start, it was understood that the large size and mixed representation of the Governing Council might be inconsistent with efficient or transparent governance.

The issue was obvious. Even before enlargement, the Governing Council – with the six Executive Board members and 12 national governors – was already bigger than the top managerial unit of any other central bank in the world. Observers were quick to question how decisions would be made with so many bodies around the table. Discussions would undoubtedly be time consuming and complicated. In the words of one informed observer (Meade, 2003: 129): 'The mere thought of a *tour-de-table* is exhausting'. Organization theory teaches that the costs of preparing and making policy rises not just in proportion but exponentially with the number of people involved. Hence, the conventional advice is to keep executive units small in order to maximize decision making efficiency. The prescribed size of the Governing Council was almost certainly too great for serious and productive dialogue. The ECB had a 'numbers problem'.

Sooner or later, it seemed, real power would have to devolve to a smaller 'inner' group formally or informally charged with resolving differences on critical issues, as so often happens in large organizations. But who would be included in this exclusive club? Would it be the Executive Board, which might be expected to take a broad approach to the euro zone's needs and interests? Or would it be a select coterie of central-bank governors, whose views could turn out to be more parochial? No one could be sure.

Enlargement simply makes the numbers problem worse. Upon joining the EU, all accession countries immediately gain observer status on the

Governing Council, with voting rights to follow once they adopt the euro. Now that Bulgaria and Romania have become EU members, that puts the number at 30, with even more governors to be added down the road as other candidate governments successfully negotiate their way into the club (or if Britain, Denmark, or Sweden ever decide to join). A gaggle of three dozen or more strong willed individuals could hardly be considered conducive to efficient decision making. As one source (Baldwin, 2001) commented sarcastically, enlargement would leave the Governing Council with 'too many to decide on where to go to dinner, let alone agree on how to run monetary policy for more than 400 million people'. Of particular concern, once EMU was up and running, was the risk that equal voting rights for all Council members would give excessive weight to smaller countries in setting policy parameters (Berger *et al*., 2004; De Grauwe, 2004; De Haan *et al*., 2004).

To their credit, Europe's leaders recognized the problem early on and sought to provide a remedy. In March 2003, following a proposal from the ECB, the European Council (comprising the heads of state or government of all EU members) approved a reform of the Governing Council restricting votes to a smaller total on a rotating basis (ECB, 2003). Membership of the Governing Council will continue to include the Executive Board and all national central-bank governors; moreover, all six members of the Executive Board will retain their individual votes. But voting rights of national governors are now to be limited to no more than 15 and will rotate among governors according to a specified formula, taking explicit account of the diversity among member states. The rotation will start in 2008, once total membership of the zone is brought up to 15 with the addition of Cyprus and Malta, and will be implemented in two stages, as follows:

1. With participation of between 15 and 22 member states, euro-zone countries will be divided into two groups, using size as a criterion. Size will be measured by a weighted average of an economy's share in total EU GDP and total assets of monetary financial institutions. A first group of governors originating from the five largest states will receive four votes. The second group of up to 17 governors will receive up to 11 votes.
2. Once participation on the Governing Council moves beyond 22 member states, a third group of up to five governors from the smallest countries will be formed with up to three votes. Correspondingly, the number of voting rights of the middle group will be reduced from 11 to eight. The four votes of the five biggest countries will remain unchanged.

The remedy, however, may be worse than the disease, creating more problems than it solves. On the one hand, the reform leaves intact the large number of bodies at the table. Every national governor, as well as the six Executive Board members, will continue to participate in all policy discussions, with full speaking rights. The approach has been defended on

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the grounds that it is vital to promoting the legitimacy of the euro enterprise. No other EU institution denies representation to any member state. In addition, it is argued, full participation may be expected to facilitate consensus building and contribute to a better flow of information (Cukierman, 2004: 70). But the approach may also be criticized for perpetuating all the gross inefficiencies of the ECB's numbers problem. As one astute observer (Gros, 2003: 124) puts it, the Governing Council will remain 'more like a mini-parliament than a decision-making body'.

On the other hand, the reform introduces several new ambiguities that add even more uncertainty to decision making at the ECB. How, for instance, will votes rotate within each of the two (eventually three) groups? Will the rules for rotation be the same in all groups? How often will the membership of groups be adjusted as economies change in size? And could the formula for measuring size itself be changed at any time? Transparency is hardly served by such a complex arrangement.

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Worse, the reform may well deepen rifts within the Governing Council, since the rotation model is so unabashedly state-based. Votes are allocated strictly along lines of national identity. In principle, governors are supposed to be fully independent professionals operating in a personal capacity, making monetary policy objectively for the euro zone as a whole. In practice, they may now be forgiven for thinking first of their own countries rather than in terms of collective interests. In the words of a prominent German economist (Belke, 2003: 122): 'The reform proposal does not meet the rationale of an integrative monetary policy ... It re-nationalises European monetary policy'. The current president of the ECB, Jean-Claude Trichet, has already more than once been forced to reprimand individual governors for publicly opposing established policies that seemed inconsistent with the needs of their home economies (*New York Times*, 3 February 2006: C6).

Of course, the danger can be exaggerated. In the Federal Reserve's key decision making body, the Federal Open Market Committee (FOMC), participation of district bank presidents is also based on as rotation model that allocates voting rights along geographic lines. Yet few observers worry that individual FOMC members will promote the interests of their regions at the expense of national objectives. The difference, however, is that Federal Reserve districts have nothing like the same sense of identity as do the sovereign states that comprise EMU. National allegiance remains a potent force in Europe that could, consciously or unconsciously, have a major influence on the deliberations of the Governing Council.

The danger would not be so serious if all EMU economies were largely convergent in real terms. The reality, however, is just the reverse. Econometric analysis shows little correlation of output shocks between accession countries, on the one hand, and the older members of the euro zone, on the other (Berger *et al.*, 2004; Hall and Hondroyiannis, 2006; Pramor and Tamirisa, 2006). Except for Slovenia and, to a lesser extent, Cyprus,

synchronization of business-cycle activity between the two groups appears actually to have weakened since the euro was born (Sadeh, 2006). National policy preferences, therefore, appear likely to diverge sharply as well.

The shame is that an alternative model was at hand that might have avoided many of these problems. Reacting to the ECB's initial proposal, the European Parliament recommended a radically different approach based on a redistribution of authority between the Executive Board and Governing Council. A broader range of practical powers over interest rates and intermediate policy objectives would be delegated to the Executive Board, converting it into a full-fledged monetary committee. Responsibilities of the Governing Council, by contrast, would be limited to questions of general strategy and guidelines for the monetary regime. The Governing Council, which presently meets twice a month, would instead convene no more than once or twice a year.

With this alternative, no changes would have been required in either the size or the voting rules of the Governing Council. Lines of accountability, however, would have been far clearer. In its operations, the Executive Board would have been directly answerable to the Governing Council; the Governing Council, in turn, would have stood as the institutional embodiment of European monetary sovereignty. But member states, clearly, were reluctant to give up direct representation in the decision making process. Hence, the European Council never even seriously considered the Parliament's alternative model. Instead, the unwieldy proposal of the ECB was swiftly approved and ratified, storing up the risk of serious problems in the future.

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Financial stability

Serious problems could also arise from EMU's provisions for maintenance of financial stability. No monetary regime is invulnerable to the risk of occasional crisis. At any time, asset prices could become excessively volatile, adversely affecting real economic conditions; or there might be a spreading contagion of illiquidity or insolvency among monetary institutions. Financial systems are inherently fragile. Unfortunately, the prevailing rules of the euro zone are not at all clear about who, ultimately, is responsible either for crisis prevention or for the management of crises should they occur. Transparency is not served in these circumstances, either.

According to the Maastricht Treaty, the European Central Bank is expected to 'contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system' (Article 105.5). But no specific tasks are assigned to the ECB to help forestall crisis, and none may be assumed by the ECB unless expressly delegated by the Council of Ministers (Article 105.6). Though linkages among national financial markets

have grown since the euro's birth, the ruling principle remains decentralization, otherwise known as subsidiarity – the notion that the lowest level of government that can efficiently carry out a function should do so. Formal authority for prudential supervision and regulation continues to reside at the national level, as it did before EMU. Each central bank is charged with responsibility for the financial institutions based within its own national borders.

Nor does the ECB have specific powers to deal with any crises that might occur. General language in the Maastricht Treaty does appear to empower the Bank to backstop TARGET, the large intra-European clearing system, in the event of a payments gridlock or other difficulties. One of the basic tasks of the ECB, declares the Treaty, shall be 'to promote the smooth operation of payment systems' (Article 105.2). But for any other contingency, such as a sudden wave of illiquidity in the banking sector, the Treaty is as uncommunicative as the Oracle of Delphi. Nothing is said about any authority for the ECB to act as a lender of last resort. Economist Garry Schinasi (2003: 3) says that this silence makes the ECB the 'ultimate "narrow" central bank'. The ECB has a mandate for price stability but not for financial stability.

The Treaty's silence has been a source of much debate. Some specialists interpret it as a form of 'constructive ambiguity' – an indication that, in practice, the ECB's crisis-management powers could be enhanced if and when needed. As one legal commentator (Lastra, 2003: 57) puts it: 'The wording of the subsidiarity principle leaves the door open for a possible Community competence'. But others disagree, arguing that because the responsibility has not been specifically transferred, it must remain at the national level. The Treaty's language is seen as restrictive rather than permissive.

In practice decentralization rules here, too. As in pre-EMU Europe, the lender-of-last-resort function is left to the individual central banks. And again, each central bank remains responsible only for financial institutions within its own national borders. Beyond that, all is opaque. No one, it appears, is directly accountable for the stability of the euro zone as a whole.

Can such a decentralized arrangement be counted on to assure smooth operation of the overall system? There is certainly room for doubt. What would happen, for instance, if in a given country a large financial institution with extensive cross-border business were to find itself in trouble? Would the national authorities be evenhanded in their response, fully recognizing the interests of claimants elsewhere in the euro zone? Or would they act protectively, even at the risk of conflict with the regulatory authorities of partner countries? We have no way of knowing. The scheme 'may work well', observes Schinasi (2005: 119–20), 'but this still remains to be seen . . . It is [not] obvious that national supervision in Europe would tend, as a first priority, to focus on European priorities . . . It is difficult to imagine

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the national supervisor pursuing European interests first and national interests second'. Echoes the IMF (2007: para. 12) in a recent review of euro zone policies: 'Progress on the ground is being held back by the governance framework. The core problem is the tension between the impulse toward integration, on the one hand, and the preference for a decentralized approach, on the other . . . This setting rules out efficient and effective crisis management and resolution'.

In short, the possibility that central banks might work at cross-purposes, provoking or aggravating a crisis, is certainly not outside the realm of possibility. There is no Invisible Hand for public agencies. Decentralized decision-making among governments without some form of coordination is potentially a recipe for disaster.

Here too, enlargement just makes the situation worse, for two reasons. First, once again, is the numbers problem. If uncoordinated decision-making is risky with 15 central banks in the game, how much more vulnerable would be an EMU of double that number? Recall organization theory's suggestion that with expansion, decision-making problems increase not just proportionally but exponentially. This does not mean that as the euro zone grows, financial instability becomes unavoidable. There is no certainty about such matters. But it does mean that with each new member, the probability of some kind of crisis keeps rising.

Second, compounding the numbers problem is the relative poverty of accession countries as compared with the present membership of EMU. On the one hand, this means that their supervisory institutions, on average, are apt to be more rudimentary – less practiced at the essential tasks of monitoring markets and assessing risk. On the other hand, it means that in their eagerness to catch up with the EU's more advanced economies, they are apt to do all they can to promote lending for productive investment. The combination is deadly. The result, as previously noted, could be an excessively rapid expansion of credit, testing the limits of financial prudence and risking overheating and asset price bubbles. The ice under the feet of the euro zone will grow increasingly thin.

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External representation

Finally, there is the issue of external representation. Who is to speak for the euro zone on broader macroeconomic issues such as policy coordination, crisis management, or reform of the international financial architecture? Here there is no answer at all, leaving a vacuum at the heart of EMU.

No single body is designated to represent EMU at the IMF or in other global forums. Instead, the Maastricht Treaty simply lays down a procedure for resolving the issue at a later date, presumably on a case-by-case basis (Article 109). Some sources excuse this on the grounds that it achieves a balance between the need to convey a common position and the prerogatives

of member states. But that seems far too kind. In fact, it was a cop-out, a diplomatic formula to mask failure to reach agreement.

At a minimum, the text compounds confusion about who is in charge. At worst, it condemns the euro zone to lasting second-class status, since it limits the group's ability to project power on monetary matters. As booster Fred Bergsten (2005: 33) laments: 'Europe still speaks with a multiplicity, even a cacophony, of voices . . . Organizational reforms that enable the countries making up Euroland to act together and speak with a single voice will probably be an essential prerequisite of full European equivalence with the United States'. The point has been best put by political scientists Kathleen McNamara and Sophie Meunier (2002: 850): 'As long as no 'single voice' has the political authority to speak on behalf of the euro area, as the US Secretary of the Treasury does for the American currency, the pre-eminence of the US in international monetary matters, as in other realms, is likely to remain unchallenged'. Washington has no single phone number to call when negotiations are required.

Clearly, the phone number cannot be in Frankfurt, where the European Central Bank is headquartered. In international monetary forums, countries are normally represented not by central banks but by finance ministers or equivalent – officials with the political clout to speak for their respective governments. The ECB obviously cannot claim that kind of authority. Indeed, it is difficult to imagine the elected governments of Europe ever delegating such a fundamental power to an institution that has been deliberately designed to be as free from political influence as possible.

Alternatively, some have suggested the appointment of a single individual with sufficient credentials and legitimacy to act as interlocutor for the euro zone (Henning, 1997; McNamara and Meunier, 2002; Zimmerman, 2004) – a Mr (or Ms) Euro, as it were. Precedent exists in the realm of foreign and security affairs, where EU members already agreed a decade ago to name a single High Representative to stand for them all – a Mr Europe (presently Javier Solana of Spain). But experience has shown that Mr. Europe's ability to speak authoritatively for the entire EU is persistently hamstrung by policy differences among individual governments. A single appointed official cannot ignore or overrule the preferences of diverse sovereign states.

The most practical solution would be a collective one, centered on the informal committee of EMU finance ministers that has emerged since the birth of the euro – what has come to be known as the Eurogroup. Like comparable EU institutions, such as the Council of Ministers or European Council, the Eurogroup could be represented at any given time by its chair; the chairmanship itself, as with those other institutions, rotates periodically among members. In 2005 the Eurogroup chair began attending meetings of the Group of Seven, but with no specified responsibilities. A more effective

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approach might be to explicitly delegate authority to the chair to speak on behalf of the euro zone.

Some criticize the idea, fearing that it could lead to a politicization of monetary policy in the euro zone and might even compromise the independence of the ECB. But such apprehensions seem overblown. Participation in international forums by America's Treasury secretary, for instance, has by no means compromised the independence of the Federal Reserve. In fact, this kind of division of labor between central bank and finance ministries is the rule around the world, not the exception. For EMU, the advantage of the Eurogroup is that it does embody the necessary degree of political authority. At last, there would be not only a single number to call but also someone empowered to pick up the phone.

So what is stopping EMU? Romano Prodi (2004: 14), a former Commission president (and more recently Prime Minister of Italy) says that it is 'a lack of will'. But that is surely an oversimplification. The question is: Why is there a lack of will? The answer, plainly, has to do with the lingering influence of national allegiance. Though EMU members may share a joint money, their interests are hardly identical. Divergent circumstances and preferences make them reluctant to give up the right to speak for themselves. Even after more than half a decade of living with the euro, national identity trumps collective interest.

Once again, enlargement just makes the situation worse. Adding accession countries will not only amplify the numbers problem, complicating decision making. Entrance of such a diverse group of relatively poor economies will also multiply and deepen internal cleavages, making it increasingly difficult to hammer out common positions on external issues. The fundamental rationale for developing a single voice for EMU, McNamara and Meunier (2002: 851) remind us, 'lies in the potential . . . to project the image of a unified, strong Europe to key international political and financial actors'. Enlargement will leave the Europeans further from that goal than ever.

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VII. CONCLUSION

The bottom line, therefore, seems clear. Bigger will not be better, despite the broader economic base and the increased potential for network externalities that comes with enlargement. On the contrary, bringing accession countries into EMU will only exacerbate the impact of factors impeding the euro's emergence as an international currency. By prolonging the segmentation of Europe's financial markets, larger numbers will delay any significant reduction of the cost of doing business in euros. By adding to inflationary and budgetary pressures, enlargement will reinforce the anti-growth bias built into the institutional structure of EMU. And by further complicating an already complex governance structure, new entrants will

cloud even more the fundamental question of who is in charge. None of this is calculated to make the euro more attractive to outside users.

Could the risks be even worse? Could EMU founder under the weight of enlargement? Though unlikely, the possibility cannot be lightly dismissed. The euro zone's problems, writes the respected economist Anna Schwartz (2004: 25), 'will only worsen with the inclusion of new members. Is this a recipe for political disintegration? Would the euro survive political disintegration?' Others warn of 'EMU's coming stress test' (Gros *et al.*, 2005), which could lead to unilateral secessions. Italy is considered a prime candidate, owing to its deteriorating public finances, sluggish growth, and eroding competitiveness. In 2005 several prominent Italian legislators publicly called for reintroduction of the lira; one, a government minister, even tried to collect enough signatures for a referendum on the matter. They are unlikely to be the last European politicians to use the euro as a scapegoat for disappointing economic performance.

Given Europe's historical commitment to the integration process, however, breakdown seems improbable. EMU will not be allowed to fail. As *The Economist* (11 June 2005: 69) writes: 'A break-up of the euro area is still in the realm of small probability rather than likelihood'. The real question is whether EMU can succeed. Can the euro ever rise above its defects to become a genuine rival to the dollar? Will the 'old dream of enthusiasts', at long last, be realized?

The answer, regrettably, is also in the realm of small probability rather than likelihood. Nothing is impossible, of course – particularly if the United States continues to mismanage its own currency as badly as it has in recent years. America's payments deficit widened to over $800 billion in 2006 (more than 7 percent of GDP) and could soon top a trillion dollars. The more the US deficit grows, threatening a crisis for the greenback, the more attractive the euro could begin to appear, whatever its defects. But that is hardly a case of leading from strength. The analysis offered here focuses on the case for the euro on its own merits, independent of what might happen to the dollar. That case, I conclude, is weak at best and likely to be made weaker by enlargement.

The fundamental problem for EMU is the mismatch between the domain of its currency and the jurisdictions of its member governments. The euro is a currency without a country – the product of an international agreement, not the expression of a single sovereign power. Its success, therefore, is critically dependent on the continued cooperation of EMU's member states, which can hardly be guaranteed for all time. Should it be any wonder, then, that outsiders might hesitate to commit themselves to the currency's future?

Monetary unions among sovereign states have existed before, of course, without major disruption. In the contemporary era one thinks of the CFA Franc Zone in Africa or the East Caribbean Currency Area. But these have

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all involved relatively small developing countries with no aspiration to major currency status. EMU, by contrast, encompasses some of the largest economies on the face of the earth and has never hidden its grand global ambitions. Unfortunately, Europe's divisions have never been hidden, either. For that reason, prospects for the euro's international role were poor even before enlargement. Enlargement of the euro zone's membership will simply make them even poorer.

NOTE

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Democratic accountability and the exchange-rate policy of the euro area

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Democratic accountability and the exchange-rate policy of the euro area[1]

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ABSTRACT

This article examines the consequences of the political 'incompleteness' of the monetary union for the democratic accountability of its external monetary policy, comparing the euro area to the United States. In most countries, exchange-rate policymaking is substantially delegated to the finance ministry and central bank; oversight by other domestic actors is relatively weak. While this is true of the United States, the role of the Congress provides the possibility for 'democratic override' when policy diverges substantially from the preferences of a broad set of private sector interests. Europe's monetary union, by contrast, lacks such a mechanism; no institution can provide an effective check on the policies pursued by the core actors, the ECB and Eurogroup. A comparison of the postures of the United States and euro area toward Chinese exchange rate policy suggests that these institutional differences affect policy outcomes.

KEYWORDS

The euro; exchange-rate policy; accountability; interest groups; China; euro governance.

INTRODUCTION

Several authors have examined the political 'incompleteness' of the monetary union. Operating a monetary union within a political structure that falls well short of a political union or cohesive state has consequences for a number of issue areas, including internal monetary policy, fiscal policy, financial regulation and supervision, and exchange rate policy. The gap between monetary integration and political integration also gives rise to questions about the democratic accountability and legitimacy of the euro area, a subset of the debate over the democratic governance of the European

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Union as a whole (Berman and McNamara, 1999; Caporaso, 2000; Dyson, 2000; Hodson and Maher, 2002; Jones, 2002; Verdun, 1998; Verdun and Christiansen, 2000).

This article examines the accountability of the euro area's external policy. Much has been written about democratic accountability and the independence of the European Central Bank. Several works have addressed the external monetary policy of the euro area (see, among others, Bergsten, 1997; Cœuré and Pisani-Ferry, 2003; Cohen, 2003; Eichengreen and Ghironi, 1998; Henning, 1997, 2006; Henning and Padoan, 2000; Kenen, 1995; McNamara and Meunier, 2002). But no study known to this author has yet addressed issues of representation and accountability for the exchange rate policy of the euro area.

One possible reason for this omission from the literature is that exchange rate policy is usually a closed affair. In almost all countries, policymaking in this realm is extensively delegated to finance ministries and central banks and oversight by outsiders is relatively weak. Although the rationale for extensive delegation is compelling, however, this does not mean that oversight and accountability are not desirable or feasible. As a normative matter, review and assessment by outsiders, especially the legislature, is appropriate in democratic systems. As a positive matter, democratic accountability of exchange rate policy is important to maintaining political support for economic openness.

This article compares the democratic accountability of exchange rate policymaking in the United States and Europe's monetary union and examines the impact of the differences on policy outcomes. In short, in the United States, the Congress plays an important role in oversight and accountability in exchange rate policy. Although the Treasury Department and Federal Reserve dominate policymaking and accountability is not perfect, the Congress has weighed in at critical junctures, asserting a 'democratic override' when policy deviates substantially from the preferences of broad coalitions of private sector groups. Owing primarily to the different institutional framework of the European Union, however, the euro area lacks an effective counterpart to the Congress in this role. The ECB and Eurogroup together operate virtually without effective external review or potential sanctions for departing even in the extreme from the preferences of a broad set of interest groups within the monetary union. These institutional differences affect policy outcomes when exchange rates become problematic, as illustrated by contrasting responses to Chinese foreign exchange intervention of unprecedented magnitudes during 2002–2006.

This article does not assess the democratic legitimacy of the exchange rate policy of the euro area. Assessing the legitimacy of the monetary union, a more subjective concept than accountability, is a complex undertaking left for other studies. Nonetheless, the argument advanced here contains a warning for the legitimacy of the euro area: if authorities' policy diverges

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from the preferences of a broad coalition of interests, weaker mechanisms of accountability leave the euro area at risk for an erosion of legitimacy over time.

The article defines the term 'accountability' and describes its different types in the next (second) section. The third section compares the United States and the euro area along this dimension. The fourth section examines US and euro-area policymaking with respect to the controversial case of the Chinese renminbi. The final section draws conclusions from this analysis.

DELEGATION, ACCOUNTABILITY AND DEMOCRACY

'Accountability', as Grant and Keohane (2005: 29) define the term, 'implies that some actors have the right to hold other actors to a set of standards, to judge whether they have fulfilled their responsibilities in light of these standards, and to impose sanctions if they determine that these responsibilities have not been met'. It presupposes 'general recognition of the legitimacy of (1) the operative standards for accountability and (2) the authority of the parties to the relationship (one to exercise particular powers and the other to hold them to account)' (see also Oakerson, 1989). Accountability also requires sufficient transparency and information to assess whether standards have been fulfilled.[2]

Borrowing from other theorists, Grant and Keohane (2005) identify two models of accountability, a 'participation' model and a 'delegation' model. Under the participation model, the performance of policymakers is evaluated by the actors that are affected by policies; under the delegation model, performance is evaluated by the actors that grant them policymaking authority. The delegation model, in turn, contains two variants: a principal-agent model, in which power-wielders reflect the preferences of principals, and a trustee model, in which power-wielders might deviate from principals' preference so long as they serve the purposes for which they are authorized to act. Independent central banks would approximate the trustee model, for example, and we return to these distinctions below.

Legitimacy of the standards of accountability and the authority of one actor to hold another to account deserves emphasis because it differentiates open democratic accountability from raw political influence. Selected interest groups can have privileged access to officials within a closed policymaking system and thus an ability to induce them to adopt or change particular policies. But susceptibility to interest group pressure alone does not constitute accountability. Democratic accountability occurs through the legitimately recognized bodies of government and policy processes, such as the legislature and legislative oversight conducted by elected representatives. Open accountability gives voice to a broad set of actors and is sufficiently transparent to allow those outside the closed circle, such as the legislature, to evaluate policy. A policy that responds to the preferences

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of a requisite majority of members of the legislature, pursuant to legislation, and subject to legislative oversight in public hearings is thus openly and democratically accountable. By contrast, a policy that is the product of a back room deal or a telephone call from the chief executive officer of a country's largest automobile manufacturer to the finance minister or prime minister is not democratically accountable. Open democratic accountability does not guarantee that policy reflects the 'national interest' or cannot be captured by particularistic groups, but it helps to render policy more consistent with broadly held preferences than a closed, insider system. This distinction between responsiveness to interest group pressure and democratic accountability relates to the comparison between the United States and euro area below.

'Legitimacy' refers to the normative acceptance by the governed of the authority and behavior of policymakers. Dyson (2000: 212–3, 243, 248) analyzes the legitimacy of the euro area, concluding that '[t]he ECB finds itself in uncharted and problematic political territory for a central bank' (see also Caporaso, 2000; Jones, 2002; McNamara and Berman, 1999; Verdun, 1998, and, on the distinction between input- and output-oriented legitimacy, Scharpf, 1999). However, arguments about the legitimacy of the monetary union and exchange rate policy *per se*, though related, go beyond the scope of the present article, which focuses on the more narrow but concrete concept of accountability. Legitimacy enters in here to the extent that it pertains specifically to standards of accountability and authority in exchange rate policymaking.

In issue areas characterized by extensive delegation to executive agencies, of which exchange rate policy is typically one, legislatures can provide political accountability through oversight. As Oakerson (1989: 123) describes it, 'Oversight consists of monitoring by committees charged with writing the legislation that pertains to agencies' authority and annual appropriations. Control over appropriations and authority gives committees leverage over agency discretion beyond the requirements of law'. In the United States, as shown below, the Congress has an additional tool of leverage: powers over legislation in areas functionally linked to exchange rate policy.

A normative debate exists over the appropriate degree of 'democratization' of exchange rate policy, arising principally from different conclusions drawn from US exchange rate policymaking during the 1980s. Destler and Henning (1989) interpret the shift in exchange rate policy of the Reagan administration during 1985 as the result, in substantial measure, of the constructive role of the Congress in intermediating between private-sector activism and executive neglect. We recommended broadening intra-executive deliberations over the exchange rate, strengthening the role of Congress in setting broad international economic objectives, and institutionalizing and legitimating private-sector advice to the Treasury.

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Dominguez and Frankel (1993: 50–3; 137–8), while advocating broader consultation within the executive, oppose a broader role for the Congress and private-sector advisory committees and more generally a 'democratized' exchange rate policy. A broadening of the exchange-rate policy process, they fear, could someday induce policymakers to push the exchange rate away from equilibrium rather than toward it. To some extent, this disagreement may reflect differences between the preoccupation of economists with policy optimization, and sometimes a professional preference for technocratic management, and the preoccupation of political scientists with connections between electorates, legislatures and officials.[3] This debate serves as a backdrop for analysis of democratic control and accountability of the exchange rate policy of the euro area.

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ACCOUNTABILITY AND EXCHANGE RATE POLICY

Exchange rate policymaking is highly delegated and relatively closed, dominated by the central bank and finance ministry, in most countries. The balance between these two institutions varies from country to country (see Henning, 1994, 2007), but together they dominate the lion's share of external monetary policymaking in virtually all countries. While delegation does not necessarily imply lack of accountability, in principle, policymaking in the exchange-rate field also typically ranks low on measures of democratic accountability.

Exchange rates are affected by many factors, including monetary, fiscal, and financial policies, and exchange rate economics is a contentious academic field. Exchange rate policymaking is thus technical, if not arcane, and must sometimes adjust with alacrity to fast-changing market conditions. Policy in this field cannot be legislated practically and legislatures wisely delegate substantial discretion to finance ministries and central banks.

As a general matter, though, that delegation is more often vague and ambiguous than clear and precise. National legislation specifying the responsibilities of these bureaucracies focuses largely on their domestic tasks and often leaves their roles in exchange-rate policy incompletely defined. So, the authority to make decisions, conduct operations and issue declarations about exchange rates is often instead established by patterns of practice and precedent, as well as non-legal understandings between central banks and finance ministries that are negotiated and renegotiated over time and largely opaque to outsiders.

Thus, delegation is often implied and implicit rather than explicit and formally structured. The role of the legislature in overseeing the finance ministry-central bank nexus is often unclear. Standards by which the performance of these bureaucracies is to be judged are also often vague. Policymaking is removed from public purview and reporting by the bureaucracies is selective and incomplete, if it occurs at all. The effectiveness

of interest group pressure varies across states; the preferences of sectoral interests are reflected in policy outcomes in many countries. But in most countries democratic accountability is weak relative to other areas of economic policy.

Nonetheless, when exchange rate policy diverges from preferences of the electorate and/or a broad set of organized interest groups, tools by which such a coalition can reclaim a degree of control over the finance ministry–central bank nexus exist in some countries, the United States in particular, and are at times critically important. Compare the United States and the euro area below.

THE UNITED STATES

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The Treasury Department and the Federal Reserve sit at the heart of the closed system in the United States. They naturally prefer to retain complete discretion in declarations, negotiations and interventions. Usually, they are quite successful in keeping the exchange rate 'act' to themselves. However, US institutional arrangements provide for a 'democratic override' when policy strays so seriously from electorate and interest group preferences that the Congress becomes engaged. Such periods have usually coincided with neglect of an overvalued dollar coupled with an import surge and large current account deficits. In the early 1970s, mid-1980s, and presently, Congress has become engaged in this way (Destler, 2005: 57–61; Destler and Henning, 1989).

The United States Constitution gives Congress the power 'To coin money, regulate the value thereof, and of foreign coin . . . ' (Article I, section 8). So, the authorities of both the Federal Reserve and the Treasury on monetary and exchange rate policy are delegated by Congress and both bureaucracies are formally accountable to the Congress across the full range of their responsibilities. Most of the time, the exchange rate is not an issue for members of Congress. At particular moments in recent history, however, Congress has been quite extensively engaged in this issue domain. When so aroused, the US legislature has several tools.

First, by virtue of its oversight responsibilities, key committees receive reports from the Treasury and Federal Reserve and can secure testimony from officials within these agencies at public hearings on exchange rate policy. Treasury reports on the use of its Exchange Stabilization Fund, its principal vehicle for foreign exchange intervention, on a monthly, quarterly and an annual basis (Henning, 1999: 45–8). Congress's oversight powers are strongly reinforced by its control over grants of authority, appropriations, and appointments to key posts in these agencies. The Omnibus Trade and Competitiveness Act of 1988 required the Treasury to submit semi-annual reports to the banking committees of both houses. The Act required Treasury to determine, among other things, whether foreign

governments 'manipulate' the value of their currencies to achieve competitive advantage and, if so, to pursue corrective negotiations with the country concerned. The legislation thus attempted to define a standard – manipulation – around which Treasury was to focus part of its efforts. Although oversight remained incomplete after 1988, the act strengthened accountability compared to previous arrangements and compared to other key currency countries.

Second, Congress can in principle legislate directly on exchange rate policy. Although usually impractical, the threat of such legislation can get the attention of a distracted administration, as it did in 1985, and reinforce Congress's determination to shift the course of policy. In practice, such proposals are usually de-fanged and re-channeled toward reinforcing oversight.

Third, Congress can legislate indirectly in fields in which it has more practical influence. Trade policy, foreign aid, and support for international financial institutions such as the International Monetary Fund and the World Bank can and have been linked by Congress to its being satisfied by the administration on exchange rates. The outstanding example, but by no means the only example, was Congress's threat in 1985 to pass protectionist legislation unless the second Reagan administration secured a substantial depreciation of the dollar – to which Treasury Secretary James A. Baker III responded with alacrity (Destler and Henning, 1989). Under specific circumstances, such linkages can thus be credible and effective threats.

Treasury's 'manipulation report' has also periodically affected the substance and tactics of US exchange rate policy. When the central banks of Taiwan, South Korea, and China restrained the rise of their currencies after the Japanese yen appreciated in the mid-1980s, US officials began to scrutinize their exchange-rate policies more carefully. These three countries were cited in the late 1980s in Treasury's reports for manipulating their currencies to achieve unfair competitive advantage (see, for example, US Department of the Treasury, 1988). Their currency policies were publicly reviewed in hearings before the banking committees of the US Congress at which members forcefully and publicly advocated appreciation. The reporting process thus underpinned a 'good cop, bad cop' routine that contributed to securing the subsequent currency adjustments by these governments.

The United States, therefore, has exchange rate policymaking arrangements that, while still dominated by the Treasury/Federal Reserve nexus and imperfect with respect to accountability, are subject to a significant extent to legislative scrutiny and influence. Checks on the otherwise closed system have affected policy outcomes at several points over the last four decades, points where US trade policy could have become considerably more protectionist for years to come in the absence of exchange-rate accommodation. Such checks, a 'democratic override', have therefore been

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quite useful in maintaining domestic political support for international economic openness in the United States.

The role of Congress is also important as an arbitrator of conflicts between the Treasury and Federal Reserve over exchange rate policy and their respective prerogatives. On several occasions during the 1970s, for example, members of Congress threatened to intervene to settle differences between these bureaucracies over foreign exchange intervention. Mutual interest in preventing such intervention has been a powerful incentive for the Treasury and Federal Reserve to resolve differences quietly (Destler and Henning, 1989: 89–90). If irresolvable differences arise in the future, though, Congress would be the ultimate adjudicator.

THE EURO AREA

The euro area lacks any significant 'democratic override' of exchange rate policies that might lie considerably beyond the range of preferences of the electorate and interest groups of the monetary union. Accountability on exchange rate policy is less open and more attenuated than accountability in the United States. Consider in this section, first, the institutional arrangements for external monetary policy in the euro area and, second, the ability of the European Parliament and European Commission, the key 'outside' institutions, to hold the core actors to account.

Authority over external monetary policy is distributed by the Treaty on European Union (Maastricht treaty) to the European Central Bank and the Council of the European Union. The European Central Bank and the national central banks of member states that have adopted the euro can be called the 'Eurosystem', in keeping with the nomenclature of the bank itself. The finance ministers of the member states within the euro area meet in a configuration of the Council dubbed the 'Eurogroup', a subunit of the Ecofin Council.

Under the Maastricht treaty, the objective of both monetary and exchange rate policy was 'to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Community' (European Union, 2002: Article 4, originally Article 3). Formal exchange rate agreements, which must respect internal price stability, are the province of the Council (European Union, 2002: Article 4, originally Article 3). In the absence of a formal agreement, the Council can issue 'general orientations' to the ECB with respect to exchange rates, although these too must respect domestic price stability (*ibid*, Article 111, paragraph 2). The Council decides the external representation and arrangements for negotiating external monetary accords as well as the position adopted within such negotiations by qualified majority (*ibid*, Article 111, paragraphs 3 and 4).[4] Under each of these procedures, the Council acts on the initiative of the Commission, or on the initiative of the ECB in the case of formal agreements,

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and must consult the ECB (for analysis of these provisions, see European Commission, 1997; Hahn, 2000; Henning, 1997, 2000; Kenen, 1995; Kutos, 2001; Smits, 1997: 367–453; see also Padoa-Schioppa, 1999, 2004).

For its part, the Eurosystem was specifically empowered to hold and manage foreign exchange reserves and conduct foreign exchange operations. Although a substantial fraction of foreign reserves was not pooled, the Eurosystem ensures that those reserves remaining in the hands of national central banks do not interfere with exchange rate policy (European Central Bank, 2003: articles 3, 6, 23, 30).

However, the treaty did not define the institutional division of labor for making public statements, negotiating with external partners and deciding on foreign exchange interventions under a regime of managed floating. Shortly after the introduction of the euro, currency movements forced euro area authorities to define these arrangements more explicitly. The Eurogroup, full Ecofin and Eurosystem reached a partial understanding on these questions during meetings in Turku, Finland, in September 1999 and Luxembourg in June 2000. Under the Turku agreement, the Eurosystem was recognized as being 'solely competent' for deciding intervention but would do so on the basis of an understanding with the Eurogroup about the strategic direction of policy and an agreement that key officials would consult and coordinate their public statements. The resulting institutional framework, for the time being, approximates the relationship between the German finance ministry and the Bundesbank prior to the monetary union – the 'German model' (the inter-institutional understanding is described in Henning, 2007).

These documents – the Maastricht treaty, Turku understanding, Eurogroup and Eurosystem statements – are virtually silent with respect to democratic accountability on external monetary policy. Beyond consistency with price stability, they enunciate no standards by why which policy is to be assessed. They mandate no disclosure of information to the public or systematic reports between institutions; neither the ECB nor the Eurogroup are transparent.[5] No process of review and/or assessment is established. Accountability was an 'oversight', in a different sense of the term, of the officials of member states and the European Union when grappling with other, hard-fought political and institutional questions in the negotiations that led to the Maastricht treaty.

The Council must consult the European Parliament when concluding formal agreements on the euro's participation in an exchange rate system (Paragraph 1, Article 111). The Parliament can hold hearings on exchange rate matters and solicit the testimony of expert witnesses. In this way, the Parliament, like the Congress, can in principle raise public consciousness of currency misalignments and build a case for policy action. Exchange rate questions are sometimes posed to ECB officials at quarterly hearings on monetary policy and at hearings to question nominees to the bank's

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Executive Board (on the accountability of the ECB on monetary policy, see Berman and McNamara, 1999; Buiter, 1999; Jabko, 2003). Members of Parliament can also highlight exchange rate issues in hearings and reports on trade and broader economic issues.

The Parliament's role in this domain is nonetheless very much constrained. ECB officials consent to appear before parliamentary committees, but are not compelled to do so; thus the word 'testify' is not used to describe their presentation. Parliament does not approve appointments to the ECB. It has no budgetary or grant-of-authority powers over the ECB – and certainly has no such authorities over the Eurogroup and its constituent finance ministers. Symptomatic of the allocation of competence among EU institutions in general, the European Parliament lacks the powers that give muscle to congressional oversight in the United States. The Parliament's role in trade policy is weaker and more tenuous than that of the Congress and it cannot of course formally initiate legislation. It cannot therefore effectively link trade actions to satisfaction on exchange rate policy.

Could the European Commission provide democratic accountability? The Commission has a window onto the exchange rate policy process: its officials attend Eurogroup and ECB meetings, among others. By its power of legislative initiative, the Commission can propose measures on exchange rates and other international monetary issues of concern to the Eurogroup and the ECB. However, it is difficult to see how the Commission could use these tools to hold the central players to account, stimulate a shift of errant policy, or otherwise provide democratic accountability. The Commission's own democratic credentials are, after all, indirect at best.

What of the normative theory that euro-area authorities are accountable to electorates through the elected governments of member states? Moravcsik (2002), for example, argues that member states have devolved issues to the EU that their electorates are content to have delegated and that the European Union in general is as democratic as the national political systems within it. With respect to the monetary union, similarly, one might observe that national governments' finance ministers sit in the Eurogroup, their heads of government sit in the European Council, and the European Council in turn appoints the top officials of the Eurosystem. The Eurogroup could issue general orientations on exchange-rate policy for the ECB under Article 111. However, as a committee, the Eurogroup (a) is inherently less coherent than a single minister or secretary and its ability to adopt a coherent position and bargain with the ECB is correspondingly limited and (b) has limited influence over the ECB owing to the central bank's independence under the treaties. Moreover, the finance ministers themselves are part of the closed system that would be held to account with a democratic override.

An advocate for the monetary union might also be tempted to argue that, although the United States and euro area have different systems, their

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accountability is equivalent. Within the United States, Congress delegates authority to the Fed and Treasury and interest-group participation through the Congress can help to keep the closed circle 'honest' – a mix of Grant and Keohane's (2005) delegation and participation models. This argument might assert that the euro area's exchange rate policy approximates the trustee model, in which officials have great discretion as long as they serve the purposes for which they are appointed.

However, on close scrutiny, the structure of the external monetary policy process in the euro area does not actually lend itself to either model of accountability. First, a substantial share of the ECB's authority in the exchange-rate area is granted by the member states through the Maastricht treaty. While the treaty-ratification process was reasonably democratic, the ECB's exercise of those powers is neither transparent, sanctionable nor effectively revocable. Second, to the extent that the Eurogroup has devolved further discretion over exchange rate policy to the ECB, by default or design, oversight by a group with diverse preferences implies considerable room-for-maneuver for the central bank. More fundamentally, the preconditions for accountability – transparency and general recognition of operative standards and authorities with respect to accountability – are nearly absent.

Could it be unfair to compare the euro area to the United States and to hold the monetary union to the same standard of democratic accountability as nation states? Euro area authorities might rely on the Grant–Keohane defense of international organizations, namely that such organizations are in fact often accountable but by means (such as markets, peer pressure and public reputation) that are not recognizable through the lens of domestic models of democratic governance. That the euro area has taken on responsibility for administering a common exchange rate policy creates a problem for this argument, however. In all aspects of monetary policy, sovereignty has been transferred completely from member states to the union. The standards by which its democratic accountability should be judged are thus closer to those of nation states than international organizations.

In sum, the euro area lacks a mechanism to effectively hold core policymakers at the ECB and Eurogroup to account on exchange rate policy or to override them if exchange rate policy deviates substantially from broadly held preferences. Accordingly, it lacks a mechanism to pressure the key actors to redress inequities in the international monetary system, such as misaligned currencies, when the Eurogroup and ECB might be reluctant to do so. By contrast, institutional arrangements in the United States have sometimes served to focus political backlash from currency misalignment on exchange rate policy solutions, defusing pressure for trade protection. Euro-area arrangements run the danger that the political response to currency misalignment will not have an outlet in exchange rate policy, but will be focused instead on trade policy and market closure.

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To be clear, this article has not argued that private interests and representative associations do not matter in the determination of European exchange rate policy. Private-sector interests mattered before the creation of the monetary union, especially the industrial and banking sectors (see, for example, Broz and Frieden, 2004; Henning, 1994; Walsh, 2000), and continue to influence the posture of member-state governments, the finance ministers in particular, on exchange rate policy. However, the shift to the monetary union also shifted the institutional framework that mediates the influence of interest-group preferences on policy. Finance ministers must now vie with one another to set a common policy and they have less collective influence *vis-à-vis* the central bank than most of them wielded individually prior to the creation of the euro. As a consequence, the transmission of interest-group preferences into policy outcomes is far less direct within the monetary union now compared to within the member states prior to the advent to the euro. Even when interest groups might have back-channel influence, moreover, euro-area exchange rate policy is not democratically accountable through transparent policy review by legitimate official bodies.

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We would expect access to the policymaking process, or lack of it, to affect the character and intensity of private-sector attempts to influence policy. Where the structure of official institutions and the division of authority among them create barriers to successful lobbying, injured groups are likely to be discouraged from seeking redress on exchange rate policy. To a significant degree, in other words, private lobbying is likely to be endogenous to policymaking institutions and their responsiveness to interest group pressure. Given differences in institutional design and accountability, we would not expect to observe as much exchange rate lobbying within the euro area as within the United States under similar economic circumstances.

RESPONSES TO CHINESE EXCHANGE RATE POLICY, 2002–2006

The responses of the United States and the euro area to the exchange rate policy of China during 2002–2006 demonstrate the differences in institutional design and accountability within each system and their consequences for policy outcomes. This case cannot be a definitive test because interest group opposition to exchange rate policy has not been as broad as in some earlier cases, yet, and this policy conflict remains ongoing. Nonetheless, comparing US and euro area policy *vis-à-vis* China is useful for two reasons. First, exchange rate politics on the two sides of the Atlantic are considerably more independent in third-country cases than in cases focused on the dollar-euro exchange rate.[6] Second, the renminbi is by far the most undervalued of the major currencies in the international monetary

system and the most important case of undervaluation since the creation of Europe's monetary union. The case thus provides a highly instructive illustration of the argument presented here.

This section describes Chinese exchange rate policy, highlights the role it plays in the global adjustment problem, compares the US and European responses to this problem with particular focus on private lobbying patterns and accountability mechanisms, and considers some alternative explanations for the different responses.

Chinese adjustment problem

During 1995–2005, the Chinese government pegged its currency, the renminbi, to the US dollar. As the dollar rose and fell over this period, the renminbi similarly rose and fell against the non-dollar currencies. As China's international trade rose dramatically, other Asian countries felt increasing competition from China and looked to China when setting their exchange rate policies. Neighbors shadowed the dollar under regimes of managed floating in order to prevent their currencies from appreciating against the renminbi when the region stabilized after the financial crises of 1997–1998. China's currency peg to the dollar therefore became something of a proxy for currency policies of the region as a whole.

During 2000–2005, however, China ran increasingly large surpluses on both its current and capital accounts. Its current account surplus alone rose to $159 billion in 2005, nearly 7 percent of China's GDP. Maintaining the exchange-rate peg therefore required increasingly large purchases of dollars by Chinese authorities, purchases that became unprecedented in magnitude. As a consequence, China became the world's largest holder of foreign exchange reserves, which breached the $1 *trillion* mark in 2006 – an all-time record for *any* country. For these reasons, Goldstein (2005) and Goldstein and Lardy (2004, 2005), for example, argued persuasively that the renminbi was substantially undervalued and should be revalued on the order of 25 percent.[7] Because other countries in the region were reluctant to allow their currencies to appreciate against China's, renminbi appreciation against the dollar became the key to East Asia's contribution to global current account adjustment.

In July 2005, Chinese authorities announced a 2 percent revaluation of the renminbi against the dollar and a shift in the regime: thereafter, the renminbi's value would supposedly be allowed to change as much as 0.3 percent per day against an undisclosed basket of currencies (People's Bank of China, 2005: 16–9). Nonetheless, subsequent exchange rate changes were quite modest: by December 2006 the renminbi had appreciated only 5.4 percent against the dollar and remained close to the 10 yuan/euro level that prevailed prior to the mid-2005 announcement, having appreciated slightly and then depreciated against the European currency in the meantime.

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Table 1 Imports from China: Comparison of the Euro Area, European Union, and the United States, 2000–2005[1] (In billions of dollars)

	2000	2001	2002	2003	2004	2005
Eurozone						
Total imports from China	48.8	51.1	58.4	84.3	115.7	146.4
Total imports from China (percent of total imports)	5.2	5.6	6.3	7.5	8.6	9.7
EU-25						
Total imports from China	68.7	73.1	84.7	119.3	158.5	196.5
Total imports from China (percent of total imports)	7.5	8.3	9.5	11.2	12.3	14.8
USA						
Total imports from China	100.0	102.3	125.2	152.4	196.7	243.5
Total imports from China (percent of total imports)	6.9	7.5	9.0	10.0	11.1	12.2

[1] *Sources:* Eurostat database and U.S. Census Bureau, Foreign Trade Division.

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Given China's rapidly expanding current account surplus, amounting to roughly nine percent of GDP in 2006, such a modest appreciation would not provide needed adjustment.

The interest of the United States, European Union and euro area in Chinese exchange rate policy is broadly equivalent, even if the absolute value of US imports from China exceeds those of the euro area. Table 1 compares US, EU and euro area trade with China. In 2005, US imports were $244 billion while EU imports were $197 billion, which amounted to 12.2 and 14.8 percent of total imports, respectively. The euro area's imports were $146 billion, 9.7 percent of total euro area imports. All three areas' imports

Table 2 Exports to China: Comparison of the Euro Area, European Union, and the United States, 2000–2005[1] (In billions of dollars)

	2000	2001	2002	2003	2004	2005
Eurozone						
Total exports to China	19.1	22.5	28.2	39.6	50.6	54.1
Total exports to China (percent of total exports)	2.1	2.4	2.8	3.3	3.5	3.5
EU-25						
Total exports to China	23.8	27.4	33.0	46.6	59.9	64.4
Total exports to China (percent of total exports)	2.6	3.1	3.7	4.4	4.7	4.8
USA						
Total exports to China	16.2	19.2	22.1	28.4	34.7	41.8
Total exports to China (percent of total exports)	1.5	1.9	2.3	2.8	3.0	3.3

[1] *Sources:* Eurostat database and U.S. Census Bureau, Foreign Trade Division.

from China grew rapidly during 2000–2005, increasing by more than two-and-a-half times in absolute value and almost doubling as a share of total imports. These increases placed particularly strong pressure on import competing firms and workers in particular sectors, such as textiles and apparel. US, EU and euro area exports to China were comparably small relative to imports (Table 2). Public opinion surveys in the United States and key member states of the euro area showed an equally widespread concern, of 59 percent of respondents, with the Chinese economic 'threat' (German Marshall Fund, 2006: 17–8).

US response

In the United States, the issue of the Chinese exchange rate produced differentiated responses on the part of the Treasury and Federal Reserve, on the one hand, and other executive agencies and the Congress, on the other hand. In short, import pressure spawned activism on the part of affected groups and sectors to which the Congress was responsive. The Treasury, by contrast, while using moral suasion to induce China to revalue renminbi, was very reluctant to threaten China for intransigence. For three years, the Treasury and Congress played 'good cop, bad cop' with China on the currency problem. With some significant differences, this pattern is reminiscent of the relationship between Congress and the Treasury on the exchange-rate issue in the mid-1980s.

Private sector lobbying on the Chinese exchange rate issue has been vigorous and contested. A succession of alliances pressed Congress and the Bush administration to secure an appreciation of the renminbi: first the Coalition for a Sound Dollar, then the Fair Currency Alliance, and finally the China Currency Coalition (CCC). Private activity manifested a cleavage between large, multinational firms with investments and facilities in China, on the one hand, and domestic manufacturers, on the other hand. The former group, represented in part by the Business Roundtable, generally advocated a moderate position on Chinese trade and currency issues. The Domestic Manufacturers Group, on the other hand, advocated far more aggressive prosecution of trade cases and correction of currency undervaluation. These differences split the National Association of Manufacturers on both China trade issues and the Chinese currency issue (see, for example, Hufbauer *et al.*, 2006; McCormack, 2006; Stokes, 2006) The CCC nonetheless gathered together 45 associations representing a broad array of potentially influential domestic manufacturers and labor unions.[8]

In this atmosphere, Treasury's 'manipulation reports' under the 1988 trade act became a semi-annual drama, with Congress, the financial markets and foreign governments waiting in anticipation for release of the document. The banking committees of both houses of Congress followed

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up on these reports with hearings at which senior Treasury officials testified. Arguably at variance with the purposes of the 1988 act, however, Treasury, bent over backwards to avoid citing China as a 'manipulator', which would have triggered requests for formal negotiations over the matter (see, for example, US Treasury, 2005).

Caught between private pressure groups and a reticent Treasury, members of Congress submitted a series of legislative measures that, if passed, would have mandated Treasury action or would have imposed trade barriers against China. During the 109th Congress alone (2005–2006), more than fifteen bills targeting renminbi valuation were submitted by members.[9] Senators Charles Schumer (D, NY) and Lindsey Graham (R, SC) co-sponsored a bill that would have imposed a tariff of 27.5 percent – their guess as to the extent of the undervaluation of the renminbi – on all Chinese imports in the absence of a substantial Chinese revaluation (Senate bill 295, 109th Congress, 1st session, submitted February 3, 2005). When this bill received 67 votes in the Senate on a procedural motion in late March 2005, the administration began taking congressional threats on China trade more seriously. Senators Schumer and Graham agreed to defer a final vote on their bill in exchange for assurances from the Treasury Department that Chinese authorities would act. Meanwhile, in an effort to provide an alternative to the Schumer-Graham proposal that would not violate US obligations in the WTO, then Senate Finance Committee Chairman Charles Grassley (R, IA) and then ranking minority member Senator Max Baucus (D, MT) co-sponsored a measure that would sharpen and enhance Treasury's reporting requirement under the 1988 trade act. Their bill also mandated sanctions for countries that maintain undervalued currencies (Senate bill 2467, 109th Congress, 2nd session, introduced March 28, 2006). These and other bills could be consolidated into compromise legislation during the Democrat-led 110th Congress.

The United States imposed trade barriers against China in specific product areas. As of Spring 2006, the United States had restricted imports of apparel, color television sets, semiconductors, shrimp, textiles and wood furniture – all under WTO-consistent provisions or negotiated with Chinese authorities. The Bush administration also began trade action on auto parts and, among other things, prepared action on violations of intellectual property rights (Hufbauer *et al.*, 2006; *Inside U.S. Trade,* various issues, Spring 2006). But such relief to US producers did not eliminate the broader coalition targeting the exchange rate and, in this respect, stands in contrast to the experience within the euro area.

The role and authority of the Congress had a substantial impact on the content and tactics of US policy *vis-à-vis* the Chinese currency. Oversight and accountability mechanisms, though incomplete, have been important instruments of congressional influence over the Treasury. In the absence of congressional pressure, Treasury could well have shied away from warning

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China in May 2005 that it would be cited as a 'manipulator' in Treasury's subsequent report in the absence of action. China could well have declined to revalue its currency in July 2005 in the absence of this political pressure. Although appreciation of the renminbi against the dollar has been relatively modest as of this writing, these measures could well prove to be early steps in a long incremental process in which congressional pressure remains important.

Euro-area response

Europe faced pressures similar to those faced by the United States and imposed similar trade restrictions. The European Union imposed safeguards actions on textiles and apparel, as has the United States, and leather shoes.[10] The United States and European Union together brought action in the WTO against China on auto parts (*Washington Post* March 28, 2006). However, by contrast, euro area policy with respect to the renminbi exchange rate was relatively complacent.

European policymakers did not form any particularly clear or coherent policy toward the Chinese currency during 2003–2005, and European officials stressed different priorities when speaking with Chinese counterparts. Moreover, European officials were explicitly critical of the US approach to China on this matter as unilateral, coercive, and consequently likely to be counterproductive (not-for-attribution interviews with European officials, Frankfurt and Brussels, May 2005). The European members of the finance G-7 advocated greater 'flexibility' for 'major countries or economic areas' with the US Treasury at Boca Raton, Florida, in February 2004[11] and agreed to mention China specifically in this context at the G-7 meeting in April 2006 (G-7 Finance Ministers and Central Bank Governors, 2006; Taylor, 2007: 294–300). However, 'flexibility' is substantially different from 'revaluation' and the Eurogroup stressed the importance of gradualism when meeting with Asian finance ministers in Vienna in April 2006 – a stance that was quite consistent with China's own rhetorical commitment to flexibility in the very long run, unmatched by serious action during 2002–2005, and in contradistinction to the position of the US Treasury (*Agence France Presse*, 2006; *AFX International Focus*, 2006; ASEM Finance Ministers, 2006). During state visits in 2006, neither German Chancellor Angela Merkel, French President Jacques Chirac, nor Italian Prime Minister Romano Prodi pressed their Chinese counterpart to raise the value of the renminbi with anywhere near the intensity of President Bush (*Financial Times,* 10 April, 19 and 24 May, 15 September 2006; *International Herald Tribune*, 26 October 2006).

In the euro area, there are relatively few reports issued by European authorities that raise Chinese exchange rate matters and no formal oversight of the exchange rate policy of the ECB and Eurogroup. Although exchange

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rate matters can in principle be raised in hearings with ECB officials at the European Parliament, and occasionally in other forums, these discussions are sparse compared to the relatively intense focus on the Chinese currency in the Congress. There is only sporadic mention of the Chinese exchange rate issue in on-line documents of the European Parliament and European Commission for the period 2003–2005. During the same period, there were nine hearings in the US Congress in which the exchange rate was a central theme, nine hearings in which it was a significant theme, and a large number at which it was mentioned several times.[12] The *European Competitiveness Report 2004*, written by the Commission, contains a substantial chapter on China but not a single mention of the exchange rate within it (European Commission, 2004). The Commission omitted renminbi appreciation from its 'priorities for action' in its 2006 China strategy paper (European Commission, 2006a,b). In short, there is little public evidence of serious review of the euro area's exchange rate policy *vis-à-vis* China by the European Parliament and European Commission or discussion between these institutions and those principally responsible for exchange rate policy, the ECB and Eurogroup.

The relative lack of attention to renminbi valuation among euro area authorities compared to those in the United States is not due to a lack of competitive pressure on traded goods producers or workers. The tripling of Chinese imports during 2000–2005 particularly impacted firms and workers in low-skill intensive industries, many of which have sought remedies. The Italian business association Confindustria, for example, warned repeatedly about competition from China in global markets, describing the renminbi as 'strongly undervalued' and citing others' estimates of the undervaluation at 20–40 percent.[13]

However, private sector lobbying on this issue was fragmented by two institutional features of the euro area. First, the different trade structures of member states conferred differentiated interests with respect to Chinese trade and exchange rate issues upon European countries (Betschart *et al.*, 2005; Larch, 2005; Oxford Economic Forecasting, 2006). Germany's trade structure is complementary with China's while that of Italy and Spain is considerably more competitive. The technology intensity of Italian and Spanish exports is substantially lower than those of German exports, for example, making them more sensitive to the competitive effects of renminbi valuation (Betschart *et al.*, 2005; Pisani-Ferry and Sapir, 2005). Even when domestic firms in low-skill-intensive industries might prevail upon their national officials, those officials face apathy or opposition from fellow ministers within the Eurogroup.

Second, the division of interests between large multinational firms and domestic manufacturers manifests differently in the European institutional setting. The companies that dominate the pan-European business associations are multinational firms that are far more likely to source

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from and invest in China than the domestic manufacturers. The voice of manufacturers with primarily domestic operations is thus muted at the European level – an example of the endogeneity of lobbying to institutional design. While the EU-level association of European business groups, UNICE, pressed the European Commission to 'adopt a more resolute and coordinated strategy vis-à-vis China' that included 'adjustment of the Chinese currency (yuan) to market forces', the exchange rate was only one out of 11 agenda items for EU–China economic relations.[14] As of this writing, nothing similar to the China Currency Coalition in the United States has emerged in Europe.

Accordingly, there are no serious threats within the euro area to restrict trade with China in order to secure a change of exchange rate policy. While the European Union invoked safeguards against Chinese textile imports, these measures and measures similar to them have not been linked to the exchange rate and would arguably have been invoked irrespective of exchange rate policy, as a result of the phase-out of the Multi-fiber Arrangement. There is no European equivalent of the Schumer-Graham bill of 2005, in other words, or of congressional threats to restrict trade in the mid-1980s.

Given the institutional arrangements of the European Union, in fact, several obstacles impede such linkages in practice. The first obstacle is the disconnect between trade policymaking, an apparatus of the European Union, and exchange-rate policymaking, an apparatus of the euro area. Member states outside the euro area may not wish to use EU trade policy as a lever for adjustment in the euro's exchange rate. The second obstacle is again the differentiation of competitive pressures from China across member states of the euro area that creates divergent preferences within the Eurogroup and Ecofin and blocks consensus in these bodies. The third obstacle is the inability of the European Parliament to make the linkage. Although it might have some influence over trade policy, the Parliament does not have legislative authority on exchange rate policy and little desire to risk its tenuous standing on trade policy by linking it to changes on external monetary policy.

Owing to the weak institutional standing of the European Parliament, groups and sectors seeking relief from import competition are more likely to access trade measures through their member-state governments and the European Commission than to press for an exchange-rate adjustment. The configuration of euro area policymaking institutions makes such an effort impractical. By contrast, the Commission can alone impose preliminary antidumping duties and its definitive duties are implemented unless there is a negative vote within the Council by simple majority (Woolcock, 2005: 387). Groups can therefore obtain relief more easily in the form of antidumping duties, for example, than in the form of a change in exchange rate policy.

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Differences in the economic circumstances of the United States and euro area, such as their foreign direct investment positions in China and their overall current account positions, are sometimes offered as alternative sources of their different responses. The use of China as a low-wage production platform would certainly confer an interest in low valuation of the renminbi upon European multinational corporations. However, the amounts of US and euro area FDI in China are roughly comparable.[15] When lobbying on trade and currency issues, moreover, both American and European multinational companies tend to give priority to securing and expanding their investment position in China's rapidly growing market for the future. Foreign direct investment and the engagement of multinational companies in China thus do not seem to explain the difference in responses.

Similarly, with respect to the current account imbalances, some European observers hope that because the euro area's deficit is relatively small, Europe can remain removed from the global adjustment process. The United States and East Asia are the main areas of savings shortage and savings surplus in the world economy, in this view, and the burden of adjustment should therefore fall mainly upon them.[16] This line of argument concludes that European officials need not become as exercised as US policymakers over Chinese exchange rate policy.

However, the more favorable current account balance of the euro area does not by any means suggest that Chinese exchange rate policy has a lesser impact on Europe. To the contrary, the euro area's interest in renminbi revaluation is arguably greater than that of the United States, for three reasons. First, owing to the greater share of manufactures in the European economy and the euro area's lesser economic flexibility, China's emergence generally represents a greater challenge for Europe than for the United States (Pisani-Ferry and Sapir, 2005). Second, if the dollar depreciates against the euro as part of the adjustment process and China does not allow a substantial appreciation, the renminbi will depreciate against the euro as well – further displacing low-skilled workers and low-technology firms (see, for example, Ahearne and von Hagen, 2005). Third, unprecedented accumulation of dollar reserves in Asia creates compelling incentives for central banks to diversify those reserves into euros to prevent capital losses on dollar depreciation – diversification that would put further upward pressure on the exchange value of the euro. On the basis of these considerations, we would expect more lobbying on the exchange rate and more attention to Chinese currency policy on the part of officials in the euro area compared to the United States; instead, we observe less.

These alternative arguments therefore do not displace the explanation presented here. While institutional structure and democratic accountability are not the only factors differentiating the US and euro area responses to Chinese exchange rate policy, they deserve a prominent place as leading

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causes of the difference in both the level of private activity and the policy outcomes. Moreover, we can expect them to manifest in other cases of exchange rate conflict in the future.

CONCLUSIONS

This paper has reviewed the policies and institutions by which exchange rate policy is made in the United States and the euro area with special focus on democratic accountability. It argues that, while accountability on exchange rate policy is fairly weak compared to other policy areas in almost all countries, institutional arrangements in the United States provide for the possibility of a 'democratic override' when policy diverges sharply from the preferences of the electorate or broad coalitions of private sector interests. Such a democratic override does not exist in the euro area – a manifestation of the political incompleteness of the monetary union and European Union. Differences in institutional design and accountability account in large measure for the contrasting responses of the United States and euro area to the exchange-rate policy of the Chinese government during 2002–2006. The weakness of accountability on exchange rate policy within the euro area has two negative potential effects. First, it tends to bias remedies for undervaluation of others' currencies toward trade measures and away from exchange-rate measures and could thereby erode political support for economic openness more broadly. Second, if exchange rate policy deviates repeatedly from the preferences of broad private-sector coalitions, the weakness of accountability could allow an erosion of legitimacy over time.

These findings provide further normative support for completion of the political project of the European Union in order to align policy competence with democratic accountability. Because the democratic development of EU institutions is at best a long-term prospect, however, the core institutions should employ interim measures to compensate for weakness of accountability mechanisms. The ECB and the Eurogroup should provide transparency above and beyond that strictly required by the treaties. These institutions should be clear with the public concerning the division of labor between them and the exchange rate policymaking process as well as clear concerning to the objectives of policy – beyond the inadequate language of the treaties. Officials of the ECB and Eurogroup should openly solicit the views of private-sector representative associations, the Parliament and the Commission on external monetary policy and develop a more robust interinstituional dialogue. Finally, the absence of any reliable mechanism for adjudicating interinstitutional conflict places an extraordinary burden on the ECB and Eurogroup to develop, formally or informally, a consensus on exchange rate policy and act accordingly. Although such measures might not provide a 'democratic override' such as that in the United States,

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they can help to ameliorate the euro area's accountability gap in this policy domain.

NOTES

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2 This framework thus adopts a concept of accountability that is procedural, institutional and rationalist. A normative concept, grounded in constructed norms and rights, represents an alternative that is certainly worth pursuing in scholarship on the accountability of policy within the euro area and European Union. Without intending to foreclose these alternative approaches, however, this article adopts the more institutional concept because it can be applied directly to the exchange-rate policymaking apparatus of the euro area, has been neglected in previous articles, and is particularly suitable for a comparison of accountability in the United States and euro area.

3 See also Freeman 2002, which evaluates the applicability of the concept of 'expert democracy' to monetary policy.

4 The Nice treaty changed the decision rule for external representation from unanimity to qualified majority.

5 The IMF staff drew attention to lack of transparency of the exchange-rate policymaking process in its 2001 report on the euro area, IMF 2001.

6 The latter is examined in Henning (2006).

7 These are critical contributions to a debate over global current account adjustment that is broad ranging. This paper does not hinge on the normative questions in this debate – such as the sustainability of the imbalances and the responsibility of the United States, euro area and East Asia, among other actors, for reducing them – interesting as such questions are. The argument developed here hinges instead on the impact of China's exchange rate policy on the economies of the United States and euro area and the responses of the two authorities.

8 See http://www.chinacurrencycoalition.org/members.html. Accessed December 11, 2006.

9 Search conducted on http://thomas.loc.gov/home/c109query.html in December 2006. Hufbauer *et al.* (2006) count 23 such bills between February 2003 and March 2006.

10 European Commission, 'Bilateral Trade Relations with China', accessed June 22, 2006 at http://ec.europa.eu/comm/trade/issues/bilateral/countries/china/index_en.htm.

11 'We continue to monitor exchange markets closely and cooperate as appropriate. In this context, we emphasize that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms'. Statement of G-7 Finance Ministers and Central Bank Governors (2004).

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12 A search on congressional hearings during 2003–2005 mentioning the 'exchange rate' generated 7 at which the phrase was mentioned more than 30 times, 2 at which the phrase was mentioned 20–29 times, 9 at which it was mentioned 10–19 times, and more than 100 at which it was mentioned 1–9 times. Thirty-two hearings addressed China specifically. Conducted in April 2006 at http://www.gpoaccess.gov/chearings/search.html.

13 Confindustria, *Economic Outlook*, September 2003 (especially p. 10) and December 2005, as well as its *Report on Italian Industry*, October 2004. Available at http://www.confindustria.it.

14 UNICE, 'UNICE Position Paper on EU-China Relations', Brussels, May 8, 2006, available at www.unice.org. Interestingly, Confindustria argued that renminbi undervaluation should be addressed within the International Monetary Fund, rather than through EU or euro area machinery. Confindustria, *Economic Outlook*, December 2003: 10

15 To the extent that the available data allow a comparison. See Eurostat database, Foreign Direct Investment, available at http://epp.eurostat.ec.europea.eu.

16 While applauding China's modest revaluation in mid-2005, Weber (2005) and Issing (2005) take this essential position. Ahearne and von Hagen (2005) and Pisani-Ferry and Sapir (2005) inveigh against European complacency with respect to the renminbi, which they also describe as pervasive.

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The legitimation of EMU: Lessons from the early years of the euro[1]

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ABSTRACT

Political economists have raised concerns that EMU's asymmetric institutional design leaves the project's legitimacy vulnerable to fluctuations in the perceived advantages and disadvantages of the euro. The evidence presented in this paper suggests that overall support for EMU within the euro area remained high over the period 1999–2005, thus allaying concerns over the project's legitimacy. At the same time, public attitudes towards EMU did vary from one euro-area member to another with perceived rather than actual economic performance appearing to be an important factor behind this cross-country variation. In policy terms, these findings underline the need for a system of euro-area economic governance that promotes a high degree of support for the single currency over the long-term. This will necessitate a more effective approach to output legitimation as well as policies that seek legitimacy for EMU by emphasising process, values and inputs.

KEYWORDS

EMU; The euro; economic governance; legitimacy; accountability; public opinion.

1. INTRODUCTION

The question of how approaches to economic governance that go beyond national borders can secure legitimacy is an enduring one in the international political economy literature (Dahl, 1999; Grant and Keohane, 2005; Held, 1995; Moravcsik, 2004). In recent years, there has been a succession of studies on the openness, transparency and accountability of bodies such as the International Monetary Fund (Woods, 2001), the World Bank (Stiglitz, 2003) and the World Trade Organisation (Howse and Nicolaidis, 2003).

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Perhaps the richest vein of research in this field has centred on the legitimation of the European Union (EU) and the so-called democratic deficit (Follesdal and Hix, 2006; Majone, 2000; Moravcsik, 2002). An important sub-strand of this debate concerns the question of how European Economic and Monetary Union (EMU), with its independent, supranational central bank and decentralised system of fiscal governance, can achieve legitimacy.

Legitimacy is a slippery concept that can mean different things to different authors. It is employed in (at least) three ways in the political economy literature on EMU. Firstly, legitimacy can refer to the democratic underpinnings of EMU i.e. the accountability of the European Central Bank (ECB) and other EU institutions to the public and its elected representatives (Amtenbrink, 1999; Buiter, 1999). Secondly, it can reflect sovereignty concerns i.e. the willingness of Member States to give up national currencies, cede control over monetary policy and coordinate their economic policies (Calmfors, 2001; Maes, 2002). Finally, it can refer to domestic support for the euro i.e. the conferral of popular consent on EMU over the long term by euro area Member States and their citizens (Hodson and Maher, 2002; Verdun and Christiansen, 2000). Concentrating on this third conception, this article explores the legitimacy and legitimation of EMU during the period 1999–2005.

Scholars offer a rather stark assessment of EMU's ability to secure and retain popular support over the long term. A recurring argument in the literature, largely theoretical in its focus, is that the euro area's asymmetric institutional design, which is built around a single supranational central bank and multiple national fiscal authorities, could pose problems for the project's legitimacy. Dyson (1994) articulates this position clearly when he argues that 'in the absence of a European political order that promotes an effective identification with a single currency, by means of a range of common political symbols and channels for popular participation and influence, a depoliticized monetary policy lacks essential legitimacy' (Dyson, 1994: 336).

Jones (2002: 77) offers a different view, arguing that EMU is, in a sense, a democratic 'non-event' as the euro is designed neither to benefit the interests of a particular coalition nor to constrain the size of government expenditure or the scope of redistributive policies. However, Jones (2002: 167) also recognises that EMU is not just 'a technology for the de-politicisation of monetary policy' but also a symbol of the evolving relationship between states and between European people and European governance. In this respect, the author finds evidence that public support for EMU is closely intertwined with support for EU membership, the perceived costs and benefits of European integration and the degree of satisfaction with EU democracy.

Verdun and Christiansen (2000: 178) go further when they warn that the failure of EMU's architects to embed the euro in a 'wider European polity'

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leaves the euro's legitimacy dangerously dependent on its perceived economic benefits and hence on short-term economic fluctuations. For the authors, the Werner Report of 1970 offered a more legitimate vision of EMU by proposing a supranational and democratically accountable economic authority to balance integration in the economic and monetary sphere (Verdun and Christiansen, 2000: 165).

For Hodson and Maher (2002), EMU's reliance on a strategy of output legitimation is made more problematic by the existence of few definite outputs against which to evaluate the euro.[2] This difficulty, it is argued, is more serious with respect to the economic aspects of EMU. Whereas euro-area monetary policy has an explicit mandate to maintain price stability, there is a degree of uncertainty about whether the economic dimension of EMU should be judged on its ability to deliver economic growth, macroeconomic stability, job creation . . . etc. For the authors, the legitimacy of EMU could be at risk unless policy makers can develop a set of popularly-accepted performance indicators for understanding and interpreting the economic achievements of the euro.

To what extent have concerns over EMU's legitimacy been borne out in practice? This paper finds that although overall support for EMU remained strong during the period 1999–2005, there are signs that attitudes towards the single currency were influenced by perceived rather than actual economic performance. In the first place, the perception that the euro cash changeover caused prices to rise sharply, though not supported by the economic data, appears to have weighed on EMU's legitimacy in some countries, as have expectations concerning future economic developments. Furthermore, survey data suggests that those viewing the euro as advantageous tended to focus on the single currency's benefits for travel and trade and on its political advantages for Europe rather than its contribution to greater macroeconomic stability and historically-low interest rates.

The implications of these findings are three-fold. Firstly, fluctuations in support for EMU demonstrate the need for economic and monetary authorities to pay due regard to the legitimacy of policy making as well as to the more traditional concerns of efficiency and credibility. Secondly, the gap between EMU's perceived and actual economic impact reinforces the role of euro-area economic governance in promoting greater understanding of the single currency's benefits and allaying concerns over its perceived costs. Thirdly, the importance of popular perceptions in shaping the legitimacy of EMU underlines the limits of elite-driven and technocratic approaches to monetary integration and demonstrates the need for more broad-based mechanisms of legitimation.

The remainder of this paper is divided into four sections. Section 2 examines the evolution of popular support for EMU over the last seven years and the factors that may have influenced it. Section 3 explores the factors that may have shaped the euro's perceived utility, including the impact of the

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euro cash changeover. Section 4 considers the implications of these findings for euro-area economic governance. Section 5 concludes with some general remarks on the implications of these findings for the political economy of transnational economic governance.

2. POPULAR SUPPORT FOR EMU

There are obvious methodological limitations to using survey data to measure popular support for EMU. For one thing, the complexity of EMU's institutional design implies that a term such as 'single currency' might mean different things to different respondents. For example, some people might focus on euro notes and coins while others might think of euro-area monetary policy, the Stability and Growth Pact and aspects of the Lisbon Strategy. Furthermore, survey data on public attitudes towards EMU are typically gathered on an annual or semi-annual basis. As a result, the data offer a series of snapshots of public opinion on the single currency rather than a moving picture. Balancing these caveats against the paucity of alternative data sources, this section uses survey data gathered by Eurobarometer to examine support for, and opposition to, EMU in euro area Member States.

The starting point for this analysis is the Standard Eurobarometer Survey, which is published twice a year and based on face-to-face interviews with approximately 1,000 respondents in each of the EU's Member States. Among the many questions contained in this survey, respondents are asked whether they are for or against 'a European Monetary Union with one single currency, the euro'. Tables 1 and 2 summarise the responses to this question in euro area Member States over the period 1999–2005.

Table 1 For a European Monetary Union with one single currency, the euro: (1999–2005)

	1999	2000	2001	2002	2003	2004	2005
AT	56	51	64	74	70	71	65
BE	77	74	74	82	83	86	84
FI	53	47	49	65	73	76	77
FR	66	65	65	69	72	73	76
IE	75	66	73	79	78	84	86
LU	82	78	83	90	86	87	87
DE	56	49	57	66	65	64	59
EL	68	70	76	76	67	63	49
ES	71	72	69	79	73	72	58
IT	85	80	81	82	76	66	67
NL	73	66	69	71	65	65	71
PT	62	61	63	72	72	67	65

Note: Average of responses for Spring and Autumn surveys except 2005 which is based on Spring only.
Source: Standard Eurobarometer Surveys 51–63.

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Table 2 Against a European Monetary Union with one single currency, the euro: (1999–2005)

	1999	2000	2001	2002	2003	2004	2005
AT	30	38	29	18	22	21	30
BE	18	23	20	13	14	13	16
FI	43	49	47	31	25	23	22
FR	29	31	29	27	24	23	21
IE	13	21	16	13	14	11	11
LU	12	19	15	8	13	12	12
DE	35	42	35	26	28	33	38
EL	21	20	19	21	30	35	49
ES	17	21	22	15	22	25	32
IT	10	16	13	14	20	28	26
NL	23	29	27	26	32	33	27
PT	23	24	27	21	23	27	27

Note: Average of responses for Spring and Autumn surveys except 2005 which is based on Spring only.
Source: Standard Eurobarometer Surveys 51–63.

The data show that EMU enjoyed a high level of popularity after seven years of the euro. In 11 out of 12 Member States, a majority of respondents supported the single currency at the end of the sample period. This figure was higher than 75 percent in five of these Member States. In only three cases did support for EMU actually fall below the 50 percent mark. In Finland, the euro's approval rating in 2000 and 2001 stood at 47 and 49 percent, respectively – thereafter rising to among the highest levels in the euro area. In Germany, support for EMU fell to 49 percent in 2000 before recovering steadily in the remainder of the sample period. The most worrying case is Greece, where opposition to EMU more than doubled over the sample period. In 2005, support for, and opposition to, the single currency in Greece were tied at 49 percent.

Looking at the evolution of popular support for EMU over time, Member States can be divided into two broad groupings. The first group, which includes Austria, Belgium, Finland, France, Luxembourg and Ireland, experienced a consolidation in support for EMU over the period 1999–2005. In some countries, including Ireland, this consolidation coincided with a sharp drop in the number of respondents who are undecided about EMU, while in others, such as Finland, opposition to EMU fell significantly.

The second group, which comprises Germany, Greece, Italy, the Netherlands, Portugal and Spain, experienced stagnant or falling support for EMU over the sample period. In three cases, Germany, the Netherlands and Portugal, support for and opposition to the euro were roughly the same in 2005 as in 1999 – in the interim, the single currency gained support but this was subsequently eroded. In the rest of the group, the euro has experienced a

sharp decline in popularity. Between 1999 and 2005, EMU's supporters fell by 19 percentage points in Greece, 13 percentage points in Spain and 18 percentage points in Italy. During this period, EMU's opponents increased by 28 percentage points in Greece, 15 percentage points in Spain and 16 percentage points in Italy.

How can these cross-country variations in support for EMU be explained? Two broad explanations are considered in the remainder of this section. The first considers whether support for EMU reflects more general attitudes towards EU membership. The second asks whether support for EMU is rooted in the perceived advantages and disadvantages of the euro.

The euro is a tangible symbol of European integration and it is plausible that support for EMU may be shaped by more general attitudes towards the EU.[3] To shed light on this issue, Table 3 measures the correlation between support for (opposition to) the euro and the belief that EU membership is a good (bad) thing, using the standard Eurobarometer survey.[4] Overall, the evidence of a linear relationship between support for EMU and EU membership is mixed. In only five Member States is there is a positive and statistically significant relationship between support for EMU and favourable attitudes towards EU membership. Opposition to EMU and dissatisfaction with EU membership are positively related in only three Member States. In Germany, Greece and Spain, there is a negative and statistically significant relationship between opposition to EMU and dissatisfaction with EU membership. This suggests that the cautiousness of these Member States

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Table 3 Support for EMU and Attitudes towards EU Membership (Pearson coefficient, 1999–2005)

	Support for the euro and EU membership a good thing	Opposition to the euro and EU membership a bad thing
AT		
BE	0.62*	0.55*
FI	0.62*	
FR	0.56*	0.63*
IE		0.68**
IT		
LU	0.71**	
DE		−0.73**
EL		−0.69**
ES		−0.84**
NL	0.65**	
PT		

Note: * and ** denote statistical significance at the 5 and 1 percent confidence levels, respectively.
Source: Authors' own calculations based on semi-annual Standard Eurobarometer Surveys 51–63.

towards the euro is not associated with a more general loss of support for EU membership.

To what extent is cross-county variation in support for EMU associated with output legitimacy i.e. with differing views on the economic advantages and disadvantages of the euro? It is more difficult to answer this question empirically as survey data on the perceived utility of the euro are available for the last four years only. Since 2002, a Flash Eurobarometer Survey on Public Opinion and EMU has been conducted based on telephone surveys of approximately 1,000 respondents in each euro area Member State. Respondents are asked the following question: 'In your opinion, for our country, is the adoption of the euro an operation that is advantageous overall and will strengthen us for the future, or rather the opposite, that is disadvantageous and will weaken us for the future?'. Table 4 presents the responses to this question over the period 2002–2005.[5]

Overall, the results suggest a tentatively positive relationship between support for EMU and the perceived utility of the single currency. In Austria, Belgium, Finland, France, Ireland and Luxembourg, Member States where support for EMU was strong, the percentage of respondents viewing the euro as overall advantageous remained above the 50 percent threshold throughout the sample period. In the remaining Member States, where support for EMU was lower, the percentage of respondents viewing the euro as overall advantageous generally remained below the 50 percent threshold. In the same Member States, the percentage viewing the single currency as overall disadvantageous was generally higher, reaching nearly 50 percent in Germany, Greece and the Netherlands after four years of euro notes and coins.

Table 4 The euro is overall advantageous or disadvantageous (2002–2005)

	Advantageous				Disadvantageous			
	2002	2003	2004	2005	2002	2003	2004	2005
AT	52	58	53	54	24	22	25	28
BE	72	70	69	68	16	18	20	21
FI	65	74	72	67	11	12	13	17
FR	65	61	66	57	23	28	30	33
IE	73	75	74	72	19	18	18	18
LU	72	79	77	77	14	12	13	12
DE	39	42	41	47	52	52	50	48
EL	46	52	51	39	22	39	38	49
ES	62	62	62	61	18	20	23	28
IT	57	47	50	43	29	39	36	43
NL	42	43	39	38	41	46	50	48
PT	57	48	55	45	25	30	24	32

Source: Flash Eurobarometer Surveys 139, 149, 153, 165 and 175.3.

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There are exceptions to this rule, however, suggesting that output is not the sole determinant of support for EMU. Although Austria, Belgium, Finland and France showed strong support for EMU, the percentage of respondents viewing the euro as overall disadvantageous appears to be on an upward trend. This trend is particularly pronounced in France, where the percentage of respondents considering the euro to be overall disadvantageous increased from 23 to 33 percent between 2002 and 2005. At the same time, not all Member States where support for EMU been less robust grew more critical of the single currency's advantages. For example, in Spain, the percentage of respondents viewing the euro as overall advantageous remained in the vicinity of 60 percent between 2002 and 2005 in spite of the country's sharp fall in support for EMU over this period.

Summing up, four key findings can be drawn from this section. Firstly, the high level of support enjoyed by the single currency seven years afer EMU's lauch suggests that talk of a legitimacy crisis in the euro area is overstated. Secondly, the experience of Member States has been far from uniform, with the euro growing in popularity in some countries but failing to do so in others. The most worrying cases in this respect are Italy, Greece and Spain, where support for the euro dipped sharply after 1999. Thirdly, the link between support for EMU and its perceived advantages and disadvantages are consistent with the view that output is a key factor in shaping the single currency's legitimacy. By and large, Member States that showed a high level of support for EMU also considered the euro to be advantageous and *vice versa*. Finally, the exceptions to this rule suggest that output is not the sole determinant of support for EMU.

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3. FACTORS INFLUENCING OUTPUT LEGITIMACY

There is a growing body of empirical work that explains popular support for the EU in terms of the economic benefits stemming from integration. Focusing on macroeconomic factors, Eichenberg and Dalton (1993) find that unemployment and GDP had a limited impact on popular support for the EU over the period 1973–1998, but that inflation had a strong negative effect. Focusing on microeconomic factors, Gabel (1998) finds that individual-level support for EU membership over the period 1978–1992 is positively related to the level of human capital (education), financial capital (income) and location (residence in an intra-EU border region).

Subjective assessments of the benefits of EU integration are also adjudged to be an important determinant of popular support for EU membership. Gabel and Whitten (1997) find that perceived economic performance had a positive and statistically significant impact on support for EU Membership over the period 1984–1989. Eichenberg (1999) goes one step further, arguing that the gap between perceived and actual economic performance

may have been heightened by the Maastricht Treaty. In particular, he finds that the impact of perceived economic performance on support for EMU was lower in the post-Maastricht period but that respondents are more likely to link perceived economic performance to the effects of European integration.

There are comparatively few empirical studies on the link between popular support for EMU and the economic benefits of the euro, with most focusing on the convergence period prior to the launch of the single currency. Gärtner (1997), for example, finds a positive link between support for EMU in 1995 on the one hand and past experience of high inflation and public debt and the length of membership of the European Monetary System on the other. In a similar study, Kaltenthaler and Anderson (2001) find that support for EMU over the period 1994–1997 was higher in Member States with past experience of high rates of inflation and current high levels of unemployment and in Member States with close trade ties with the rest of the euro area.

This section takes a rudimentary look at the factors that may have influenced popular support for EMU following the launch of the euro. The basis for this analysis is the Flash Eurobarometer Survey of 2004 which asks (a) respondents who consider the euro to be overall advantageous what they consider to be the main advantages of the euro, and (b) respondents who consider the euro to be overall disadvantageous what they consider to be

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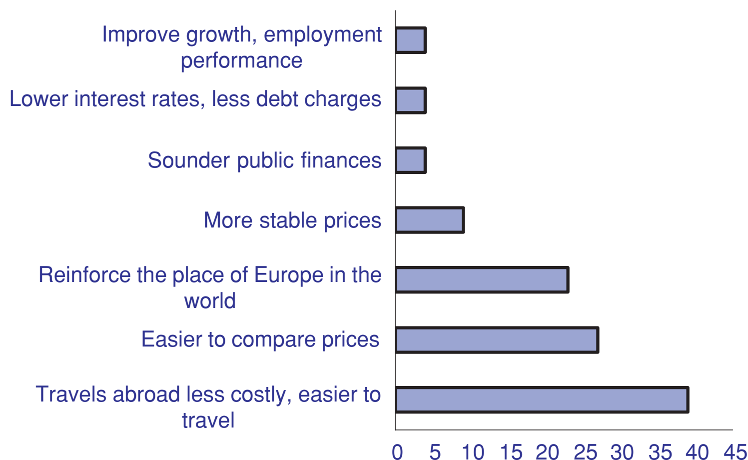

Figure 1 Main reasons for viewing the euro as overall advantageous. *Source:* Flash Eurobarometer Survey 175. *Note:* Other reasons accounted for 32 and 9 percent accounted for don't knows. The relatively high number of respondents citing 'other reasons' indicates that the survey did not capture all the reasons for viewing the euro as overall advantageous

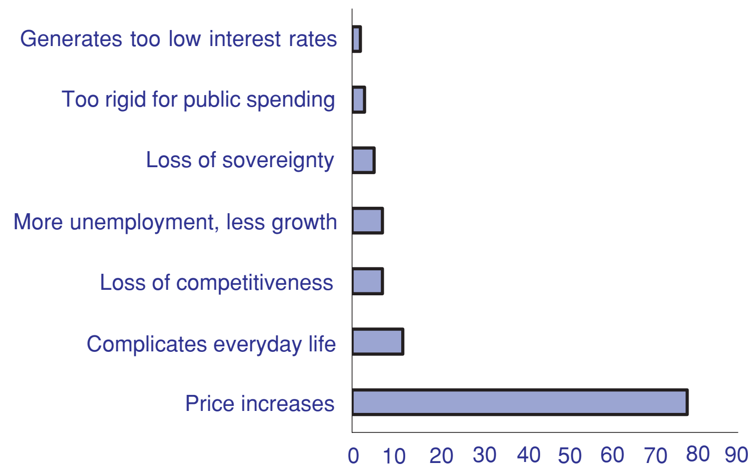

Figure 2 Main reasons for viewing the euro as overall disadvantageous. *Source:* Flash Eurobarometer Survey 175. *Note:* Other reasons accounted for 18 and 8 percent accounted for don't knows. The relatively high number of respondents citing 'other reasons' indicates that the survey did not capture all the reasons for viewing the euro as overall disadvantageous.

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the main disadvantages of the euro. Figures 1 and 2 present the results of the Flash Eurobarometer Survey for the euro-area aggregate.

For respondents that consider the euro to be overall advantageous, microeconomic reasoning dominates. For example, around 39 percent of those interviewed said that a main benefit of the euro was that it makes travel abroad easier and lowers the cost of travel, while 27 percent agreed that it made prices easier to compare. Political factors also play a role, with 23 percent of respondents welcoming the fact that the euro reinforces Europe's place in the world. Macroeconomic reasons seem to be largely irrelevant. Only 4 percent of people, for example, considered that the euro has had a positive impact on growth and employment, contributed to sounder public finances and reduced interest rates and debt charges. This pattern also describes attitudes at the Member State level, although the intensity of preferences varies. A notable outlier is Greece, where 23 percent of respondents agreed that the euro has made prices more stable.

For respondents that considered the euro to be overall disadvantageous, concerns over inflation dominated. In the euro area as a whole, 78 percent of respondents considered price increases to be a main drawback of the single currency. By and large, respondents did not identify with the other economic and political disadvantages of the euro. The second most popular complaint is that the euro complicates everyday life, but only 12 percent of people supported this proposition. This pattern remains fairly constant at the national level, with the perception that the euro caused prices to

rise ranging from a high of 89 percent in Italy and Austria to a low of 61 percent in France, Belgium and Ireland. An unusual case is Portugal, where, in addition to complaining of prices rises, an above average percentage of respondents blamed the euro for causing higher unemployment and less growth (17 percent), a loss of competitiveness (17 percent), too low interest rates (9 percent) and constraints on public spending (6 percent).

Thus, EMU's output legitimacy appears to have been negatively affected by the euro's perceived impact on prices. To what extent is this perception supported by the facts? Figures 3 and 4 show annual rates of harmonised consumer price inflation in the two groups of euro area Member States over the period 1999–2005. Certainly, inflation pressures were present in some Member States that grew more critical of the euro. In Spain and Greece, inflation rates have remained between 0.5 and 1.6 percentage points above the euro-area average between 1999 and 2005. In the Netherlands and Portugal, this differential exceeded 2 percentage points in 2001, as a period of overheating reached its peak. This does not mean, however, that scepticism with the single currency and above-average inflation go hand in hand. Italy and Germany, both of which remained circumspect about the single currency's benefits, experienced rates of inflation that were close to (in the case of the former) or below (in the case of the latter) the euro-area average since 1999. Meanwhile, in Ireland, support for the euro remained strong even though its inflation rate outstripped the euro-area by between 1.3 and 3.2 percentage points in the first five years of the euro.

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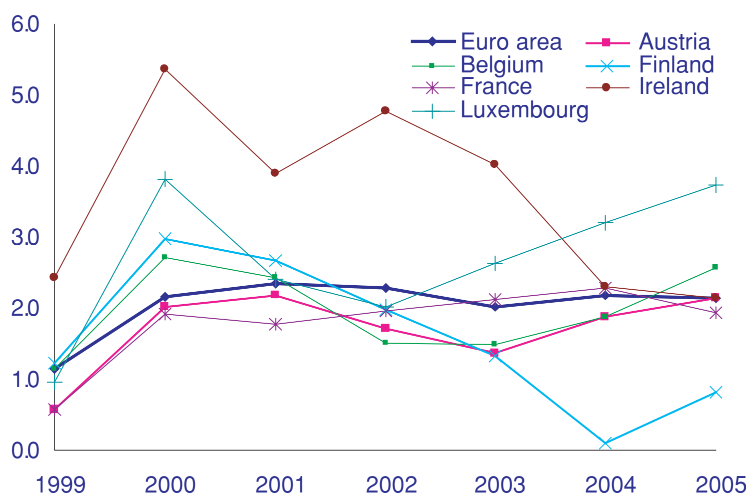

Figure 3 Harmonised index of consumer prices (annual % change, 1999–2005). *Source:* European Commission AMECO database.

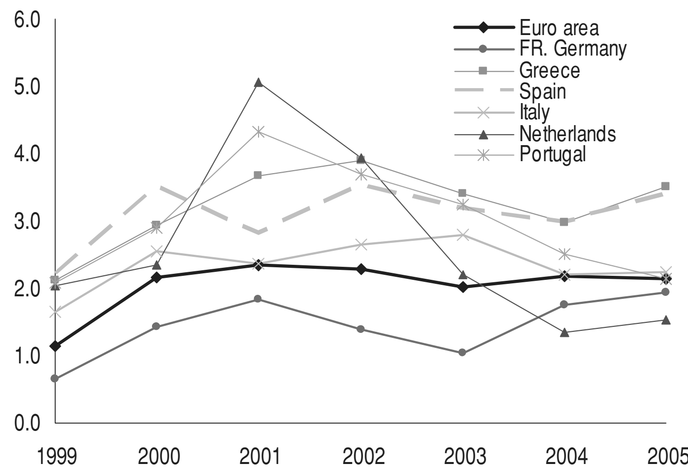

Figure 4 Harmonised index of consumer prices (annual % change, 1999–2005). *Source:* European Commission AMECO database.

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The gap between actual and perceived inflation among Member States appears to have been driven, in part, by the changeover from national currencies to euro notes and coins, which began on 1 January 2002. According to an *ex-post* study by Eurostat (2003), the impulse given by the euro cash changeover to consumer price inflation was minor – somewhere in the region of 0.1–0.3 percentage points for the euro area as a whole. Nevertheless, there appears to have been a widespread belief among consumers that the introduction of euro notes and coins caused a sharp increase in the general price level. This may have been due to, *inter alia*, disproportionately large increases in the price of frequently purchased goods and services, a sharp rise in the price of alcohol and tobacco and a heightened interest in price developments. To what extent was the impression of sharp rises in consumer prices more pronounced in Member States where support for EMU has stagnated or fallen?

Each month, as part of the European Commission's Harmonised Consumer Survey, around 33,000 consumers across the 25 Member States are asked to give their subjective assessment of price developments over the previous 12 months. The results are conveyed in the form of a 'balance statistic' which ranges between 100 (when all respondents reply that consumer prices have risen a lot in the last 12 months) and –100 (when all respondents consider that consumer prices have fallen). Treating this balance statistic as a subjective measure of inflation, Table 5 compares actual and perceived changes in consumer prices between 2001 and 2002 – the period of the euro cash changeover – with changes in support for and opposition to the euro since the launch of EMU.

Table 5 Euro cash changeover and support for EMU (percentage points change)

	Perceived inflation* (2001–2002)	Actual rate of inflation** (2001–2002)	Support for the euro (1999–2005)	Opposition to the euro (1999–2005)
PT	15.0	−0.7	3.0	5.0
BE	17.0	−0.9	8.0	−2.0
FI	17.0	−0.7	25.0	−21.0
FR	23.0	0.2	10.0	−8.0
IE	30.0	0.7	12.0	−2.0
AT	30.0	−0.6	10.0	0.0
DE	33.0	−0.6	3.0	4.0
ES	35.0	0.8	−13.0	16.0
EL	36.0	0.3	−19.0	29.0
NL	43.0	−1.2	−2.0	5.0
IT	46.0	0.3	−18.0	16.0

Notes: *change in balance statistic for price developments over the previous 12 months; **change in harmonised consumer price inflation.
Source: European Commission's AMECO Database and Consumer Survey.

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Overall, these data suggested that in Member States where support for EMU has fallen and opposition to EMU has increased since 1999, the gap between perceived and actual inflation was relatively large around the time of the euro cash changeover. In Italy and Greece, the perceived inflation index jumped by 46 and 36 points, respectively, in 2002, in spite of a moderate acceleration in the actual rate of inflation. In the Netherlands, Germany and Portugal, perceived inflation rose even though the rate of actual inflation slowed. This discrepancy was particularly pronounced in the Netherlands, where the perceived inflation index increased by 43 points while actual inflation fell by 1.2 percentage points.

As noted above, a recurring theme in the literature is that the perceived economic benefits of integration can have a marked impact on public opinion. To put this idea to the test for the case of EMU, the remainder of this section considers the link between the perceived benefits of the euro and subjective assessments of the economic outlook. Once again, the Standard Eurobarometer Survey comes in useful, as it asks respondents whether they expect their national economic performance in the following 12 months to be worse, the same or better. Combining these data with those from the Flash Eurobarometer Survey discussed in Section 2, Figure 5 plots the percentage of respondents who expected the economic situation to deteriorate against the percentage of respondents considering the euro to be overall advantageous. Figure 6 does the same for respondents expecting the economic situation to improve and those considering the euro to be overall advantageous.

Figure 5 gives evidence of a positive and non-trivial relationship between the expectation that the national economy will perform worse in

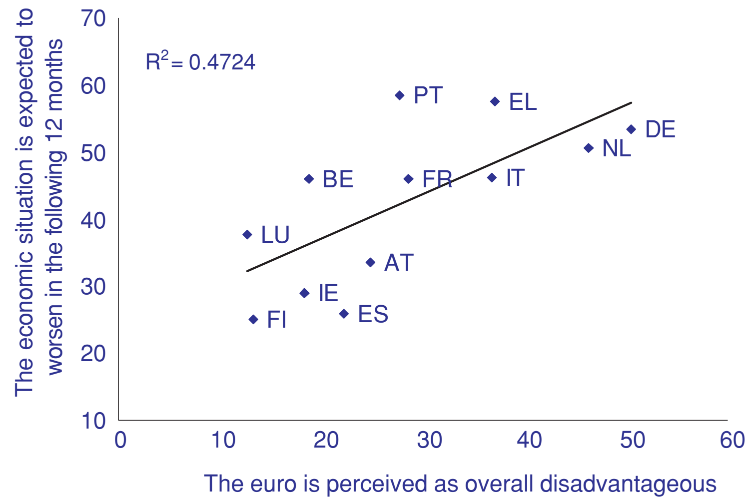

Figure 5 The expected performance of the national economy and the perception of the euro as overall disadvantageous (average 2002–2005). *Source:* Eurobarometer. *Note*: R^2 rises to 0.5811 if Portugal is deleted from the sample.

the following year and the perception that the euro is overall disadvantageous. This would explain why public opinion in Member States such as Italy and the Netherlands focused on the perceived disadvantages of the euro; there was a general expectation in these Member States that the economic situation would worsen during the sample period in question. In Figure 6, the link between an expected improvement in the national economy and the perception that the euro is overall advantageous appears to be weaker. This suggests that the output legitimation of EMU may be asymmetric with the single currency losing support in economic upturns more rapidly than it gains support during economic upturns. This may reflect the cautiousness of respondents when assessing the economic outlook for the coming year; positive assessments of the economic outlook fluctuate less than expectations that it will get worse or stay the same. This asymmetry may also be linked to the observation in Figures 1 and 2 that macroeconomic reasons feature more prominently in the perceived disadvantages of EMU than in the perceived advantages.

Evidently, there are limitations to this simplified analysis of popular support for EMU. For example, by focusing on cross-country variations, the analysis downplays differences of opinion on EMU within Member States and with this the possible distributional consequences of the single currency.[6] This caveat notwithstanding, three tentative points emerge from the preceding analysis. Firstly, those who consider EMU to be overall advantageous focus on the single currency's benefits for travel and

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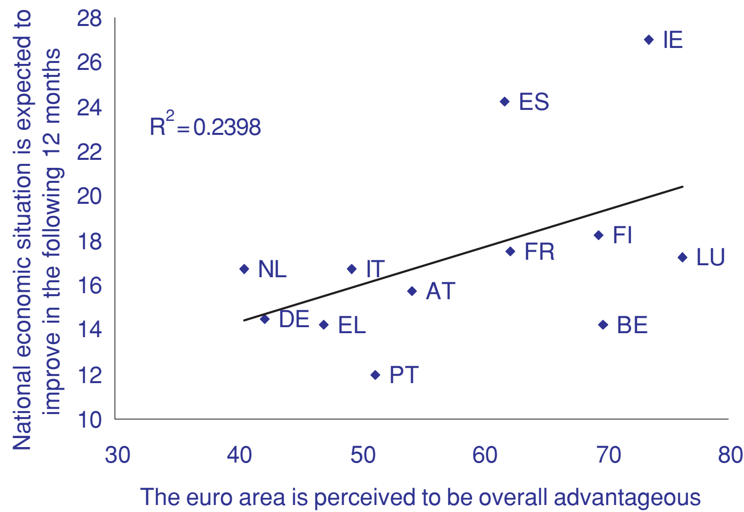

Figure 6 The expected performance of the national economy and the perception of the euro as overall advantageous (average 2002–2005). *Source*: Eurobarometer.

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trade and on its political advantages for Europe, but attach little weight to its macroeconomic benefits. Secondly, those who view EMU as overall disadvantageous, above all, blame the single currency for causing price increases. This view appears to be driven by perceptions rather than reality. Consumer price inflation has not been highest in Member States that have grown most sceptical about the euro's benefits. However, the gap between perceived and actual inflation following the euro cash changeover appears to have been pronounced in these countries. Thirdly, attitudes towards the single currency may have been influenced by the economic outlook. In particular, it appears that people are more likely to view the euro as disadvantageous when they expect the economic situation to be worse the following year.

4. POLICY IMPLICATIONS

The empirical evidence presented in this paper suggests that legitimating EMU is no longer just a theoretical exercise for political economists, but also a practical concern for euro-area policy makers. In general, there are reasons to be positive, with EMU enjoying widespread support and the single currency being viewed as broadly beneficial by the majority of people in euro-area countries. Nevertheless, the failure of the euro to build on its popularity in some Member States and a growing sense of scepticism in others shows that EMU's legitimacy cannot be taken for granted.

Of particular concern is EMU's seeming reliance on a process of output legitimation in which the perceived costs and benefits of the euro are imperfectly correlated with the actual costs and benefits. A striking feature of the survey data reviewed in this paper is that euro supporters tend to discount the historically low interest rates and generally improved fiscal positions experienced under EMU while the euro's critics accuse EMU of causing prices to rise at a time of historically low inflation. The overarching policy implication of these findings is two-fold. Firstly, to the extent that EMU continues to rely on a process of output legitimacy, euro-area policy makers must strive not only to make EMU an economic success but also to ensure that people give it sufficient credit for doing so. Secondly, to the extent that long-term support for the euro cannot be secured through output legitimacy alone, euro-area policy makers must turn to the alternative channels of legitimacy: process, values and inputs.

In recent years, there have been several attempts by EU policy makers to enhance EMU's legitimacy. In particular, steps have been taken to enhance process legitimacy by promoting greater transparency over euro-area monetary policy and input legitimacy by encouraging elected officials at the Member State and EU level to hold euro-area policy makers to account.

Progress has been most significant in the monetary domain, where the European Parliament's Economic and Monetary Affairs (ECON) Committee has steadily upgraded its Monetary Dialogue with the ECB President. Although it may lack the political visibility of, say, the Federal Reserve Chairman's appearances before the Joint Economic Committee of the United States Congress, the Monetary Dialogue has developed into a high-profile set-piece in which the ECB President can be questioned by MEPs before the gaze of the euro-area's financial press. In addition to its role in promoting input legitimacy, the Monetary Dialogue has had a degree of success in promoting greater process legitimacy by, *inter alia*, encouraging the ECB to publish its macroeconomic forecasts.

In the economic domain, the growing use of the term 'economic governance' by euro-area policy makers suggests a greater sensitivity to the legitimacy of EMU, at least on a semantic level. As the European Commission (2004: 349) has recognised, economic governance goes beyond traditional terms such as 'economic policy coordination' and 'economic cooperation' to embrace broader questions of 'accountability, transparency and responsibility' (European Commission, 2004: 349). In terms of practical follow-up, the EU's economic governance agenda has yielded a number of policy initiatives. These include an invitation to National Parliaments to become more involved in EU economic surveillance by, *inter alia*, providing input into National Reform Programmes under the re-launched Lisbon Strategy and discussing Member States' Stability Programme updates under the revised Stability and Growth Pact. There are also signs that the European Parliament is seeking to enhance the input legitimacy of EMU's economic

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dimension by inviting the Eurogroup and Commission to take part in a 'more regular and structured dialogue on macroeconomic issues... similar to the monetary dialogue between the Parliament and the ECB' (European Parliament, 2006: 28).

It is premature at this stage to speculate on what impact these policy initiatives will have on EMU's legitimacy. What is certain, however, is that such measures are piecemeal and that none challenge, what many political economists consider to be, the structural determinants of EMU's legitimacy challenge: the absence of a *gouvernement économique* at the euro-area level.

On the basis of the analysis presented in this paper, there are reasons to be agnostic about the ability of a euro-area economic authority to secure the long-term legitimacy of the single currency. One the one hand, it could be argued that a *gouvernement économique* could help to counter both misperceptions of EMU's effects and attempts to scapegoat the euro for economic reforms. On the other hand, it is unclear precisely what a new centralised economic authority could do to explain the effects of EMU on euro-area inflation that the existing centralised monetary authority could not. A more fundamental doubt here concerns the means by which a fully-fledged euro-area economic authority would itself secure legitimacy. Indeed, if scapegoating of the EU is commonplace, then the creation of a *de novo* supranational institution could fuel controversies over the legitimacy of European involvement in a domain where Member States have traditionally enjoyed (the appearance of) sovereignty. At a minimum, these reservations call for further research on the pursuit of legitimacy under EMU's asymmetric institutional architecture.

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5. CONCLUDING REMARKS

The Canadian explorer, Vilhjalmur Stefansson, once wrote, 'There are two kinds of Arctic problems, the imaginary and the real. Of the two, the imaginary are the most real'. The findings presented in this paper suggest that Stefansson's adage could equally be applied to the legitimation of monetary integration. Although support for the euro remained strong during the period 1999–2005, the perceived disadvantages of the single currency appear nevertheless to have weighed on EMU's legitimacy. This effect was particularly pronounced in Germany, the Netherlands and Portugal, where support for EMU stagnated after 1999, and, to an even greater extent, in Greece, Italy and Spain, where it has dropped. With the exception of Spain, this development can be linked to a high or growing degree of scepticism concerning EMU's advantages, which in turn is associated with the widespread belief that the euro cash changeover in 2002 caused prices to rise. That such a belief is not supported by the economic facts, which show that inflation remained broadly stable over this period, makes the challenge of legitimating EMU no less real.

These findings are also relevant for our understanding of the political economy of transnational economic governance. They suggest that whereas an elite-driven, technocratic consensus may sometimes provide the catalyst for international economic policy coordination, the long-term legitimacy of such initiatives is likely to require more solid foundations. Where the effects of transnational economic governance are widespread, output legitimacy is likely to play some role for the simple reason that people will form views regarding the positive and negative effects of transnational economic governance which in turn may affect their support for the project. Under such circumstances, there is a real need for a system of governance that not only delivers economic results but that also promotes a widespread understanding of its economic achievements. By the same token, positive outputs do not always translate into increased support for transnational economic governance. For this reason, other mechanisms of legitimation will be important too, including policies that build support for the euro through the channels of process, values and inputs.

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NOTES

1 The views expressed in this paper are strictly personal and should not be attributed to the European Commission. Thanks to Erik Jones, Lars Jonung, Ivo Maes, Tal Sadeh and Amy Verdun for comments on an earlier version of this paper. The usual disclaimer applies.
2 Here and in the rest of the paper, the political science concept of output, which refers to the outcome of policy making, should not be confused with the economic concept of output, which refers to the total value of goods and services produced by an economy.
3 For this reason it is also possible that attitudes towards specific EU policies could 'spillover' into support for the euro. As a large number of EU policy areas are of potential relevance here, it is beyond the scope of this paper to explore all conceivable channels of spillover.
4 Respondents are also asked whether they consider support for EU membership to be 'neither good nor bad' or whether they do not know. The responses to these questions are not considered here.
5 The Pearson coefficients for these series suggest a positive and statistically significant relationship between attitudes towards EMU and the perceived utility of the euro in Spain and Greece and a negative and statistically significant relationship in France, Germany, and Luxembourg. Given the short sample period, however, these findings must be interpreted with extreme caution.
6 See Jonung and Vlachos (2007) for an interesting analysis of voters' attitudes towards the costs and benefits of EMU in the Swedish referenda on the euro in 2003.

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Running an enlarged euro-zone - reforming the European Central Bank: Efficiency, legitimacy and national economic interest

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Running an enlarged euro-zone – reforming the European Central Bank: Efficiency, legitimacy and national economic interest

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ABSTRACT

This article analyses the December 2002 reform of decision making in the European Central Bank's (ECB) Governing Council in terms of national economy size reflected in the bargaining power of the ECB Governing Council members and member state macroeconomic interest. The National Central Bank (NCB) governors of the largest member states were concerned about the impact upon ECB monetary policy making of equal representation being extended to future member states. By eliminating equal voting rights, the reform distorts the meaning of equality, representativeness and *ad personam* participation as guiding principles of ECB decision making, moving from equal member state representation towards an emphasis placed upon Euro-zone economy representation. At the same time, two possible concerns watered down efforts to modify 'representativeness' and prevent enlargement contributing to inefficiency in Governing Council decision making. First, the current smaller member state NCB governors opposed a significant reduction of their 'voice' in ECB monetary policy making. Second, legitimacy concerns ensured persistent support for the maintenance of a large and 'decentralised' Governing Council.

KEYWORDS

ECB; EMU; central banking; enlargement; efficiency; legitimacy.

INTRODUCTION

On 19 December 2002, in preparation for the coming into force of the Treaty of Nice, the European Central Bank (ECB) Governing Council adopted a recommendation on new Governing Council voting procedures following the enlargement of the Euro-zone (formally approved on 3 February

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2003).[1] Prior to this agreement, there was a growing literature on the manner in which enlargement should/might affect ECB decision making institutionally including Berger (2002), Buiter (1999), Baldwin *et al*. (2001a, b), Bjorksten (2000), Eichengreen and Ghironi (2001), Fatum (2000) and de Grauwe (2000). This work contributes to the literature focusing on the efficiency of monetary policy making and the coherence of monetary policy making for economically diverse states – including Deutsche Bundesbank (2001), de Grauwe (2000), EP (2001) and Gros and Hefeker (2000). To this can be added the literature on the legitimacy of the existing decision making structures of the ECB, including Buiter (1999), de Haan and Eijffinger (2000), de Haan *et al.* (2005), ECB (2002), Issing (1999) and Leino (2001). Heisenberg (2003) attempts to bridge discussions about efficiency, transparency, enlargement and democratic legitimacy.

This paper analyses the recent agreement on ECB Governing Council reform in terms of national economy size reflected in the bargaining power of the Governing Council members and macroeconomic preference. The reform was subject to consensual decision making in the Governing Council and subsequently met the unanimous approval of national finance ministers in the Economics and Finance Council (Ecofin). While acting in an *ad personam* (that is, independent and personal[2]) capacity, the 12 NCB governors and six Executive Board members of the Governing Council agreed upon a reform that reflects national macroeconomic policy interests and particularly the interests of the member states with the largest economies. The reform conforms *barely* to the principles of *ad personam* participation,[3] equality[4] ('one governor, one vote') and representativeness[5] (all the Euro-zone is represented) set out in the Protocol to the TEC on the Statute of the European System of Central Banks (ESCB) and of the ECB. The reform also *inadequately* addresses concerns about Governing Council decision making inefficiency. In order to prevent enlargement from contributing significantly to decision making inefficiency, the principles of 'equality' and 'representativeness' were distorted. Yet the reform was a 'fudge', stopping far short of the kinds of changes sought by many monetary economists and central bankers. Ultimately, the reform might also reflect the recognition by Governing Council members of the ECB's problematic legitimacy.

This article in effect presents a loose intergovernmentalist explanation – 'intergovernmentalism without governments' – of the agreement on Governing Council reform. Not only does the reform adopted suggest that Governing Council members defended the macroeconomic interests of their home member states but also that the individual members had bargaining power that reflected the size of their home economies which likewise contradicts their *ad personam* status. Despite the official requirement that the ECB targets Euro-zone wide inflation there is suspicion – albeit not yet proven – that the ECB is also particularly preoccupied with the effect

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of its monetary policy on the largest national economies (Heinemann and Huefner, 2004; Howarth and Loedel, 2005).

The ECB reform process lacked transparency. The argument presented in this paper about Governing Council member and member state government preferences is thus speculative. The argument is based on an analysis of the preoccupations about monetary (and specifically ECB Governing Council) decision making that have been outlined by monetary economists and central bankers over the past decade. A small number of ECB officials involved either directly or indirectly with the reform have been interviewed and official justifications of the reform considered. The reform adopted is examined in relation to major reform alternatives that have been presented over the years as more effectively addressing particular concerns (efficiency and/or representation) than others. Critiques of the reform by monetary economists and central bankers are also considered. Based on this analysis, the reform adopted appears to be a trade-off that reflects both 'intergovernmentalism without governments' and legitimacy concerns.

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THE DIFFICULTIES POSED BY ENLARGEMENT: SIZE MATTERS BUT SO TOO DOES REPRESENTATION

The 2000 Intergovernmental Conference which preceded the Nice Summit agreed upon the reform of several EU institutions to cope with a considerable increase in member state numbers yet largely ignored the impact of enlargement upon the operation of the ECB. Article 10.6 was introduced in the Statute of the ESCB and of the ECB calling upon the ECB Governing Council to present a recommendation 'as soon as possible' following the entry into force of the Treaty of Nice on the necessary institutional reforms in the bank to cope with enlargement. While the new EU member states were expected to respect most of the convergence criteria and, following accession, could potentially include their currencies in the Exchange Rate Mechanism (ERM) II, they could only participate in the Euro-zone at a later stage. At the time of writing (January 2007) six of the new member states are ERM II members: Cyprus, Estonia, Latvia, Lithuania, Malta and Slovakia. On 1 January 2007, Slovenia became the 13th Euro-zone member and the Governing Council expanded to 19 members.

The impact of Euro-zone enlargement looms large for the ECB principally because it highlights existing problems with the operation of the Governing Council – problems that reflect the uneasy balance between equality, representativeness and decision making efficiency and effectiveness. The ECB Governing Council is already the largest monetary policy committee of any central bank (the voting contingent of the Federal Open Market Committee (FOMC) of the US Federal Reserve has only 12 members). There is a growing body of work on optimal monetary policy

committee (MPC) size to best ensure decision making efficiency and effectiveness (see Blinder, 2004; Sibert, 2003 and 2006). Sibert (2006) examines the economics literature on monetary policy making by committee and the literature on groups in the other social sciences – especially social psychology – focusing on the effect of size on group performance and decision outcomes. She concludes that the optimal number of MPC members is at least five and not much beyond this. On the basis of such studies, personal experience and observation, many other observers argue that the ECB Governing Council is too large. At 18 (now 19) members it is conducive neither to maximum efficiency nor to effectiveness in monetary policy making – in particular on technical as opposed to political aspects (notably, the specification of the ECB's operational goals) (see for example, de Haan *et al.*, 2005; Eijffinger, 2006; Sibert, 2006). Future enlargements exacerbate such concerns. Amongst others, Willem Buiter, a former member of the Monetary Policy Committee of the Bank of England, complains of the Governing Council's size prior to Greek accession:

> A group of 17 is already too large for the serious and productive exchange of views, discussion and group decision making. . . . A squad of 21 will be quite unwieldy. Thirty would be a mob. . . . Based on my own limited experience, a policy making body with seven members would probably be optimal (Buiter, 1999, p. 200).

The Governing Council was empowered to change (by unanimity) its own practices if it found problems or potential problems in its decision making subject to the approval of the Council. There is much scope for its procedures to evolve — such as the creation of more working groups — and the work of the Governing Council can involve more activity at the ECB level or through the NCBs. However, the size problem still matters. Some monetary economists have argued that the problem could be resolved by more centralised policy making along the lines of the FOMC of the US Federal Reserve. In the ECB this would involve increasing the power of the Executive Board in relation to the NCB governors and rotating a smaller number of Governing Council places among the governors (de Haan *et al.*, 2005; Eijffinger, 2006; Favero *et al*., 2000). Others see an entirely centralised system – the creation of a Monetary Board detached from the member state NCBs – as the only effective way to resolve the efficiency problem (Baldwin *et al*., 2001a, b).

Such recommendations ignore the unique character of both the Eurosystem as a 'federal' banking system and the EU as a political entity. First, the centre (the ECB) is considerably less dominant in the Eurosystem than in the American system. The NCBs retain considerably more power than the US Federal Reserve District Banks and the governors have final say — thanks to their majority in the Governing Council — over the allocation of functions. Any reform to strengthen the Executive Board at the expense of

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the NCB governors would be challenged on grounds of legitimacy: despite their *ad personam* status (and *not* as national representatives), the strong presence of the NCB governors on the Governing Council was considered vital to selling the EMU project to sceptical national publics (de Haan *et al*., 2005; Howarth and Loedel, 2005). The arrangements of the US Federal Reserve Board were developed just over 60 years ago, around 160 years after the creation of the United States as a country and long after the conclusion of the Civil War successfully asserted federal government authority. There is obviously no parallel situation in the EU. The legitimacy concerns that the principles of equality and representativeness seek to address require a decentralised form of Euro-zone monetary policy making.

Verdun and Christiansen (2000) and Dyson (2000) argue that the independence of the ECB and the specific objectives assigned to it in the TEC and the Statute of the ESCB and of the ECB places importance upon 'output' rather than 'input' legitimacy. The 'output' legitimacy of the ECB and the EMU project involves providing low inflationary economic growth. The focus of most monetary economists and central bankers on improving the efficiency and effectiveness of ECB monetary policy directly concerns this form of EMU legitimacy. Although of secondary importance to overall ECB and EMU legitimacy, 'input' legitimacy is nonetheless of some relevance. The ECB's goal setting and operational independence means that democratic control via elected representatives is unable to provide this 'input' (apart from the unlikely possibility of treaty reform). Without direct democratic control, the make-up of the membership of the Governing Council assumes greater importance in providing 'input' legitimacy. The technocratic expertise of the members provides some (Dyson, 2000). It is argued here that the presence of national representatives (even in an *ad personam* capacity) provides further 'input' legitimacy. EMU has normally been presented by the governments of member states participating in the Euro-zone as the *pooling* and *sharing* of monetary policy making powers. EMU is rarely presented as the transfer or loss of these powers. The presence of national representatives in the ECB confirms the former. The absence suggests the latter. The limited forms of interaction between the ECB and various EU institutions – the European Parliament, the European Commission, the Council of Ministers (Ecofin and the Eurogroup) and the Economic and Financial Committee – further reinforces the importance of the bank's link to the member states. The ECB is poorly embedded in the contested political system of the EU which is, at present, unable to provide 'input' legitimacy (Amtenbrink, 1999 & 2004; Banchoff & Smith, 1999; Beetham & Lord, 1998; Wincott, 2004). The importance of 'input' legitimacy as a consideration was strongly suggested by the explicit emphasis placed upon 'decentralisation' as a 'core principle' by members of the Governing Council guiding their consideration of reform alternatives (Mersch, 2003). A practical dimension to this emphasis

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on 'decentralisation' should also be mentioned. The continued importance of national macroeconomic policy making and the weakness of EU-level economic governance provides an additional reason to maintain the direct link with member states and member state governments via NCB governors.

Calls to restrict the total number of NCB governors in the Governing Council are thus problematic.[6] No other EU institution[7] currently denies member states representation (although the Treaty of Nice creates this possibility for the European Commission once the number of EU member states exceeds 27).[8] Officially, each NCB governor participates in the Governing Council in a personal capacity as an experienced expert on central banking not as a national representative *per se*. In theory, therefore, a rotation of governors (either all or only the less populated member states) would be an adequate resolution of the size problem: a particular group of them should be as representative of informed opinion as all of them. However, it would be difficult for the governors to present the perspectives of other member states as effectively as their own and thus highly problematic to exclude certain member states from voting on a permanent, let alone regular, basis. Moreover, the governors are de facto national representatives because they each come from one of the member states and are most familiar with their own national economies and banking systems. De Grauwe *et al.* (1999) also note that there is nothing in the treaties to prevent NCB governors from prioritising the economic interests of their own member states (although it is unlikely that they would do so overtly as this would undermine the credibility of their commitment to the ECB's operational goals which target the entire Euro-zone).[9]

ALTERNATIVE REFORM PROPOSALS

In addition to variants of the rotation system (discussed below), five alternative reform proposals were considered and rejected by Governing Council members: a constituency model, a system of weighted voting, a double majority system, the creation of a Monetary Board and an election system (Berger *et al.*, 2004; de Haan *et al.*, 2005; ECB, 2003; ECB officials, interviews 2004; Mersch, 2003). A constituency model, based on regional groupings as in the World Bank and the IMF, was rejected. Officially (ECB, 2003; Mersch, 2003) it was argued that this would violate the principle of independence of the individual NCB governors in that they would become *de jure* representatives of a specific constituency rather than operate on an *ad personam* basis (in a personal capacity). The extension of the system of weighted voting was deemed contrary to the 'one member, one vote' principle established in Article 10.2 of the Protocol to the TEC on the Statute of the ESCB and ECB. This Statute allows weighted voting (excluding EB members) only on matters pertaining to shareholdership, i.e., NCB

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capital. Governing Council members also rejected the kind of double majority system (number, population and/or GDP to be considered) adopted in the Nice Treaty for the Council which, 'concerning an intergovernmental body', was not seen to be a relevant precedent for Governing Council reform (Mersch, 2003). The NCB governors from the smaller member states were concerned that the need for a double majority would result in a kind of *directoire* dominated by the largest member states. One variant of this model required a majority vote including at least 3 of the 6 Executive Board members, with any Governing Council member possessing the right to verify that a pre-set GDP level was represented, thus (if based on current figures) giving the French and German NCB governors the possibility of blockage if that level was set at 62 percent. Another rejected model was a Governing Council consisting of a preponderance of Executive Board members and a few rotating NCB governors (akin to the FOMC of the American Federal Reserve). This model was seen as contradicting the 'core principles of decentralisation and representation' (Mersch, 2003). Finally, an 'election system' in which NCB governors would elect a limited number of their colleagues to the Governing Council was rejected on several grounds: an unrestricted election might infringe the representativeness criteria, result in the creation of a 'market' for votes and undermine cooperation among Governing Council members.

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ROTATION SYSTEM

The rotation system for voting in the Governing Council is impressively complex for the uninitiated. The lack of transparency in the preparation of the proposed reform – itself suggestive that considerations beyond the core principles and efficiency goals were influential in determining the system agreed upon – has been criticised by several ECB watchers, notably the well-known German monetary economist Daniel Gros (2003). According to the reform agreement, the number of NCB governors exercising a voting right would be capped at 15, while all governors would continue to attend meetings. When the number of NCB governors in the Governing Council exceeded 15, voting rights would be exercised on the basis of a rotation system, designed to ensure that the NCB governors with the right to vote would be from member states which, taken together, were representative of the Euro-zone's economy as a whole. Consequently, the NCB governors would exercise a voting right with different frequencies depending on an indicator of the relative size of the economies of their member states within the Euro-zone. Based on this indicator, NCB governors would be allocated to different groups.

Initially, there would be two groups. The governors from the five member states with the largest economies (currently, Germany, France, Italy, Spain, Netherlands) would form one rotating group possessing four votes (thus

only four of these five governors would have the right to vote at any one time with a voting frequency of 80 percent). The governors from the other member states (numbering 11 to 17) would form the second rotating group, sharing 11 votes. Once the total number of member states in the Euro-zone increased beyond 22 (up to 27, i.e., the current EU member states and the 12 accession countries listed in the Protocol on enlargement annexed to the Treaty of Nice), three groups would be established. The first would remain the same. The second group would consist of the NCB governors from the countries with the next largest economies, sharing eight votes on a rotational basis. The size of this group would equal the total number of governors divided by two (then rounded up to a full number if necessary). The third group would consist of the governors from the countries with the smallest economies sharing three votes on a rotational basis. The members of the Executive Board would preserve their permanent voting rights.

The division of member states into the two/three groups would reflect their share in the Euro-zone according to a composite indicator of 'representativeness' consisting of principally the member states' GDP at market prices (five-sixths weight in the indicator) and its total assets of the aggregated balance sheet of monetary financial institutions (TABS-MFI) (one-sixth weight). The data on GDP would be provided by the European Commission, while the rules for the calculation of the key for subscription of the ECB's capital would apply (article 29.2 Statute of the ESCB). The data on TABS-MFI would be defined on the basis of an existing Council Regulation (No. 2533/98 of 23 November 1998) concerning the collection of statistical information by the ECB. This data would be updated every five years. The Governing Council proposed that a two-thirds majority of *all* its members would be required to decide on the initial adaptation of the voting rights in the two-group system as the number of Euro-zone member states increased. The same procedure of a two-thirds majority of *all* members would apply to the definition of the precise implementing provisions for the rotation of voting rights within each group (for example, the time interval between the rotation of voting rights).

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THE OFFICIAL JUSTIFICATION

The agreement on the rotation system reflects the concern of many Governing Council members (especially Executive Board members and NCB governors from the larger participating member states) with regard to the potential inefficiencies of an excessively large Governing Council. A principal concern was that one form of representativeness (namely, one member, one vote) would override representation of the actual Euro-zone economy as simple majority voting could (see also Berger, 2002; de Haan *et al.*, 2005; Eijffinger, 2006). Such a possibility currently exists in the system of representation and voting in the Governing Council. However, the

possibility would increase considerably if all the accession NCB governors obtained voting rights. The official ECB position was that a system of rotation with varying voting rights on the basis of reasonable economic criteria ensured the true equal treatment of the NCB governors and 'sufficient' levels of representativeness. The design of the rotation system was, according to the ECB, guided by the following principles (ECB, 2002b):[10]

> The '*equality*' of NCB governors ('one member, one vote' principle) is maintained in three ways. Even though all the governors do not vote all the time, the votes all carry the same weight regardless of the size of national economies. No NCB governor retains a permanent vote. Furthermore, all governors are allowed to attend all Governing Council meetings.
>
> The principle of '*ad personam participation*' (allowing all Governing Council members to attend all meetings in a personal and independent capacity rather than as representatives of a specific member state per se or constituency) is preserved.
>
> *Representativeness* is preserved in the sense that voting NCB governors will be representative of the entire Euro-zone (even though some NCB governors are not voting) yet there is no 'renationalisation' in the sense of governors being required to represent specific regions.
>
> *Consistency* is to be maintained during the transition from two to three phases by avoiding that governors of certain NCBs move randomly up and down between certain groups.

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The rotation system was defended also in terms of not discriminating against the NCB governors of countries acceding to the Euro-zone in the future. Four of the new member states were expected to enter the second rotating group – assuming the continued non-participation of the UK, Sweden and Denmark – while the strong possibility exists that several of the other new member states would move eventually from the third to the second group because of their relatively strong economic growth (on average much higher than the Euro-zone 12).[11]

DEBATES ON THE NUMBER AND COMPOSITION OF ROTATING GROUPS, VOTING RIGHTS, COMPOSITE INDICATOR AND REPRESENTATIVENESS

Two or three rotating group models

The number of rotating groups was debated at length in the Governing Council. Numerous alternative proposals of two group models of different sizes were proposed (interviews, ECB, 2004). These were likely rejected

because of the concerns expressed by several of the current NCB governors of being placed in a rotating group with governors from member states with much smaller economies. The NCB governors from the largest member states also sought to create a small group with relatively high voting frequency. Thus the three group model – with NCB governors from large, medium and small member states, respectively – was the preferred option from the start of discussions with the intermediary phase of a two-group model.

Eighteen versus 21 votes

The concern for decision making efficiency encouraged the governors from the largest member states to favour maintaining the existing 18 votes, while several governors from the smaller member states defended a higher number of voting members to ensure greater voting frequency in the second and third groups. The compromise reached was 21 votes: 6 permanent votes for the Executive Board members and up to 15 rotating votes for the governors.

Representativeness indicator

The NCB governors from several of the member states (notably the Netherlands) preferred to avoid the use of population criteria given that this would allow several of the NCB governors from Central and Eastern European Countries (CEECs) to replace existing member state governors in the second group and allow Poland to replace the Netherlands in the first group. The official logic for excluding the population criterion (ECB, 2003; Mersch, 2003) is curious: this was seen as inappropriate as the ECB is 'an economic and not a political body', even though the population criterion is already used in addition to GDP for determining member state capital contributions to the ECB and voting on these contributions. Most NCB governors and member states preferred just using the GDP criterion. However, the NCB governors from some of then Euro-zone member states (notably Luxembourg) also sought to include recognition of the financial sector. This was defended (ECB, 2003; Mersch, 2003) on the grounds that central banks are charged (de jure and/or de facto) with observing financial sector stability. The bankers also made explicit reference (ECB, 2003) to the experience of the American Federal Reserve System which takes into consideration financial sector size by granting only one Federal Reserve District Bank president – the president of the New York Federal Reserve Bank – permanent voting rights in the Federal Open Market Committee (FOMC).[12] TABS-MFI was adopted on the grounds that it was the broadest measure of the financial sector, with an existing definition in EU law and an established and consistent statistical framework.

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COMPROMISING REPRESENTATIVENESS AND EFFICIENCY

The reform proposed by the ECB Governing Council has been widely criticised by academics, journalists, non-Euro-zone central bank officials and politicians. Gros (2003: 1) has been particularly outspoken in his criticism arguing that 'the solution proposed by the ECB is worse than the status quo. It is inefficient, opaque, internally inconsistent and arbitrary'[13] (see also Bofinger, 2003). After several debates and expressions of expert opinion, the reform proposals were rejected by the European Parliament's Committee on Economics and Monetary Affairs on the grounds of their 'complexity' – although this rejection was not binding upon the Council. The parliamentary committee voted to retain the 'status quo', that is the preservation of votes for all NCB governors, with an enlarged Executive Board of nine members, thus challenging the validity of claims of a size-efficiency trade-off. However, if rotation was to be adopted, the parliamentary committee accepted the use of a composite indicator, based on the criteria of economy and financial market size *but also* population, thus challenging the legitimacy of the ECB's more restricted criteria (European Parliament, 2004).

On efficiency grounds, the proposed reform does not address the concerns that the ECB Governing Council is already too big: the Governing Council is set to grow to 21 members from the present 18. Preventing some NCB governors from voting is not the same as preventing them from speaking and they will continue to attend all Governing Council meetings. Thus the potential for cacophony, that concerns Buiter (1999) and others remains. The nod in favour of efficiency was managed only in the context of a great distortion of the principle 'one member, one vote' with the new rotation system reflecting national economic size. The reform – in order to ensure representativeness – moves in the opposite direction to the preference of those observers who advocate a more centre-heavy US Federal Reserve model (de Haan *et al.*, 2005; Eijffinger, 2006; Favero *et al*., 2000) or the Monetary Board proposed by Baldwin *et al*. (2001). The reform places increased emphasis on representation of the Euro-zone economy rather than member states but all NCB governors can continue to attend Governing Council meetings and there is an increased number of voting members.

The new form of representativeness reflected in the rotation system and the failure to meet efficiency objectives reflects the macroeconomic preferences of the five Euro-zone member states with the biggest economies more than the other current and future member states. The establishment of two/three groups for rotation, with the NCB governors from the five member states with the biggest economies assured more frequent voting rights than the other governors seems to contradict the *ad personam* status of the NCB governors. The reform officially recognises that the status of the

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NCB governors should vary and this in turn suggests that the governors are not to be treated as truly independent people operating in a personal capacity. The reform demonstrates that the governors' home member state is of relevance and determines their status, at least by guaranteeing governors from member states with larger economies a more frequent vote than governors from member states with smaller economies.

Of course, one might see the proposed reform as 'politically reasonable' and legitimate in that it appears that the governors have recognised that economy and financial market size do in fact matter: if there must be rotation why should the governors of the banks of Malta and Slovenia be treated the same as the Bundesbank President? Clearly, the member states with the biggest economies have already lost out in terms of a 'representativeness' that reflects economic size. Officially, their central bank governors possess the same vote as the others on all decisions except those having to do with the capital of the ECB. The adoption of the new rotational scheme is a way of potentially strengthening this kind of 'representativeness', if only to a limited degree. Put another way, the 'representativeness' of one governor one vote has been qualified by a 'politically reasonable' 'representativeness' that accepts the relevance of economy size. This qualification reflects the reality that most Euro-zone citizens are preoccupied, first and foremost, with conditions in their national economy rather than the Euro-zone economy as a whole. While this qualification no doubt reflects the power concerns of NCB governors from the largest member states, it might also reflect a concern with regard to public perception in these member states of the legitimacy of Euro-zone monetary policy making.

Crucially, the two/three rotating group system and the agreed cap of 21 for Governing Council voting members reflects the macroeconomic preferences of the largest member states (especially Germany and France). The voice of the five largest member states is hardly diminished by the proposed reform, dropping from five out of 18 to four out of 21 (in a Euro-zone of 22 member states or more). It might also be argued that de facto overrepresentation of the large member states in the Governing Council is set to continue. Howarth and Loedel (2005) show that the underlying objective of equal national representation was undermined with the first appointment of the Executive Board in 1998 and the (almost) constant representation of the four largest member states on the Executive Board.[14] These Executive Board members are expected to maintain a focus on the entire Euro-zone, as required by the Statute of the ESCB and of the ECB. Nonetheless, the overrepresentation of large member states does challenge the principles of equality and representativeness. At the very least, it can be argued that having served most, if not all, of their career in their member states of origin, the Executive Board members are more familiar with their home economy than other national economies. As explained below, this familiarity can have an impact on monetary policy making preferences. If Executive Board

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members are to be considered potential national representatives in disguise, the 21 maximum membership of the Governing Council established in 2003 only slightly diminishes the weight of the largest five member states from currently nine out of 18 to eight out of 21. It is very likely (interviews, ECB, 2004) that the French and German NCB governors (and perhaps even the Italian and Spanish ones) preferred a double majority system of GDP size and voting members – or a voting system weighted according to GDP – which would have given two or three of these governors an effective veto on all monetary policy making. Clearly, such a system would have been unacceptable to the large majority of NCB governors. It would also have posed considerable risks for the public's perception of the legitimacy of Euro-zone monetary policy making – especially, in the event of a future move to greater transparency in the Governing Council.[15]

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THE ECONOMIC DANGER OF 'EQUALITY'

In the context of enlargement, one principal consideration linked to the different economies and economic needs of the future Euro-zone member states likely contributed to the reform preferences of the largest member state NCB governors (interviews, ECB, 2004). Given the more rapid expansion of their economies over the medium to long term, the future member states would have much higher inflation on average than existing member states and considerably higher inflation than France and Germany (and even Italy and Spain). Completely equal member state NCB governor representation on the Governing Council in an enlarged Euro-zone would result in the over-representation of inflation-prone member states and the possible establishment of an entrenched bias in favour of higher interest rates. This over-representation arguably already exists in the current Governing Council, where inflation differentials between the member states have spilled over to private and public differences between ECB Governing Council members on interest rate changes, and vociferous criticism by certain Executive Board members of certain member states with higher inflation (Howarth and Loedel, 2005).

The fear of over-representation is linked to two related concerns. The first is the extent to which national policy preferences shape the governors' (and even the Executive Board members') positions. The second is the structural differences of the national economies. Regarding the first concern – as already noted – no explicit provision in the TEC and the Statute of the ESCB and of the ECB prevents a NCB governor from presenting policy positions based on domestic data and national needs (de Grauwe *et al.*, 1999; Meade and Sheets, 2002). There have been a small number of studies which attempt to differentiate between policy making on the basis of national preferences and policy making on the basis Euro-zone-wide preferences and the low inflation target of the ECB (e.g. de Grauwe *et al.*, 1999; Heinemann

and Huefner, 2004; Sanchez-Santos and Varela, 2003). The jury is out on whether or not national preferences have had a 'distorting' effect on ECB monetary policy making and this article does not attempt to enter into this debate. However, it is important to emphasise that the presence of a much larger number of NCB governors from small and medium sized national economies with relatively high inflation creates additional pressure for a monetary policy which focuses less on the interests of the biggest member state economies (Heinemann and Huefner, 2004).[16]

The likelihood of a considerable inflation differential in the future enlarged Euro-zone is due to the Balassa-Samuelson effect: inflation rates in the poorer ten CEECs will be systematically higher than in wealthier current member states and will likely remain so for some time (Baldwin, 2001b; Bjorksten, 2000; Égert *et al.*, 2003; Égert, 2005; Eichengreen & Ghironi, 2001). In 2004, for example, there was an inflation rate of 3.7 percent for the ten future member states and 4.4 percent for the 12 (the ten, Romania and Bulgaria) versus an average of 2 percent for the current Euro-zone (ECB, 2005). If we are to assume that all NCB governors view inflation risks similarly – despite the ECB's overall inflation target of or close to 2 percent over the medium term – those governors from the future member states would tend to prefer tighter monetary policy while those from many of old member states would prefer a looser policy. Baldwin *et al.* (2001b) thus complain of a strong potential for a disjuncture between the requirements of the economy of the entire Euro-zone (more than 70 percent of which is made up of the five largest member states) and the preferences of the smallest 14 (16) member states which will form a majority of members in the Governing Council of an enlarged Euro-zone of 22 (24) member states. The economic situation of the 10 (12) accession countries thus creates difficulties for the entire Euro-zone and problems for monetary policy making. Without the 2003 reform to Governing Council voting procedures, member states with only 6 percent of the Euro-zone GDP (2000 figures) (but 35 percent of the population) would have controlled 10 voting positions on the Governing Council. In the future enlarged Euro-zone of 24 member states, Germany, France and Italy would comprise 67 percent of the GDP yet – according to the old voting system – would have held only three of the NCB governors' 24 votes or 12.5 percent (assuming Sweden, Denmark and Britain stay out but all the new accession countries, Romania and Bulgaria come in). In a monetary union of 27 member states, the smallest 17 would represent only 10 percent of the Euro-zone's economy yet would form a majority of votes in the Governing Council (Berger, 2002). Without reform, all newcomers to the Euro-zone – with the exception of the United Kingdom – will have greater political than economic weight.

In addition to the concern about inflation differentials between the larger and future poorer member states, the largest member states also had other economic reasons to seek to preserve their relative voting power in the

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Governing Council. The differences in monetary transmission mechanisms due to national economic structural differences and different national banking systems – see Angeloni *et al*. (2003), Bank of England (1999), Corsetti & Pesenti (1999), de Grauwe (2000) and EP (2001) – can result in different monetary policy preferences. Interest rate changes have significantly different effects on the national economies of the Euro-zone (although understanding the precise impact is an inexact science given the complexity of variables in the national economies). Therefore, while NCB governors might agree on the need for an interest rate change, a consideration of the impact of the change on national economies might encourage them to push for varying levels of change. Several variables can be mentioned. There are different levels of consumer and public debt: thus interest rate changes will have a considerably different impact on consumer and public spending in different member states. The maturities of debt also vary considerably: for example, because firms in Italy and France have shorter-term loans than the firms in other Euro-zone member states, they are more affected by ECB interest rate changes. Furthermore, the degree to which interest rate changes are buffered by national banks varies (Angeloni *et al.*, 2003). The economic structures of the future new member states of the Euro-zone will likely vary as much as the current member states. Thus, the concern of the current large member state NCB governors regarding new member state voting is not only related to their economic differences as a group but rather the further dilution of large member state concerns regarding the impact of interest changes.

CONCLUSION

Disenfranchising a significant number of the smaller member states was thus considered vital to the preservation of the macroeconomic preferences of the largest member states but also the perception of the legitimacy of Euro-zone monetary policy making for the citizens of these member states. However, the only way that the NCB governors from the existing smaller member states would agree to this reduction of total votes was if rotation was to apply to all the member states and if the established principles of equality ('one member, one vote') and representativeness were respected officially. These treaty-based principles were distorted to become, in effect: 'one member, one vote only some of the time with varying frequency determined by economy and financial market size'.[17] For the full Euro-zone of 27 members including all current EU member states, Romania and Bulgaria, the total number of votes and frequency of voting will vary considerably: 4 out of 5 and 80 percent frequency for the first group; 8 out of 14 or 57 percent for the second; and 3 out of 8 or 37 percent for the third. Even with fewer Euro-zone members, the preferences of the smallest (and crucially the future poorer) member states are much less likely to prevail and

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those of the larger member states more likely to be asserted. The insistence that economy and financial market size matter over population size (however reasonable from the perspective of monetary policy making) was also reflected in the preferences of the smallest of the current large member states (notably the Netherlands) and other current small member states, few of which would end up in the third rotating group. With the possibility (however remote) of future Turkish entry into the Euro-zone, even German, French and Italian NCB governors had a clear interest in establishing group selection by economy and financial market size as opposed to GDP and population size.

Given the lack of transparency surrounding the intra-ECB discussions and negotiations on Governing Council reform, the precise policy positions of the different NCB governors and the precise nature of internal debates are impossible to determine for the time being. However, the reform agreed upon suggests that the NCB governors of the largest member states defended policy positions conforming to national macroeconomic interests, even though compromise was necessary that took on board the concerns of other current Euro-zone NCB governors and respected – albeit only in a highly distorted manner – treaty-based principles and legitimacy concerns. The distortion reflects possible efforts to weaken the representation of the NCB governors from the future CEEC member states in order to diminish a structurally determined bias in favour of higher interest rates. The distortion also reflects the interests of the NCB governors of the largest member states to maintain their disproportionate representation in the Governing Council in order to ensure their relatively strong influence on interest rate changes affecting their economies in a particular way due to specific national economic structures. The reform of Governing Council voting procedures transforms the underlying concept of 'representativeness' in the Euro-zone. It undermines the principle of member state representation that has been (and remains) vital to the legitimacy of ECB policy making (and EMU more generally), while strengthening the relevance of national economic size and the representation of the entire economy of the Euro-zone (rather than its member states and their populations). The official ambition to avoid enlargement contributing *significantly* to decision making inefficiency can arguably be said to have been met. However, inefficiency was, nonetheless, potentially worsened and the core concerns about size raised by many monetary economists were not addressed.

Some monetary economists have granted qualified praise to the agreed reform of the ECB Governing Council and the creation of the three rotating groups. They do so on the grounds that this reform moves in the right direction towards a truly desirable voting system that aligns 'political power and economic weight' of national central bank governors as closely as possible (de Hann *et al.*, 2005; Eijffinger, 2006; see also Berger *et al.*, 2004). Such a system is, according to these authors, 'the best way' – short of the

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centralisation of operational policy making in the Executive Board – 'to ensure that national interests will not unduly influence ECB policy-making' (Eijffinger, 2006: 97). Their argument doubts the *ad personam* participation of NCB governors and the possibility that they can make monetary policy decisions without specific reference to their own national economies. If NCB governors can in effect represent national economic concerns over those of the Euro-zone as a whole, the alignment of voting power in the Governing Council with economic weight negates the possibility of reflecting this bias in ECB monetary policy. These observers are concerned with the policy making inefficiencies created by emphasising NCB governor equality and member state representativeness. They also believe that treating NCB governors equally in terms of voting rights in the Governing Council results in the over-representation of the smaller national economies of the Euro-zone which in turn damages effective ECB monetary policy. The problem will worsen with enlargement.

The analysis adopted in this paper accepts that these considerations might well have influenced the reform agreed by the Governing Council members. However, it is argued here that the move in the direction of aligning political (voting) weight and economic weight runs contrary to the 'equality' and 'representativeness' principles in a manner which undermines ECB and EMU legitimacy. The argument that political weight should reflect economic weight responds to the legitimacy and power concerns of the governments of the largest Euro-zone national economies. However, the way in which this argument denies the equality and *ad personam* participation of NCB governors – by emphasising that they represent member state economies – undermines the legitimacy of the ECB and in turn the EMU project. Rooted in a contested EU political system, ECB and EMU legitimacy relies to an unclear extent on equal member state representation, however indirect and qualified by the principle of *ad personam* participation. The agreed Governing Council reform of December 2002 and February 2003 fudges the principles of equality, representativeness and *ad personam* participation of the Governing Council members. Yet the reform does not entirely discard these principles. The reform is potentially damaging to ECB and EMU legitimacy but it is considerably less so than the reform proposals driven solely by either efficiency concerns or the recognition of member state economic weight or both. The monetary economists who advocate such proposals would do well to consider 'input' as well as 'output' legitimacy.

NOTES

1 This ECB recommendation, under Article 10.6 of the Statute of the European System of Central Banks and of the European Central Bank, for a Council Decision on an amendment to Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank (ECB/2003/1; 2003/C29/07)

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was submitted by the European Central Bank to the Council on 3 February 2003. The decision of the Council, meeting in the composition of the Heads of State or Government, was taken on 21 March 2003 (Council 2003/223/EC) after taking into consideration the opinions of the European Commission and the European Parliament. The agreed amendment was then recommended to the member states for ratification in accordance with their respective constitutional requirements.

2 Article 108 TEC and Article 7 of the Statute of the ESCB and of the ECB establish the independence of Governing Council members. They cannot 'seek or take instructions from Community institutions or bodies, from any government of a member state or from any other body'.

3 All Governing Council members are independent from both national and other EU bodies and cannot take instruction from these bodies (Article 7 of the Statute of the ESCB and of the ECB). They are also officially committed official to Euro-zone goals (Article 2 of the Statute of the ESCB and of the ECB) which suggests that these goals over-ride specifically national concerns. However, it should be noted that no TEC or Statute provisions explicitly prevent a NCB Governor from representing specifically national concerns.

4 The 'one member, one vote' principle is established in Article 10.2 of the Protocol to the TEC on the Statute of the ESCB and ECB: '. . . each member of the Governing Council shall have one vote' except on a limited range of matters concerning the capital of the ECB where votes are weighted according to the national central banks' shares in the subscribed capital of the ECB (Art. 10.3) and the terms and conditions of employment of the members of the Executive Board (on which Executive Board members have no right to vote (Art. 11.3)).

5 The principle of 'representativeness' can be said to be established in TEC Article III-382 and Article 10.1 of the Protocol to the TEC on the Statute of the ESCB and ECB which confirm that 'the Governing Council of the European Central Bank shall comprise . . . the Governors of the national central banks of the Member States'. This provision is further reinforced by the equality provision of Article 10.2 of the Protocol to establish 'representativeness'.

6 Buiter (1999) for example recommends – even without Euro-zone enlargement – restricting the size of the Governing Council to nine members and the Executive Board to four.

7 The ECB enjoys a special status and is not a Community institution in the legal sense.

8 The Nice Treaty (Article 4(2)) requires the Council to adopt a rotation of European Commission places totalling below the number of member states once this number exceeds 27. The Draft Treaty Establishing a Constitution for Europe (Article I-26(6)) specifies this further, allowing – after one full Commission term under existing rules – for the number of Commissioners to equal two-thirds the number of member states (subject to possible modification by the European Council acting unanimously).

9 In terms of the ECB's operational goals, the Euro-zone wide inflation target should effectively force individual governors to disguise specifically national concerns. Furthermore, to adopt an explicitly national perspective in the Governing Council would discredit a NCB governor as an 'objective' analyst of Euro-zone wide inflation.

10 The fifth principle was transparency (of the wording of the text outlining the rotation system). ECB Press Statement, 20 December 2002.

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11 See the section below on 'The economic dangers of equal representation'.

12 The other 11 Federal Reserve District Banks presidents rotate into four voting positions on the FOMC. The US Federal Reserve Act makes no reference to the relative weight of Federal Reserve districts, while section 2 of the Act establishes the criteria of convenience and 'customary course of business' to determine voting weights.

13 In addition to the points made in the text, Gros challenges the lack of clarity and the arbitrariness surrounding the rotation of NCB governors with voting rights. He provides an alternative for the reform of the ECB developed by the CEPS Macroeconomic Policy Group – which involves the Governing Council meeting less often and setting the guidelines for monetary policy, while the Executive Board assumes more control over the execution of monetary policy – and urges the European Commission to propose an alternative reform for adoption by the Council.

14 Three replacements since June 2004 demonstrate the continuity of large member state representation: the Spanish Executive Board member, Eugenio Domingo Solans, was replaced by another Spaniard, Jose Manuel Gonzalez-Paramo; the Italian Tommaso Padoa-Schioppa by Lorenzo Bini Smaghi; and the German Ottmar Issing by Jürgen Stark. France was not represented on the Executive Board for only a brief period following the replacement of Christian Noyer as ECB Vice President and the accession of Jean-Claude Trichet as president. However, this was an inevitable interruption given that Noyer's departure was part of the controversial compromise allowing Trichet to take office. The extent to which the French President went in 1998 to ensure the appointment of the Bank of France Governor, Trichet, as the ECB president, further suggests the importance attached to securing Executive Board places by the largest member states.

15 There is disagreement among legal scholars whether primary Community law prohibits the publication of minutes of the meetings of the Governing Council. It has been argued by some that Article 10.4 of Statute of the ESCB and of the ECB limits transparency in this regard (Amtenbrink, 1999). Article 10.4 states: 'The proceedings of the meetings shall be confidential. The Governing Council may decide to make the outcome of its deliberations public.' Although no provision in the TEC (and specifically Article VII or the Protocol on the Statute of the ESCB and of the ECB) necessarily blocks transparency, the ECB Governing Council members justified their 1998 decision to prevent disclosure of Governing Council minutes as a necessary evil to prevent the exertion of domestic political pressures on national central bankers (ECB, 1999). In effect, non-transparency might also the decrease the appearance of NCB governors advocating monetary policy changes that conform to national preferences (Howarth and Loedel, 2005).

16 Heinemann and Huefner (2004) apply different economic approaches to determine if national preferences rather than a Euro-zone focus determine ECB interest rate decisions. Using the ordered probit approach, these authors conclude that national preferences (based on controlling national inflation rates rather than the Euro-zone inflation rate) do affect monetary policy – although they accept clear limitations to their study. Given the increased divergence in the economies, and inflation rates, among member states in a future enlarged Euro-zone. These authors argue that . . .

If for EMU-12 there is some evidence that divergence is not irrelevant in the Governing Council this should be even more pronounced for EMU-27. In this sense our first results back the case for adjusting the representation and/or

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voting weights in the Governing Council in favour of the countries with large GDP shares as recommended by the ECB (556).

17 Author's own words.

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Reforming Europe's stability and growth pact: Lessons from the American experience in macrobudgeting

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Reforming Europe's stability and growth pact: Lessons from the American experience in macrobudgeting

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ABSTRACT

Proposed and actual reforms to the European Union (EU) Stability and Growth Pact commonly retain the Pact's deficit and debt targets. The American experience with similar macrobudgetary rules suggests that deficit targets may actually act as an incentive for political leaders to engage in noncompliant behavior. If targets were revised to budgetary objectives that politicians could achieve more easily and claim credit for accomplishing, compliance with the new macrobudgetary rules might be increased.

KEYWORDS

Balanced budgets; Economic and Monetary Union; European Commission; European Union; Excessive Deficit Procedure; Maastricht Treaty; Public Finance; Stability and Growth Pact; Treaty on European Union; United States.

1. INTRODUCTION

Governments of industrialized societies have struggled to keep their public finances under control since the oil shocks and stagflation of the 1970s. The Thatcher government reformed the United Kingdom's public finances, the Japanese adopted the Fiscal Structural Reform Act of 1997 to control their growing deficits, and after years of budgetary conflict the governments of Canada and the United States (US) balanced their budgets in 1997 and 1998 (Savage, 2000). When conceptualizing the creation of Economic and

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Monetary Union (EMU) in the early 1990s as part of this broader effort at inducing fiscal restraint, European member states included in the Treaty on European Union (TEU), also known as the Maastricht Treaty, the famous ratio of debt to gross domestic product (GDP) of 60 percent (then the average of the member states), and a annual budgetary deficit as a ratio of GDP of 3 percent (a reference value agreed to by member states representatives) as key convergence criteria for determining EMU membership (Verdun, 2000). In 1997 European Union (EU) member states supplemented the TEU with the Stability and Growth Pact (SGP), which provided for a number of clear steps with deadlines and possible penalties if member states failed to comply with the TEU's fiscal rules. By late 2003, however, this system of fiscal constraint verged on the brink of collapse (Heipertz and Verdun, 2003, 2005, 2006). In the intervening years, the EU continues its search for a politically acceptable compromise to keep its fiscal rules intact while improving their efficiency and effectiveness in gaining member state compliance.

Can the SGP be reformed to improve EU member state compliance with its budgetary provisions? The Pact is widely criticized as economically unnecessary, fiscally counterproductive, and simply politically ineffective, as a significant number of member states violate the three per cent ceiling on budgetary deficits years following the introduction of euro banknotes and coins. Public criticism includes European Commission President Romano Prodi's famous description of the SGP as 'stupid', (*Financial Times*, 22 October 2002). Others characterize the SGP as 'an empty shell' and call for doing away with the law (Eichengreen and Wyplosz, 1998; Enderlein, 2004; Gros *et al.*, 2005; Posen, 2005a,b). The SGP's defenders, meanwhile, point to the overall fiscal restraint of the euro area and the valuable role the SGP plays in macroeconomic coordination (Artis and Buti, 2001; Beetsma, 2001; Buti and Giudice, 2002; Buti and Pench, 2004). Regardless of the status of this debate, the SGP stands as EU law, firmly embedded in the Treaty on European Union and EU secondary law, and the member states remain committed for the foreseeable future to the basic architecture of EU fiscal policy coordination (Heipertz and Verdun, 2005, 2006).

The EU's determination to maintain some version of the SGP is reflected in the reforms adopted in March 2005 by the Council of Ministers on Economic and Financial Affairs (ECOFIN). ECOFIN's revisions retained the SGP's budgetary targets, including the three percent of GDP excessive deficit threshold; emphasized the role of cyclically adjusted deficit calculations; declared that the member states should avoid procyclical fiscal policies; affirmed that the administrative and statistical capacity of the Commission be strengthened for purposes of the surveillance process; and elevated the importance of the member states' debt levels in evaluating their compliance with the SGP. The reforms also expanded the conditions under which the member states could exceed the three percent deficit level

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and increased the number of months from four to six during which they could take corrective measures (Council of the European Union, 2005). Despite these reforms there continues to be significant breaching of the three percent ceiling on budgetary deficits as a percentage of GDP, even under the more flexible rules agreed upon in March 2005. On 23 October 2006, the European Commission issued its formal report on the compliance of the member states with the SGP in 2005. One-third of the original 15 states ran deficits in excess of 3.0 percent of GDP, as did four of the ten newest EU member states. Successful compliance with the SGP is more than simply avoiding excessive deficits. The Pact calls for the member states to adhere to a medium-term objective of budgetary positions of close to balance or in surplus. Only nine of the 25 member states and three of the 12 member states in the euro area complied with this standard (Eurostat, 2006). More importantly, since 2004 the economic cycle has been in an upswing, which means that achieving the budgetary rules is currently much easier than a few years ago at a time of recession. It is widely held that the real test of the SGP will come when another major economic downturn occurs in Europe. The fact that the SGP has proved itself unable to ensure that member states will comply with the budgetary deficit rules at a time of economic recession or even economic recovery, suggests that other revisions should be considered that may produce greater compliance with the EU's macrobudgetary rules in times of future economic difficulty.

Numerous proposals for either terminating the SGP altogether or reforming it have emerged since 2003 (Collignon, 2004; Crowley, 2002; Enderlein, 2004; Hodson, 2004). Eliminating the SGP is obviously one solution to the problem of member state noncompliance. Indeed, the elimination of the SGP would still leave the excessive deficit procedure intact in the TEU's Article 104. Thus, full elimination would also imply changing the Treaty text on the EDP or in any case a radically different approach to obtain the end result. Yet, if the EU remains committed to the goal of fiscal sustainability and the need for some type of restrictive macrobudgetary architecture, the debate over what the SGP should look like continues. Though the summaries of the following recommendations shown in Table 1 certainly do not constitute an exhaustive list of proposed revisions, they are indicative of the types of suggestions that are commonly offered to reform the SGP. In addition to terminating the SGP, these recommendations generally fall into five categories. They range from proposals that, first, emphasize greater flexibility by way of the application of 'soft' rather than 'hard' rules; second, that promote enhanced versions of the use of hard rules; third, that rely upon the 'open' coordination supplied by the member states themselves; fourth, that turn to powerful, autonomous, centralizing regulators and veto players at both the EU and member state levels, which under some conditions take the SGP's decision making process out of the hands of ECOFIN and the member states altogether (Collignon, 2004; Hodson, 2004); fifth,

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Table 1 Proposed reforms to the Stability and Growth Pact

*__Terminate the SGP, Emphasize the EU Member States in Fiscal Policy Coordination, Rely on Soft Rather than Hard Fiscal Coordination:__ Abolish the SGP, and emphasize the member states' role in coordinating their fiscal policies. The hard deficit and debt targets and explicit enforcement sanctions failed, financial penalties are too confrontational, and the SGP is too politically intrusive in member state fiscal policy decisions. Rely on the soft fiscal coordination present in the creation of the Broad Economic Policy Guidelines (BEPG) and the surveillance process provided for in the Maastricht Treaty's Article 99, rather than the excessive deficit procedure of Article 104 (Enderlein, 2004).

*__Soft Rather than Hard Fiscal Coordination with Revised Sanctions:__ The SGP's hard deficit and debt targets and explicit enforcement sanctions have failed, financial penalties are too confrontational, and the SGP is too politically intrusive in member state fiscal policy decisions. Encourage member state learning and experimentation by relying upon the creation of individual fiscal sustainability plans that are developed through negotiation with the Commission. Create new economic metrics to determine compliance. Rely upon reputational sanctions and the potential loss of rights at the EU level, such as voting on issues related to the euro area (Schelkle, 2004, 2005; Begg and Schelkle, 2004)

*__Reform without Hard Penalties__: Focus on debt to GDP ratios rather than deficits to GDP, taking into account the need for public investment. Concentrate on cyclically adjusted budgets, and permit deficits exceeding 3 percent of GDP for cyclical reasons. Strengthen the Commission's role in the surveillance procedure. Renounce the use of financial penalties in favor of reputational sanctions and peer pressure (Walton, 2004).

*__Redirect SGP Incentives to Encourage Good Behavior in Good Times:__ The SGP fails to restrain fiscal policies when member state economies are growing, and imposes financial penalties on member states when their economies are weak. SGP should take into account the nature and composition of discretionary fiscal policy (Mayes and Viren, 2004).

*__Keep the SGP As Is, but Strengthen Domestic Budgetary Institutions:__ Strengthen the domestic institutions of the member states, particularly their ministries of finance, throughout their budgetary processes, and encourage coalition governments to create domestic 'fiscal contracts' to reinforce their compliance with the SGP (Hallerberg, 2004b).

*__Reinforce the Commission as SGP Enforcer:__ Strengthen the Commission's role as the SGP's 'supreme enforcer', while moving to a system of political rather than financial penalties for noncompliance. Political penalties could include requiring finance ministers to justify their policies before their own parliaments if the Commission issued an excessive deficit warning or recommendation against a member state. More resources would be devoted to developing the Commission's cyclically adjusted analyses (Ubide, 2004).

*__Create Independent Sustainability Council:__ The SGP's deficit and debt targets are 'dead rules' due to their inflexibility, the goal shifted from sustainability towards 'optimal' fiscal policies, and it is increasingly difficult to enforce. A newly created independent Sustainability Council reporting to the European Parliament, would be charged with ensuring the sustainability EMU member state finances. The Council would assess the fiscal condition of the member

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Table 1 Proposed reforms to the Stability and Growth Pact *(Continued)*

states, particularly the size of their public debt, and provide a flexible alternative to the dead rules. The member states would have to submit fiscal plans to the Council, which would have the authority to veto these plans. The Council would rely upon reputational and political sanctions derived from public support for the Council's rulings, rather than financial sanctions on the member states (Fatas *et al.*, 2003).

***Move to Further 'Political Integration' or 'Ever Closer Union':** Following the logic of the earlier Werner Plan and the Delors Report, a step towards further economic integration would be necessary. A supranational authority would need to be set-up to deal with budgetary and fiscal matters to find the appropriate policy mix between 'economic' and 'monetary' policies. The 'economic' policies in this context would be budgetary policies (budgetary deficits and public debt) as well as further integration on fiscal policies (perhaps harmonization of corporate taxation). Advocates argue that it has been this asymmetry between transferring sovereignty from national to the supranational (EU) level in the one area (monetary policy) whereas a lack of transferring such sovereignty over economic policy (budgetary and some degree of fiscal policy) that makes EMU potentially unstable (Verdun, 1996, 1998; Padoa-Schioppa, 2004; Hodson, 2006).

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that the EU pursue further political and economic integration as a broader strategy to overcome macroeconomic difficulties and SGP noncompliance (Padoa-Schioppa, 2004; Hodson, 2006).

Despite the variation in these proposals, what characterizes nearly all of them is their continued reliance on the SGP's deficit and debt targets. The continued reliance on deficit targets both in ECOFIN's revised SGP and in these proposed reforms, we argue, is reason why the member states so often fail to comply with the EU's macrobudgetary rules. What the current SGP and these recommendations neglect to provide for in the architecture of their rules is the need to allow for politically achievable budgetary goals. If national political leaders are expected to make the difficult decisions that are required to comply with the SGP, they must be rewarded for their efforts. Realistic opportunities and positive incentives must, in other words, be created for national politicians to able to claim credit for their actions. As demonstrated by the American case presented here, macrobudgetary rules that rely upon deficit criteria produce budgetary targets that are often beyond the control of political actors. Thus, despite their efforts at fiscal restraint, which usually require a significant expenditure of political capital, political leaders receive at best limited political credit, even as weak economies drive their budgets deeper into deficit. The SGP reforms outlined in Table 1 depend upon almost all stick and very little carrot as incentives for compliance; even references to 'peer pressure' and 'reputational sanctions' are employed much more as forms of punishment rather than as rewards for political action. Meanwhile, some recommendations propose the solution to SGP noncompliance rests with strengthening

domestic budgetary institutions, such as ministries of finance that have the power to reject the budget requests of spending ministries (Hallerberg, 2004a,b). Yet, even member states that have expended the political capital needed to create strong 'delegation' finance ministries, the strongest of which are those of France, Germany, Greece, and the United Kingdom, all recently incurred deficits in excess of that mandated by the SGP. Despite these reforms in domestic budgetary processes and institutions, each member state remained tied to SGP's deficit and debt targets. What the American experience suggests is that a reform the EU may want to consider is revising its budgetary goals in a way that pays greater attention to political leadership needs for credit claiming, in order to enhance its efforts at fiscal sustainability and budgetary compliance.

This study first explores the American experience since 1985 with three similar macrobudgetary laws aimed at promoting fiscal stability: Gramm–Rudman–Hollings, a law that aimed at reducing deficits to balance the budget, and the Budget Enforcement Act of 1990 and the Balanced Budget Act of 1997, which both targeted levels of spending rather than the size of deficits. Though the mechanics of the Gramm–Rudman–Hollings' law certainly differ from those of the SGP, this paper argues that as the measure of successful compliance they both suffer from the same design flaw, namely their focus on deficit spending. After several futile years of trying to control their deficits, the Americans learned from this design flaw by changing the goal from constraining deficits and balancing the budget, to controlling spending in their latter two macrobudgetary laws. Details of these laws are provided so that their institutional strengths and weaknesses might be better understood for comparison with the SGP. Our research then suggests how these most recent American laws would apply in the case of Germany in 2003. Finally, this study offers recommendations for how the SGP could be improved by borrowing from the American trial-and-error learning in the development of such macrobudgetary rules.

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2. LEARNING FROM THE AMERICAN EXPERIENCE WITH MACROBUDGETARY RULES

There are several reasons why the EU may look to the United States (US) for useful examples in macrobudgetary practices. First, the American experiment with these macro rules for fiscal consolidation at the national level dates from 1985, several years earlier than the Maastricht Treaty and the SGP. American state governments, meanwhile, have employed balanced budget requirements since the 1840s (Savage, 1988). Because of this extensive history, much of the literature on the design of budgetary rules is derived from American experiences at all levels of government, and has been applied by scholars to a variety of political and economic systems (Milesi-Ferretti, 1997; Poterba and von Hagen, 1999; Strauch and

von Hagen, 2000). Second, although the US is a single-state case study, as compared to the supra- and multi-national EU, its presidential system, with competing centers of executive and legislative budgetary decision-making power resembles the diversity of power centers in the EU. Third, the US struggled with macrobudgetary noncompliance, just as the EU does with the SGP, but found ways to reform its rules to gain compliance and achieve fiscal sustainability. The lessons the Americans painfully learned from the development of their national macrobudgetary rules may indeed suggest different, and perhaps more effective reforms for the SGP than those identified in Table 1.

2.1. The American experience with macrobudgetary rules: Gramm–Rudman–Hollings

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The United States adopted the Balanced Budget and Emergency Deficit Control Act of 1985, better known as Gramm–Rudman–Hollings (GRH), in order to balance the federal budget. The word 'emergency' in the law's title can convey only a little of how the fear of large-scale deficit spending and the desire to balance the budget dominated American domestic politics in the 1980s. Peacetime deficits of $200 billion were simply unheard of in American history. In only a few short years, the deficit grew from $27.7 billion in 1979 to previously unknown triple digit levels. The authors of the legislation, senators Phil Gramm (Republican-Texas), Warren Rudman (Republican-New Hampshire), and Fritz Hollings (Democrat-South Carolina), declared that failure to bring the deficit under control stemmed from the partisan and institutional stalemate over the composition of fiscal policy, and only a dramatic change in the government's regular budgetary process could create the institutional rules and political incentives to break that partisan deadlock.

The deep partisan distrust that existed accounts for the budgetary process created by GRH. The president and Congress, it was argued, could not be counted on to balance the budget or even achieve meaningful deficit

Table 2 Gramm–Rudman–Hollings 1985 and 1987 deficit targets (billions of dollars)

	Fiscal year							
	1986	1987	1988	1989	1990	1991	1992	1993
1985 Law	−172	−144	−108	−72	−36	0		
1987 Law			−144	−136	−100	−64	−28	0
Actual deficit	−221	−150	−155	−152	−221	−269	−290	−255

Source: US Senate Budget Committee (1987).

reduction. So, as shown in Table 2, diminishing, annual allowable maximum deficit amounts (MDA) were identified, with a balanced budget reached in the sixth year after the law's enactment. The President's Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) were charged with monitoring compliance with the law and developing a report on deficit and expenditure estimates, taking into account changes in the economy, to determine whether a gap occurred between the MDA and the actual deficit. Differences between the two estimates would be resolved by averaging the figures. Because of the distrust existing between the executive and legislative branches, the more independent General Accounting Office (GAO) would evaluate the joint OMB/CBO report, and then issue its own definitive report. The objectivity of GAO's report was undermined by a Supreme Court decision that declared the GAO's involvement violated the Constitution's separation of powers, as GAO was an agent of the Congress conducting an executive branch function by activating the sequester process. In GAO's place, a joint House–Senate congressional committee was established to review the OMB/CBO report. It would then submit a resolution for congressional approval and presidential signature, which then, if necessary, activated GRH's sanctions (Havens, 1986). Under the new system, the president, not the GAO with its congressional connection, would initiate the sequester.

GRH's sanction consisted of sequestering, the cutting of budgets in an across-the-board fashion in designated accounts. The size of the sequester depended upon the amount necessary to eliminate the gap between the OMB/CBO estimated deficit and that year's MDA, if the difference between the two were at least $10 billion. Such a sequester was immediately imposed in 1986, when the $171.9 billion MDA was projected to be exceeded by an estimated $48.6 billion. To test the law, but not activate it fully during its first year, a sequester of $11.7 billion, or 4.3 percent of nonexempt spending was imposed in 1986. Added to this institutional sanction was the continued, though by that time proven ineffective, reputational and political sanction of incurring large deficits. The primary incentive for politicians to comply with GRH came from the threat to cut their most cherished programs through sequestration. Fear of the sequester served as the incentive for politicians to do whatever was necessary to balance the budget. Yet, here again, mistrust influenced the design of the law. Congressional Democrats distrusted the Republican White House and the OMB from applying the law evenly and fairly to all programs. So, an extensive set of rules were developed as part of GRH that specified which programs would be cut and to what extent. Half the budget reductions would come from defense, the other half from non-defense programs. Some programs were completely exempt from the sequester, including Social Security, interest payments on the national debt, and certain welfare programs, such as food stamps. Other entitlement programs were partially protected, with

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reductions limited to a maximum of 1 or 2 percent, or to cuts made only in their inflation adjustments. Altogether, the law exempted nearly two-thirds of the budget from sequestration.

2.2. Criticism of Gramm–Rudman–Hollings

GRH was immediately subject to intense criticism. First, critics decried the democratic deficit inherent in the automatic provisions in the sequester procedure. Rather than make the difficult decisions required to balance the budget, politicians surrendered their responsibilities to across-the-board budget cuts. Second, politicians whose favored programs were exempt from the sequester would be less motivated to protect the remaining programs by making the necessary policy fiscal policy decisions to avoid sequestration. Third, the one-third of the budget's unprotected programs would unfairly bear the burden of these sequesters. In this way, the law perversely created an incentive for some members of Congress actually to increase their level of spending for their favored programs, if these programs were among the 30–40 percent that was subject to sequestering. These programs would be hit with an across-the-board sequester, regardless of the size of their budgets. The best way to protect these programs, therefore, would be to increase their budgets to better weather the sequester, rather than take action to avoid the sequester altogether. Fourth, to avoid these sequesters completely, the president's budget could exaggerate economic assumptions that would reduce the size of the budget deficit. These assumptions would then determine whether there would be a sequester. In fact, both the OMB and the Congress manipulated economic and deficit estimates throughout the budgetary process. In some years the Senate would use one set of assumptions and the House a different set, both with the intent of avoiding sequesters. In this way, the Supreme Court's ruling against the use of an impartial GAO crippled GRH's surveillance process. Fifth, the fear of sequester encouraged the government to employ various accounting devices to reduce the deficit, including shifting expenditures to future fiscal years, one-time selling of government assets, overestimating tax collection receipts, and shifting programs into exempted categories of spending. Sixth, and most telling, the government failed to meet each of the law's annual deficit targets and balance the budget (US National Economic Commission, 1989; Rubin, 2003).

To remedy some of these problems, a second version of the law was passed in 1987, commonly called Gramm–Rudman–Hollings II (GRH II). The revised law ordered that only one set of economic assumptions could be used throughout the budgetary process, so that the estimates would not be revised more positively to show greater deficit reduction. The new law eliminated the receipts derived from asset sales from use in the deficit calculation, and it also strengthened GRH II in a parliamentary fashion,

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by providing for a point of order procedure in the Senate. Members could call a point of order against the violation of budgetary rules that could be overridden only by a super 60-vote majority. So, for example, a senator could call a point of order against an appropriations bill that exceeded its spending limit, and the bill would be forced back to its subcommittee origin for reconsideration. Only if the point of order were overridden by 60 votes could it be approved by the Senate. The revision also weakened the law's sanction by allowing the president to exempt almost all personnel accounts from sequestration and by including certain inflation adjustments in the deficit calculation. Finally, the most significant change was the raising of the annual deficit targets and the extension of the balanced budget goal by two years (US Senate Budget Committee, 1987).

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2.3. Lessons learned from Gramm–Rudman–Hollings

GRH is often regarded as a failure. Annual deficit targets were regularly exceeded and the budget never was balanced. The gap between the MDA and the actual deficits would have triggered draconian sequesters that would have devastated non-exempt programs. The gap of $121 billion for 1990, for example, would have imposed sequesters equal to 20–30 percent of those programs' budgets. What this observation neglects, however, is that politicians enacted real reductions in spending and increased revenues because of the law, particularly in 1987. The initial 1986 GRH sequester, for example, produced some $28 billion in savings over two years, while the budget agreement of 1987 called for an estimated $76 billion in savings over two years. One well-regarded study of GRH's influence indicates that the law restrained spending by $59 billion by 1989 in nonexempt programs (Hahm *et al.*, 1992). The law proved to be weakest in constraining spending in the exempt categories, which included the politically sensitive entitlement programs. Consequently, if deficits were to be reduced and the budget eventually balanced, these programs needed to be subjected to some form of effective procedural control.

The GRH experiment in macrobudgeting left the nation's political leadership frustrated politically and personally by their inability to fulfill the law's expectations. Despite imposing budget cuts on politically favored programs and raising some politically unpopular revenues, not only was the budget not balanced, the annual deficit targets proved to be increasingly elusive. The law essentially punished lawmakers each year leading up to the one in which the budget would be balanced. As that goal over time became less likely to be realized, member of Congress became increasingly creative in their ways of evading the law's sanctions. The most important lesson learned from the GRH experiment was that the law held the Congress politically responsible for the deficit regardless of its budgetary policies, and regardless of what drove the deficit, the condition of

the nation's macroeconomy. The law simply neglected to take into account the need to provide politicians with politically achievable, realistic, and rewarding goals.

The Gramm–Rudman–Hollings law was unprecedented in the history of American budgeting. The law not only specified deficit reduction targets, it created a procedure that automatically cut the budget to reach these targets if elected officials failed to reach them. The need for some automatic process reflected the stalemate present in American politics that stymied efforts to achieve an accepted national goal. Though widely criticized, the law proved to be the first, and perhaps necessarily painful, stage in the development of American macrobudgetary rules that eventually helped the government balance the national budget.

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3. THE AMERICAN EXPERIENCE WITH MACROBUDGETING: THE BUDGET ENFORCEMENT ACT OF 1990 AND THE BALANCED BUDGET ACT OF 1997

Much had been learned about the incentive structures of budgetary procedures during the four years the government operated under GRH. Above all, the Congress wanted to be held responsible for activities under its direct control, namely the size of federal spending, not the size of the budget deficit, which varied according to changes in the macroeconomy. Political leaders sought to limit sequesters to the programs that caused them, rather than punish those that were relatively innocent. They also recognized that reducing the size of deficits and federal spending depended upon creating some process to control mandatory entitlement growth. Finally, Congress sought to defeat some of the more egregious loopholes identified in GRH. President George H.W. Bush and the Congress, by large, bipartisan margins, then responded to GRH's failure by adopting the Budget Enforcement Act of 1990 (BEA).

The most important difference between GRH and BEA was that balancing the budget no longer remained the government's explicit policy goal. Where GRH required annual deficit reductions leading to a balanced budget, the BEA focused on controlling spending and avoiding breaching predetermined spending limits. So, where GRH required some combination of spending cuts and tax increases to reduce the annual MDA to balance the budget in six years, BEA essentially froze spending or allowed limited annual increases for five years. The BEA's budgetary success would be determined by whether spending was held within 'discretionary spending limits'. This meant that caps were placed on the total spending level of discretionary, non-mandatory programs. As shown in Table 3, discretionary spending was divided into three categories: defense, international, and domestic. Each category was capped in terms of budget authority and

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Table 3 Budget Enforcement Act of 1990: Discretionary spending limits (billions of dollars)

	Fiscal year				
	1991	1992	1993	1994	1995
Defense					
Budget authority	288.918	291.643	291.785		
Outlays	297.660	295.744	292.686		
International					
Budget authority	20.100	20.500	21.400		
Outlays	18.600	19.100	19.600		
Domestic					
Budget authority	182.700	191.300	198.300		
Outlays	198.100	210.100	221.700		
Combined categories					
Budget authority				510.800	517.700
Outlays				534.800	540.800

Source: US House Budget Committee (1997).

outlays for three fiscal years, FY1991–93.[1] Total levels of spending were set for FY1994 and FY1995, with the division of these totals into categories to take place during the consideration of the FY1993 budget. The caps could be adjusted to take into account inflation, changes in accounting rules, and emergency spending. The economic estimates used for the budget cycle would be locked into place when the president submitted his budget to Congress, thereby avoiding politically motivated optimistic revisions in the economic forecast.

To address the issue of controlling mandatory spending, the new law initiated the use of a pay-as-you-go (PAYGO) process. The PAYGO provisions required that all new tax as well as new mandatory legislation had to be deficit-neutral. This requirement applied to the net of all such legislation, not to individual bills. So, for example, the net legislative proposals that would increase entitlement benefits had to be offset by revenue increases that made the legislation deficit-neutral. By creating this tradeoff, PAYGO was designed to encourage compromise and bargaining in the setting of fiscal priorities (Frankel, 2005). PAYGO, it should be made clear, did not apply to the entitlement benefits and the resulting spending that stemmed from existing mandatory programs.

To enforce the spending caps and the PAYGO rules, the new law retained sequestration as the primary form of sanction for budgetary noncompliance. Sequesteration in the BEA for discretionary spending differed from GRH in two important ways. First, there were far fewer exempt discretionary programs, the most noticeable exclusion being military personnel. Among entitlement programs, Social Security, most prominently, was

declared exempt. Second, only the categories of spending that exceeded the spending caps would be subject to sequestration. If the defense category exceeds its cap, only that category would undergo sequestration sufficient to comply with the cap, with that amount determined by OMB. Both OMB and CBO would produce sequestration reports, and GAO would produce a sequestration compliance report. 'Firewalls' were erected between the spending categories, so defense funding, for example, could not be transferred into the international category. Sequesters would be imposed if either budget authority or outlay targets were breached. If both forms of spending caps were exceeded, the sequester on budget authority would be calculated first, because changes in budget authority most accurately reflected changes in public policy. Sequesters could occur at various points at time in the budget cycle, depending upon type of appropriations bill and its enacting date, including a 'look back' procedure if a spending cap or PAYGO violation took place during a fiscal year. Furthermore, determining whether spending exceeded these caps proved to be a simpler procedure than making the more complex economic analysis of whether the GRH deficit levels were exceeded. Levels of spending could be calculated by examining the historical rate of outlays by account, whereas estimating deficit levels depended upon a broader analysis of the macroeconomy. Finally, an additional form of sanction came by way of parliamentary points of order made by individual legislators that were enhanced over their GRH versions. For example, rather than single-year points of order, legislation could be subjected to a five-year points of order if the item in question violated the forthcoming year's spending levels, the sum of five year spending levels in a budget resolution, or if it violated the spending allocations made to the House and Senate Appropriations subcommittees (Rubin, 2003).

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The BEA framework was extended throughout the 1990s, most notably in the Balanced Budget Act of 1997 (BBA). The Act stemmed from a broad budgetary agreement that reasserted the goal of balancing the federal budget. The BBA's spending and revenue provisions reflected the political balance that had shifted from 1990. Whereas the president in 1990 was George H.W. Bush, a Republican who faced a Democratically controlled Congress, in 1997 the president, Bill Clinton, faced a Republican controlled Congress. Not surprisingly, under the American Constitution which locates the locus of budgetary decision making with the legislative branch, the budgetary priorities largely reflected the relatively unified Republican Congress. Under the BBA, total spending would decline by $961 billion over ten years, and revenues would be cut by $250 billion over the same period. Spending priorities would also change from the 1990 BEA. Comparing Table 3, which outlines the spending levels of the BEA, with Table 4, which does the same for the BBA, it may be seen that the 1997 law provided for a greater increase in budget authority for defense than the BEA, 7.8 percent over five years, versus less than one percent over three years. The 1997 BBA collapsed the

Table 4 Balanced Budget Act of 1997 (billions of dollars)

	Fiscal year				
	1998	1999	2000	2001	2002
	Total discretionary spending				
Defense					
Budget authority	269	272	275	282	290
Outlays	267	267	269	271	273
Nondefense					
Budget authority	258	261	262	260	261
Outlays	286	293	295	294	288
	Total entitlement spending				
Medicare	221	233	253	261	280
Medicaid	105	112	120	129	138
Entitlements	564	597	625	662	673

Source: US House Budget Committee (1997).

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discretionary domestic and international spending categories created by the BEA into a single nondefense category, and essentially froze spending for those programs at a 1.2 percent increase over a five-year period (US House Budget Committee, 1997). Under the BEA, however, domestic spending was permitted to grow by 5.8 percent over three years. Though these changes in the content of spending were of political relevance for the politics of the day, the important consideration here is that both political parties supported the BEA's macrobudgetary architecture.

3.1. Evaluating the effectiveness of BEA/BBA

How well did the federal government comply with the BEA/BBA spending caps, which constituted the core element of these laws? The relevant years for evaluating compliance with the laws are FY1991 through FY1998. By FY1999, with the budget balanced and the size of projected surpluses continuing to rise, the government *de facto* ignored the BBA and then formally suspended it in 2001. Table 5 provides data on the laws' annual spending limits and the amount of spending that either was above or below the caps. The data indicate that from FY1991 through FY1994, budget authority for discretionary spending exceeded the caps by as much as $14 billion in 1992, but from FY1994 through FY1998 budget authority consistently fell below the spending level. Meanwhile, outlays exceeded the cap in several years, but by no more than $7 billion. Due to these spending violations, sequesters were twice imposed in the early FY1990s.

There are important caveats that should be considered when evaluating these laws. First, BEA/BBA only restrained new mandatory entitlement

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Table 5 Discretionary spending under the BEA/BBA: Variation between original spending caps and actual spending (billions of dollars)

	Fiscal years											
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
	Spending limits as enacted											
Budget authority	492	503	511	511	518	519	528	531	533	537	542	553
Outlays	514	525	534	535	541	547	547	548	559	564	564	563
	Amount of spending that was above or below (–) the limits											
Budget authority	10	14	11	2	−16	−18	−17	−1	49	47	122	182
Outlays	−14	−6	5	7	4	−15	0	4	13	51	85	172
	Actual budget deficit (–) or surplus											
	−269	−290	−255	−203	−164	−107	−22	69	125	236	127	−158

Source: US Congressional Budget Office (2003).

spending through the PAYGO rules, they did not reform or contain the spending associated with existing programs. As a result, entitlement spending grew by approximately four to six percent during these years, even as discretionary spending was limited to some two percent growth at the same time. Second, the laws depended upon spending caps that were arbitrarily selected. Third, as in the case of GRH, the laws encouraged an annual, short-term focus in budgeting that did little to encourage thoughtful programmatic prioritization. This short-term thinking also encouraged the inevitable efforts at budgetary gimmickry. These included the shifting of programs from discretionary accounts to the mandatory category of spending, and the rise of emergency spending, which was exempt from the spending caps and sequestration.

Given the magnitude of total discretionary spending, BEA/BBA proved to be remarkably successful in limiting the growth of federal discretionary expenditures and the expansion of new unfunded mandatory programs. During the period FY1991 through FY1997, total regular discretionary budget authority fell $14 billion below the spending caps, and outlays fell $19 billion below the caps (US Congressional Budget Office, 2003). During these years of fiscal restraint, the budget deficit of $290 billion in FY1992 became a surplus of $69 billion in FY1998. Surpluses were then projected for at least the next ten years, with the real possibility that the entire national debt could be extinguished. As a result, the spending caps were ignored during next three years and the law was permitted to expire in 2002. Moreover, both George Bush and Al Gore proposed major tax cuts in 2000, with Bush's enacted 2001 cuts reaching 1.4 percent of GDP. Recently, as the federal budget again is running huge deficits, many Republicans and Democrats have called for the reinstitutionalization of the BEA/BBA fiscal rules.

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4. THE GERMAN CASE: APPLYING THE BEA/BBA TO THE EU

How would these American attempts at macrobudgetary rules work in the EU? To answer this question, it is useful to examine the case of Germany and the events that led to the crisis of 2003.

The fiscal and monetary regime in the EU's euro area is characterized by supranational sovereignty over monetary policy provided by the European Central Bank, with fiscal policy determined by the sum of the policies of the national member state governments. To encourage some degree of fiscal coordination in the euro area, the TEU includes a macroeconomic and budgetary surveillance process and the excessive deficit procedure, which were later enhanced by enforcement provisions of the SGP. The SGP's critics argue, however, that its sanctions are insufficient to prevent free-riding behavior by the member states. The SGP penalty system is

so draconian that it would only be applied after an extended period of blaming-and-shaming. The theme of our paper is on the benefits of an SGP that focuses on the level of government expenditures, rather than a government's budget deficit as a percentage of GDP, as the measure of compliance with efforts at realizing euro area fiscal coordination.

As for the events that led to the crisis of 2003, recall that the Stability and Growth Pact consists of provisions that further strengthen and clarify the timetable and steps to take in the excessive deficit procedure (TEU Article 104). As a member state moves further along in the excessive deficit procedure, it comes closer to being penalized by paying a financial deposit or ultimately a fine for exceeding the deficit ceiling. In 2000, Germany recorded a budget surplus of 1.1 percent of GDP, with Finance Minister Hans Eichel predicting significant debt reduction, tax cuts, and spending increases. These plans were quickly set aside as Germany entered a recession in the third quarter of 2001, causing the government to estimate its deficit for that year at 2.5 percent of GDP. In August, Eichel raised the idea that the SGP be revised, with its focus placed on controlling spending targets rather than deficits, as deficits stemmed from changes in the macroeconomy rather than from policy decisions (Savage, 2005). 'You can plan spending in a budget but you cannot plan your income', Eichel noted. 'The decisive thing for me is that we pursue [budget] consolidation steadfastly, independently of whether or not there is more or less income one year due to economic developments' (Hulverscheidt and Dombey, 2001). After much outcry, Eichel recanted and declared, 'We are firmly sticking to our goals of balancing the budget by 2006' (Simonian, 2001).

As the recession deepened, Germany's fiscal condition worsened. In January 2002, the Commission urged ECOFIN to issue Germany an early warning reprimand. Rather than embarrass the German government before the federal elections, due to be held in September of 2002, ECOFIN instead reached an 'agreement' with Germany that it would balance its budget in 2004. Nonetheless, the deficit continued to grow, and on 22 November 2002 the Commission initiated the first stage of the excessive deficit procedure (TEU Article 104 §3). ECOFIN agreed and in January of 2003 adopted the Commission's recommendations, based on its cyclical econometric models, that Germany take corrective action to lower its deficit to 2.75 percent of GDP for 2003 (TEU Articles 104 §6 and §7). This Council recommendation required that Germany make fiscal policy changes amounting to one percent of GDP. The Germans, in compliance with the TEU and SGP's surveillance procedure, reported that their 2002 deficit was 3.6 percent of GDP and that it would exceed 3.0 percent of GDP for 2003. In November 2003, the Commission notified ECOFIN that Germany's deficit would remain excessive and recommended that further corrective action was necessary, equivalent to 0.8 percent GDP in 2004 and 0.5 percent of GDP in 2005

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(Commission Recommendation for a Council decision TEU Article 104 §8 and Commission recommendation for Council decision TEU Article 104 §9). ECOFIN then shocked the Commission and the rest of the world by rejecting its findings and suspending the excessive deficit procedure against Germany (Council Conclusion of 25 November 2003). ECOFIN declared that the German government complied with its January recommendations to make budgetary changes equal to one percent of GDP, and that its excessive deficits stemmed not from the lack of political will or as a result of a rouge fiscal policy, but from a failing economy and a two percent fall in Germany's GDP. ECOFIN rejected the Commission recommendation that a further 0.8 percent of GDP fiscal policy changes were required, and instead indicated that 0.6 percent was sufficient (Council Conclusion of 25 November 2003).

As the Council noted, Germany's ability to comply with the Commission's recommendation were greatly complicated by its domestic economic situation. In addition to a worsening macroeconomy, Chancellor Gerhard Schröder's efforts to achieve budgetary savings through the reforms outlined in his 'Agenda 2010 package' required the support not only of his own Social-Democratic party, but also of the opposition Christian Democratic party and from the governments of the states (or *Länder*) who have competency over these policy areas. These politically difficult to enact reforms were a serious attempt at reforming the social welfare system and labor market in Germany. Thus, at a time when Schröder was engaged in highly sensitive coalition building, he confronted the Commission's reprimand, and ultimately that of the Council, for failing to comply with the SGP. Seeing that France was facing its own reprimand in September 2003 (and that country had originally been willing to accept the next steps of sanction in the SGP), Germany sought an ally in France against the Commission. Joining then with France, the two member states successfully convinced the Council to suspend the excessive deficit procedures for both France and Germany (Heipertz and Verdun, 2003, 2005, 2006).

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4.1. The German case: The value of spending targets rather than SGP deficit targets

If the SGP had relied upon spending targets, as found in the American macrobudgetary rules and called for by Hans Eichel, the EU's crisis of 2003 and its aftermath could have been averted. If the targets had been met, particularly after the German government complied with ECOFIN's January recommendations, Germany would have been in compliance with the SGP. The deficit, no doubt, would continue to grow, responding to both changes in Germany and Europe's macroeconomic problems, and to Germany's own automatic stabilizers. Yet, Germany's public officials could

have justifiably claimed credit for complying with the SGP, and ECOFIN would not have appeared favoring the big member states. Germany, therefore, would have been behaving in a proper counter-cyclical fashion.

Finally, by determining whether Germany's spending remained within its designated limits, the Commission would have spared itself from the criticism that its cyclical deficit calculations were flawed, if not biased. Spending levels can be evaluated by extrapolating from expenditure trends by budgetary accounts. The calculation of cyclically-adjusted deficit levels, as called for in the SGP, rests upon far more complex econometric models of the macroeconomy and fiscal policy. German authorities challenged the accuracy of the Commission's cyclical forecasts, as one German economist noted, 'The whole notion of structural deficit is very shaky. A lot of questionable assumptions go into these calculations' (Savage, 2005: 177). The quality of the Commission's cyclical models has been the subject of some debate in the EU (Fatas *et al.*, 2003; Hodson and Maher, 2004). Without reliable models, the SGP's reliance on deficit targets as the measure of proper budgetary policy is undermined. An SGP based on spending limits would free the EU of much of this discussion.

There are three reasons why such a revision in the SGP would be both practical and effective in the German case. First, as Hallerberg (2004a,b) suggests, Germany already possesses one of the four 'delegation' budgetary systems with strong ministries of finance in the EU, which has the power to reject the budget requests of spending ministries. Second, Germany's strong Ministry of Finance and budgetary process is complemented by reforms that took place in 2004 that strengthen the fiscal link between the federal government and Germany's 16 federal states (Benoit, 2004). These reforms include having the states share in any financial penalties imposed on the federal government because of SGP violations. European Commissioner Joaquín Alumnia praised this new relationship in an October 2006 speech, saying 'Some countries such as Austria, Belgium and Germany have adopted a cooperative approach that seeks to reach an agreement on the fiscal targets assigned to each level of government in order to ensure the respect of the SGP' (Alumnia, 2006). Third, as Hans Eichel suggested, Germany has already proved itself capable of controlling budgetary expenditures. Table 6 shows the level of general government expenditures for all types of spending for all levels of government, as well as the size of the budget deficit as a percent of GDP for the years 2000 through 2005. The table indicates that following a spurt of expenditure growth upon Germany's entry into EMU, spending remained essentially steady-state in 2001 through 2003, and actually fell in 2004 and 2005 from 2003 levels as a percentage of GDP. If the SGP targeted expenditures rather than deficits, Germany would have been in compliance in 2003. Moreover, Germany's political leadership received faint praise and little opportunity for political credit claiming for their efforts that kept spending

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Table 6 German general government budget expenditures and deficit, 2000–2005 (millions of 1999 DEM euros and as a percent of GDP)

	2000	2001	2002	2003	2004	2005
	928,470	1,005,060	1,030,760	1,046,810	1,038,040	1,048,700*
Expenditures as a percent of GDP	45.7	48.3	48.1	48.5	47.1	46.8
Deficit as a percent of GDP	+1.3	−2.8	−3.7	−4.0	−3.7	−3.2

*Estimate
Sources: Eurostat (2004, 2006).
OECD General Government Accounts, V. IV, Paris (2004, 2005).

under control. Instead, they experienced EU condemnation for growing deficits stemming from macroeconomic forces that overtook much of Europe.

5. CONCLUSION: RECOMMENDATIONS FOR REFORMING THE SGP

Having been part of an international change in government public finance reform, the EU might have produced a budgetary regime that member states could have more easily complied with had it not only reflected on its own path towards EMU, but also the experience of other countries seeking to achieve similar goals (i.e. reduce public debt and deficits). Failing that, the EU remains caught in its legal structure and thus stays within the paradigm of keeping budgetary deficits at three percent of GDP.

As long as the EU retains the SGP, it is imperative that the law be made politically credible and effective in restraining member state budgets. Having one of its most publicly visible laws openly and repeatedly violated undermines the reputation, integrity, and political cohesion of the EU and the euro area. How, then, might the SGP reverse the member states' difficulty with achieving compliance? To answer this question, the EU may benefit from the lessons the United States has learned from its experience with macrobudgetary rules.

First, the design of such rules must take into account the need for politicians to be able to claim credit for successfully compliant fiscal action. The Americans revised their macrobudgetary rules to accommodate this political requirement. The framers of the Maastricht Treaty were, in fact, also sensitive to this matter when they selected the Treaty's fiscal convergence criteria. In 1992, high levels of compliance were expected for both the deficit and debt reference values, as the deficit criterion seemed within easy reach of most of the member states. By early 1997, however, a weak economy drove up the deficits of many of the EU's governments, regardless

of their efforts to meet the convergence criteria. Without a burst of revenue producing GDP growth in the fourth quarter of 1997 (and some favorable budgetary accounting rulings by the Commission) Germany, France, Spain, and Italy would have incurred deficits in excess of 3 percent of GDP. Including economically dependent deficit reference values in the Treaty almost led widespread noncompliance with the Treaty's convergence criteria and the collapse of the Economic and Monetary Union (Dyson and Featherstone, 1999; Savage, 2005). The crafting of SGP focused more on accommodating the immediate concerns of the Germans, rather than addressing the strategic need of all politicians to be able to claim credit for successful political action (Heipertz and Verdun, 2004). Hence, there was very little learning about the political difficulties of relying upon deficit targets incorporated into the design of the SGP.

Second, substitute spending targets for deficit targets. Macroeconomically driven deficit targets are often impossible to meet and, history shows, politically unrewarding. This will be the situation in the EU when the current euro area economic expansion inevitably begins to contract, and with it an increase in SGP noncompliance (*International Herald Tribune*, 2006). Even member states with strong domestic institutions, those that scholars describe as 'delegation' states because they possess powerful finance ministries that can control profligate spending ministries, will incur excessive deficits when their economies are weak (Hallerberg, 2004a), as has been the case in Germany, France, Greece, and the United Kingdom. As the International Monetary Fund (IMF) pointed out, the use of macrobudgetary rules that rely on spending limitations is already successfully at work in Europe, e.g. in Finland, the Netherlands, and Sweden. 'This type of framework directly addresses distortions leading to excessive spending and does not automatically lead to a procyclical fiscal stance because stabilizers on the revenue side are free to operate. This type of rule can also curb the tendency to increase public spending during upturns. In addition, an expenditure rule can be easily explained to the general public and market participants, provided that the control aggregate is clear' (Daban *et al.*, 2003). Spending limits, consequently, would appeal to both small and large member states, because all would have greater control over their ability to comply with EU law than under the current SGP framework. Moreover, as the IMF noted, the member states would be encouraged to run proper countercyclical fiscal policies, rather than procyclical policies that chase after deficit reduction and balanced budgets in economically difficult times.

Third, employ spending targets rather than deficit targets to avoid dependency on unreliable econometric models. The shift from GRH to BEA/BBA pointed the way to a more credible and simpler estimate of budgetary aggregates that would activate the law's sanctions for non-compliance behavior. Member states are now subjected to cyclical models of budgetary deficits that

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are controversial, if not unreliable (Fatas *et al.*, 2003; Hodson and Maher, 2004). As the German case indicates, because these models react to shifts in the macroeconomy throughout the fiscal year, the member states are at the mercy of ever-changing cyclical estimates of budgetary deficits. Fixed spending limits would enable the member states to better plan their fiscal policies, and they would be free from of the constant uncertainty of cyclical modeling.

Fourth, create politically realistic and compliable fiscal sanctions. The American reform of its macrobudgetary rules shifted sanctions from draconian sequesters aimed at 'innocent' programs, to smaller, more politically acceptable and administratively manageable sequesters targeted at 'guilty' spending categories. A number of the recommendations shown in Table 1 suggest that the SGP's hard financial sanctions be scrapped. The problem, however, is not that the SGP's sanctions are financial or budgetary in nature, but that they are politically unrealistic. They require significant financial payments and impose significant political costs. Not surprisingly, ECOFIN has never punished a member state in this way as the SGP demands.

Fifth, create programmatic spending caps to set budgetary and policy priorities. These caps could be set, for example, in euros or perhaps in terms of percent of GDP. Setting the caps in terms of euros provides fixed spending targets throughout the fiscal year and thereby contributes to rational fiscal planning. A central point of this paper is that the initial American rule with its deficit reduction/balanced budget goal resembles that of the SGP, in that both rules aim at a moving target in the form of budget deficits, which are largely a function of changes in the macroeconomy that are often beyond the control of politicians. The Americans changed their rule to make it more effective by aiming at the more fixed target of spending levels than the moving deficit target of the SGP, and the EU may benefit by doing the same. So, using a GDP basis for setting caps has its own advantages, but spending levels may become less predictable with fluctuations in the economy and shifts in GDP. In the German case, for example, setting the cap at 47 percent of GDP for 2001 through 2005 would have allowed for an increase from 2000, but would have frozen spending during the next several years, while still allowing for higher spending rates than in 2004 and 2005. Obviously, these spending levels are open to negotiation. It is worth noting that the EU has recently developed the capacity to do so in a fashion similar to the BEA/BBA, by organizing spending by programmatic categories as well as by total levels of spending. This is a new development in international and national accounting rules and data collection, which permits the harmonization of budgetary figures by spending categories (OECD, 2004). The Maastricht Treaty required such harmonization of member state deficits by way of national accounting rules to determine their compliance with the convergence process (Savage, 2005). Using fundamentally the

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same set of accounting rules, the Organisation for Economic Co-operation and Development (OECD) now has collected data on national budgetary expenditures by program. This means that spending caps by types of programs can help set budget priorities, perhaps in support of research and education programs as called for at the Lisbon Summit, in a more harmonized manner throughout the EU.

Sixth, create specific budgetary mechanisms to control entitlement programs and tax policy. PAYGO rules force politicians to make explicit tradeoffs that require offsets to accommodate additional spending for such programs or the lost revenue due to tax reductions. The EU may consider employing similar rules to complement caps on discretionary spending.

In conclusion, the EU needs to make further reforms to its macroeconomic framework (SGP and the Treaty) if it is to avoid the ongoing, politically corrosive effects of member state noncompliance. The model for these reforms may well be drawn from the painful lessons the Americans learned in creating their own macrobudgetary rules.

NOTE

1 Budget authority is the total dollar value of obligations that an agency may incur that require immediate or future fiscal year expenditures. The actual expenditures for a given year are called outlays. Annual balanced budgets, deficits, and surpluses are determined by calculating the difference between revenues and outlays. To make changes in policy, lawmakers look first to changing levels of budget authority, which determines the size of outlays.

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How and why Britain might join the single currency: The role of policy failure

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How and why Britain might join the single currency: The role of policy failure

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ABSTRACT

Why has Britain declined to adopt the single currency? The conventional view holds that there are multiple political and economic barriers to British entry into monetary union–large fractions of public opinion, business leaders, and the Conservative party oppose entry; Britain's economic cycle is not synchronized with that of the euro-zone; adoption of the single currency would harm foreign trade and investment; British political institutions make it difficult to muster support for such a move, and so on. I argue that policy failure is a more important influence on British economic policy. Major changes occur when extant policy fails and there exists an alternative policy idea that both explains this failure persuasively and prescribes a new and more effective way forward. A British government might advocate euro membership if the current framework for policy in Britain—central bank independence with a floating exchange rate—fails, and policies pursued by the European Central Bank address the source of this failure. This combination would also lead many politicians, business leaders, and voters to see the advantages of euro membership.

KEYWORDS

Policy failure; Policy change; Euro; Monetary policy.

INTRODUCTION

Why has Britain declined to adopt the single currency? The conventional view holds that there are multiple structural barriers to British entry into monetary union. From this perspective, Britain's decision to retain sterling is over-determined – fractions of public opinion, business leaders, and the Conservative party oppose entry; Britain's economic cycle is not synchronized with that of the euro-zone; adoption of the single currency would

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harm foreign trade and investment; British political institutions make it difficult to muster support for such a move, and so on. Because most of these influences change only slowly, many are very skeptical that Britain will join the single currency in the foreseeable future.

Each of these barriers is important, but as the next section demonstrates is also more susceptible to rapid change than is often recognized. I base this conclusion on an understanding of the political process in which 'policy ideas' have a substantial influence on policy choice. Policy ideas identify goals for policy and make claims about the effects of different policies. Here I focus on how policy failure leads politicians to ignore or adopt rival policy ideas. Policy failure endangers the career prospects of politicians, and leads them to search for and consider alternative policy ideas. They select and seek to implement a rival idea, *ceteris paribus*, that identifies causal mechanisms that explain recent failure and offers an intellectually coherent and politically attractive set of policy prescriptions.

The penultimate section examines the recent pattern of British macroeconomic policy making and concludes that it is consistent with this line of thinking. Since the 1970s there have been three episodes in which policy failed, and in each case the authorities identified and implemented a new policy idea that explained the source of this failure and offered new policy prescriptions. There have also been episodes in which policy failure did *not* lead to policy change; the reason, I argue, is that there was not immediately available an alternative policy idea that could explain and remedy this failure. The theory thus accurately explains the conditions under which failure does and does not produce substantial policy change. It also helps us to understand why policy ideas rejected as unviable at one point in time are adopted at others. The reason for this is that the appeal of a policy idea depends on the form of the policy failure that precedes its consideration by politicians; an idea is more attractive after episodes of failure that it can effectively explain and rectify than after other types of failure.

In the concluding section I argue that a sharp deterioration in British economic performance, combined with the conclusion that euro membership would address the sources of this failure, could quickly make euro membership an attractive alternative to the status quo. Predicting the timing of such a policy failure is impossible, although it seems quite likely that policy will fail to generate positive macroeconomic outcomes for the indefinite future. If and when such a policy failure does occur, much of the British political elite, business leaders, and public might advocate joining the euro more quickly than most observers now believe.

BRITAIN AND THE SINGLE CURRENCY

Why is Britain the only major member-state to have retained its national currency? My argument is that the particular arrangement of social forces

and institutions in contemporary Britain make policy failure the most important source of macroeconomic policy change. Other sources of change have considerably less influence. The current section seeks to justify this contention. I consider five widely-discussed sources of British government's reluctance to join the single currency. On close examination each cause of Britain's reluctance to joining the euro is weaker than often assumed.

Divergent business cycles

One often-cited reason for British reluctance to adopt the single currency is concern politicians about divergences between the British and continental European business cycles. A single currency or fixed exchange rate effectively requires that all participating countries maintain the same interest rates. British politicians have in the past been reluctant to fix the exchange rate for this reason. If Britain were to adopt the euro and divergences in business cycles with the rest of the eurozone were to re-appear, the European Central Bank would likely set interest rates at a level most appropriate for the larger continental economies, or might determine interest rates based on some average of the business cycles across the eurozone. In either case British politicians would lose the ability they now have to tailor monetary policy to the needs of the national economy. Thus, the first of the five 'tests' for entry into monetary union that the Labour government laid out in 1997 – convergence – reflect precisely this concern, and it is supported by economic evidence (see the review in Takana, 2002).

However, there is good reason to believe that such concerns are less important today than they were in the past. Differences in inflation rates between Britain and the eurozone have essentially disappeared since well before the introduction of the single currency (see Figure 1). Joining the euro in this environment would not require Britain to alter its monetary policy stance substantially in the short run. Furthermore, adopting the euro would likely influence the relationship between the British and euro-zone business cycles, as the two economies adopted the same interest rates and monetary integration promoted business cycle convergence through greater trade and investment (see Frankel and Rose, 1998).

International trade and investment

Until the 1980s Britain's trade and investment links with the rest of the world differed from those of other member states. Britain traded and invested more intensively with North America and with former colonies, while the trade and investment of other member states was concentrated

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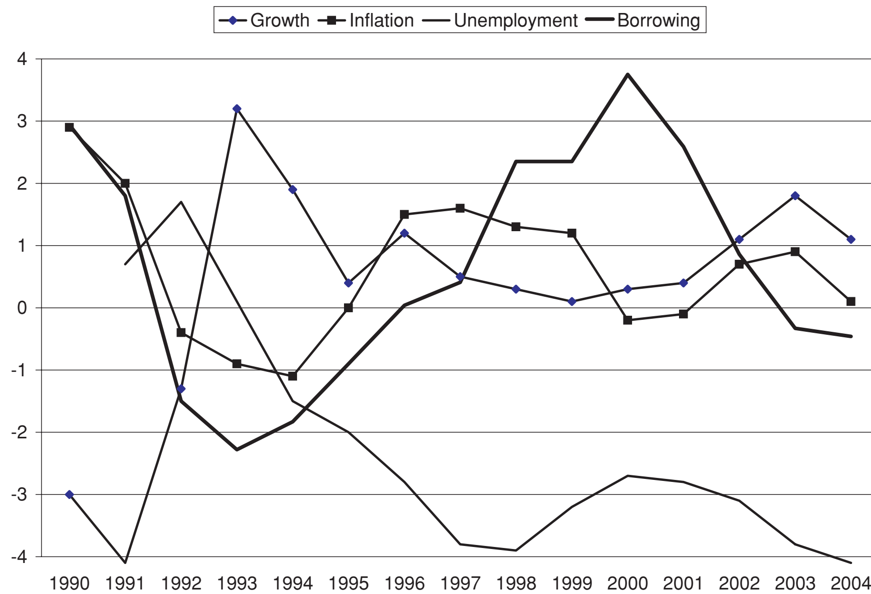

Figure 1 British and eurozone macroeconomic performance. *Note:* Time series calculated as British performance minus eurozone performance. Data before 1999 include indicators from the 12 countries participating in the eurozone in 2002. Growth is annual percentage change in gross domestic product. Inflation is annual percentage change in the consumer price index. Unemployment is a percentage of the labor market. Borrowing is annual public sector borrowing as a percentage of gross domestic product.

on Europe. This meant that British export-oriented producers and overseas investors would secure fewer economic advantages from stabilizing sterling against other European Union currencies (Frieden, 2002). Most of these differences have disappeared in the last two decades. Trade with former colonies has declined to low levels, and membership in the European Union has led to significant growth of British trade with other member states (see the figures discussed in Walsh, 2000). British firms are still more likely to invest outside of Europe than are firms in France, Germany, and Italy, but now also invest heavily in the European Union as well. Indeed, there is evidence that the euro has stimulated trade not only among the countries that have adopted the single currency but also between the euro-zone and Britain (the evidence on foreign direct investment is more mixed; see Begg *et al.*, 2003: 14–29). Euro membership would provide substantial benefits the large and growing number of firms and investors that trade with and invest in the rest of the Union.

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Social institutions

The economic sector most interested in fixed exchange rates and a single currency is producers of tradable goods, such as manufactured goods. Exchange rate stability eliminates an important source of the economic uncertainty that manufacturing firms face (Frieden, 1991). Manufacturing firms in continental countries have close ties to banks. They rely on banks rather than the stock market to finance most of their investment. These banks have powerful incentives to ensure that their industrial clients prosper. They therefore join industry in lobbying governments for policies that will produce stable exchange rates (Henning, 1994). The social institutions linking banks and industry in Britain are much weaker. Here industrial firms rely more heavily on the stock and bond markets to raise funds for investment. Banks concentrate more on trading financial instruments and on international activities. The political coalition favoring stable exchange rates is thus less influential than in continental Europe; while industry lobbies for stable exchange rates, banks either do not care much about this issue or prefer policies that will keep inflation low (Walsh, 2000).

This means that the British government faces substantially less political pressure to stabilize the currency than do other member states with close bank-industry ties, such as Germany and Italy. British governments do not face such pressures, but they also get few consistent signals from society about external monetary policy. This may be one reason why the goals and frameworks of British monetary and exchange rate policy have changed so frequently over the last two decades. Governments develop and abandon new goals and frameworks with relative ease since they lack a domestic political anchor that consistently pulls them towards a single objective. In any event, while there is at present no strong coalition in society favoring adoption of the euro, there is also no strong, institutionalized social coalition opposing such a step.

Political institutions

British politics is dominated by two large catch-all parties, Labour and Conservative. This is in part a function of the first-past-the-post electoral system, which tends to deliver more parliamentary seats to the two largest parties and punishes smaller parties with fewer seats. Most other European democracies use some sort of proportional representation electoral system, which produces more and smaller parties that govern in coalitions. One result of this is that both major parties are large and diverse in their membership, and have strong divisions among their members on the merits of the European Union. In recent years, for example, a few prominent Conservative party leaders, including Kenneth Clarke and Michael Heseltine, have supported euro membership, while most others have strongly

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opposed such a move. There are frequent reports of strong divisions among leaders of the Labour party on this question as well, although these have not played out as publicly. These differences have made it difficult for both Labour and Conservative governments to advocate membership in the euro, since a substantial number of their own supporters oppose such a step (Aspinwall, 2004). The flip side of this is that there are also substantial numbers of Labour MPs (less so Conservative) that support monetary union. There are also likely a large number of MPs that do not hold strong preferences on the single currency in the abstract, but would support joining it they perceived that doing so was popular with the voters our would allow the government to pursue more successful economic policies that would ensure its re-election.

Public opinion

The attitude of the public is very important since both parties have promised to hold a referendum before joining euro. Polls consistently show that at most 40 percent of respondents favor such a step. The Blair government has been deterred from advocating adoption of the euro in part because it fears a humiliating loss in a referendum. But public opinion can change, especially when confronted with a real choice rather than a poll. Polling majorities against joining the European Union quickly turned into a majority in favor once the question was put to a vote in the 1975 referendum. The key issue, then, is not the opinions that voters express now, but those they are likely to express in the voting booth if and when a referendum is scheduled.

A referendum will ask voters to respond with a simple yes or no to the question should Britain adopt the single currency. And all reputable polls conducted over the last decade have shown that a decisive majority would vote no. More nuanced gauges of public opinion towards the euro measure respondents' commitment to voting for or against entry. Just under half of all voters are 'euro waverers' who respond that their opinions are not set (Mortimore and Atkinson, 2003). Persuading a substantial part of these waverers to support the euro would allow the government to win a referendum. Other research shows that political leaders influence voters' choices in important ways. Gabel and Hix (2005), for example, show that many potential predictors of individual support or opposition to the single currency do not actually explain responses. Important here is the fact that partisan identification does seem to influence choice – voters identifying with the Conservative party are more likely to oppose joining the single currency and those identifying with Labour are more likely to favor it. This indicates that a governing party that takes a strong stand on the currency question in a referendum could influence voters (see also Howarth, 2007, for a detailed discussion of this issue). An important prior question, then,

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is what would lead the government to advocate membership in the euro? The developments that lead a British government to change its policy towards one of supporting membership likely would influence at least some of the public to shift their preferences in the same direction.

POLICY FAILURE AND POLICY CHANGE

As this short review makes clear, British governments have faced few strong domestic advocates of joining monetary union. But they also do not face as many committed opponents of this move as is often believed. British governments get few clear signals from important constituents, including the public, business leaders, the financial sector, and political elites, about their preferred frameworks for external monetary policy. The consequence of this arrangement of social forces and institutions is that decisions are driven largely by recent policy's success or failure in allowing the government of the day to achieve its political objectives. Policies perceived by those in power as successful create few pressures for change. Policy failure does create such pressure, leading politicians to consider seriously the costs and benefits of alternative approaches. But not all episodes of policy failure are followed by a fundamental change in the objectives and tools of policy. Instead, policy failure only leads to change when there exists an alternative policy idea whose causal logic both explains the past failure and offers a new set of prescriptions that promise to produce more successful outcomes. The explanation of changes in British monetary policy that I offer thus relies heavily on the role of ideas, rather than material interests or institutions alone. It differs from other ideational accounts in emphasizing how the *content* of rival policy ideas, combined with the failure of current policy, helps explain why politicians find some ideas useful guides to action but ignore others.

Hall (1993: 279) defines a policy idea, or what he terms a policy paradigm, as 'a framework . . . that specifies not only the goals of policy and the kind of instruments that can be used to attain them, but also the very nature of the problems they are meant to be addressing'. Policy ideas differ from more general ideologies and world-views because they have a programmatic element that indicates how to achieve a desired outcome (Berman, 1998: 21). In other words, policy ideas identify not only the appropriate objectives of government action, but also specify specific causal mechanism or mechanisms that explains how and why these actions allow authorities to achieve these objectives. Ideas reduce uncertainty about how the social world operates by providing decision-makers with simplified models of reality in the form of causal mechanisms that explain how policy influences outcomes (see especially Blyth, 2002). These are particularly useful to politicians, who often lack professional expertise in the policy areas that they supervise, and whose time and resources may be stretched across

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many political and policy domains, and who seek well-crafted proposals that can be more easily communicated to others.

Policy failure is an important reason why politicians seek out and evaluate alternative policy ideas. Politicians are never certain about the true relationships between the policy options available to them and the outcomes each will produce. When extant policy produces desirable outcomes, politicians have little reason to question its usefulness. Undesirable outcomes undermine politicians' confidence in their estimates of the relationship between actions and outcomes and create pressure to consider alternative policy ideas. More specifically, it is *unexpected* policy failure that influences the likelihood of change. As Legro puts it, '[i]deational prescriptions carry a set of social expectations of what should or should not result from group action. When expectations of what should happen are not matched by the consequences of experienced events, there is pressure for collective reflection and reassessment' (Legro, 2000: 424–5).

There is empirical support across a wide array of issue areas that failure leads politicians to consider new policy ideas. Many works on foreign policy explore this connection. Policy failure figures prominently in Jervis' psychological model of policy learning (Jervis, 1976: 275–9). Levy's (1994) review of the literature of learning and foreign policy accords a key role to policy failure, often in combination with other variables, in prompting change. Checkel (1997) shows how the failure of many the Soviet Union's foreign and domestic policies led Mikhail Gorbachev to consider seriously and then attempt to implement a wide array of alternatives grouped under the term 'new thinking'. Reiter (1996) argues that the success or failure of a state's choice between alliance or neutrality in one period has a decisive impact on alliance policy in subsequent periods. Others working on the role of ideas in domestic policy reach similar conclusions. McNamara (1998) holds that the failure of monetary and fiscal expansion in western Europe in the 1970s to produce acceptable economic outcomes led to the diffusion of new policy ideas that supported tightening monetary policy, granting independence to national central banks, and cooperating more closely to stabilize exchange rates in the 1980s. Hall (1993) shows that policy failure led to a fundamental rethinking of the goals and tools of macroeconomic policy in Britain during the 1970s. Heclo's influential study of the development of the welfare state in Britain and Sweden in the twentieth century demonstrates that politicians in each country responded to negative experiences when developing new policies (Heclo, 1974, especially pp. 315–8). In his study of the diffusion of policies across polities, Rose (1993: 50–76) attaches much importance to how failure in one polity leads its politicians to investigate the policies pursued in other polities.

There is thus good reason to believe that failure prompts politicians to search for and to evaluate new policy ideas. But how do they select among rival ideas? Which rival idea, if any, will they find most persuasive and

useful? And why do politicians sometimes continue to implement failed policies when rival ideas' policy prescriptions are available? The existing literature offers unsatisfactory answers to these questions. Many of the empirical studies of policy failure cited earlier do not explain in detail why politicians found one new idea more useful than others after experiencing failure, or select cases in which only a single rival policy was considered seriously. Legro (2000: 429–30) argues on theoretical grounds that there is often only one alternative idea:

> Such [ideational] structures seem to frequently take a binary form with a dominant idea that guides societal action and an alternative idea that exists in opposition-be it containment-engagement, free trade-protectionism, isolationism-internationalism, Keynsianism-monetarism, or offense-defense. When an old orthodoxy collapses, an oppositional idea with preexisting social support that appears to coincide with socially desired results (whether it actually caused such results is irrelevant) is likely to be the new focal point of consolidation and institutionalization.

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It may be true that in some cases there is really only one realistic alternative to the status quo. But it seems likely that there are as many or more cases where there are multiple plausible alternatives. Government departments, independent agencies, research institutes, political parties, interest groups, universities, international organizations, and political leaders themselves are in the business of creating, evaluating, and lobbying for policy ideas. Very often the difficulty that politicians face is not the paucity of new policy ideas but the plethora of them, for this raises the issue of how do politicians rank these ideas? Consider contemporary monetary policy. The policy literature focuses on the strategic interactions between politicians' goals and the inflation expectations of the private sector.[1] This assumes that attempts to reduce unemployment with an expansionary monetary policy are effective only in the short run. In the long run, such policies result in higher inflation and unemployment reverts to the natural rate. But politicians face a 'time inconsistency problem': they are tempted to promise not to try to push unemployment below the natural rate but then to renege on this promise, since the unexpected inflation this generates will not influence private sector behavior immediately. The private sector eventually catches on to this and adjusts its behavior to politicians' previous reneging. The solution is to create rules that constrain politicians' ability to try to spring inflation surprises on the public. Abiding by clearly-specified rules for the conduct of monetary policy both constrains politicians' choices and allows them to build up the credibility of their promises to manage the economy responsibly.

The difficulty is that there are many plausible rules that are potential solutions to the time inconsistency problem. Setting targets for the rate

of growth of the money supply or inflation, creating a politically independent central bank, fixing the exchange rate, entering monetary union, and so on are all examples of such rules.[2] Central bank independence, a fixed exchange rate, inflation targets, and so on share the basic principle that macroeconomic outcomes will be superior when politicians are constrained by a rule. But each offers a different solution to the same basic problem (Verdun, 2000). How are politicians, most of whom lack expert knowledge of these rules' intellectual underpinnings and economic effects, to select among them? The analytic content of a policy idea is an important source of influence. Research on ideas and politics focuses a surprisingly small amount of attention on the degree to which what an idea says makes it more or less important in policy debates. Instead, much of the debate has been about how policy ideas can compliment explanations of political outcomes that focus most of their attention on actors' material interests or institutional arrangements (see Blyth, 1997 for this point; two important works that draw attention to the content of ideas are Hall, 1993, and Legro, 2000). Politicians are attracted to policy ideas whose causal mechanisms can both persuasively explain why failure occurred in the past and draw on this explanation to provide new prescriptions for more successful policy in the future. Both of these elements are important for understanding why politicians will express interest in some policy ideas but dismiss others. Policy ideas whose causal mechanisms can explain recent past failure are immediately more plausible to politicians. Political decision makers are oriented towards practical steps and outcomes, not epistemology. This means that they are more interested in policy ideas whose causal mechanisms can explain the cause of the policy failure that they face right now. The ability (or inability) of the policy idea to persuasively explain episodes of policy failure in the more distant past, or in different empirical contexts, is less important to politicians when they evaluate an idea's utility. The ability to explain recent failure also has the advantage allowing politicians to draw on the idea to justify and explain persuasively their diagnosis of the problems they face to other political leaders, interested elites, and the public.

Politicians favor policy ideas whose causal mechanisms also identify new policy tools and settings that have the promise of generating more successful outcomes. Recall that policy failure makes politicians and other interested parties less certain of which tools and settings will produce desirable outcomes. The ideational component of a policy – the causal connections it draws between various policy actions and outcomes – is an important source of its influence because it reduces uncertainty in the minds of politicians about the range of options available to them and the consequences that would result from the implementation of these options. Unexpected policy failure leads politicians to listen seriously to advocates of rival ideas inside and outside of the government. Politicians favor those

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		Does policy idea exist that explains failure and provides prescriptions?	
		No	Yes
Has extant policy failed?	No	No Policy Change *Central Bank Independence and Floating Exchange Rate, 1997–Present*	No Policy Change
	Yes	Policy Drift *MTFS (1983–1988), EMS (1992)*	Policy Change *MTFS (1979–1982), EMS (1990–1991), Central Bank Independence and Floating Exchange Rate (1993–1996)*

Figure 2 Policy failure and policy change.

ideas that persuasively might mitigate their now-heightened uncertainty and that provide coherent and comprehensive packages of policy changes that can be explained to bureaucratic and public audiences.

It is not only the causal mechanisms upon which a policy idea is based that make it more attractive to politicians. Instead, a specific policy idea is more persuasive only if it 'fits' with an episode of recent policy failure in the sense that it can explain this specific failure and offer novel prescriptions for reversing it. The political value of policy ideas is not absolute, but depends on the *context* in which it is discussed and considered by political leaders. The chance that a given policy idea will be adopted is thus path-dependent; a particular idea might be very interesting to politicians after one type of policy failure, but marginalized in policymaking circles after another type of failure. Figure 2 illustrates this interaction between policy failure and the content of rival ideas. The absence of policy failure creates few pressures for change, and makes politicians reluctant to seriously address the advantages and disadvantages of alternatives. So even ideas whose intellectual content is judged superior to the status quo face an uphill struggle in attracting the attention of politicians in the absence of policy failure. But conversely, not all episodes of policy failure lead to the adoption of a new idea. If there does not exist an alternative idea that can explain this particular episode of failure and prescribe novel actions, policy after failure drifts in the sense that it lacks coherent intellectual links between tools and desired outcomes. This drift can take the form of

continuing to implement failed policies or altering the selection and settings of policy tools in cosmetic or contradictory ways that do not address the sources of failure. It is only when there is a rival policy idea that can adequately explain the failure that politicians must address and provide them with guidance regarding superior policies that its prescriptions will be turned into action.

I am not arguing that the ability of an alternative policy to explain and to correct past failure alone explains its adoption by government leaders. The political viability of an alternative is also important to politicians. They may lack sufficient political support from powerful constituents to implement the policy proposal that they conclude best explains past failure and offers new prescriptions. These constituents may block implementation because of ideological opposition to proposed policy changes, because they want to change the government's composition, or because they will have to pay additional costs if the new policy is implemented. The identity of such constituents is likely to vary a great deal depending on the policy issue and institutional context involved. For some issues and in some institutional milieus, politicians may adopt a new idea but will have to persuade many others, such as bureau managers, legislators, interest groups, to support its implementation. This need to secure the assent of others is less salient for the topic of this analysis, monetary and exchange rate policies in Britain. This means that the dynamic relationship between policy failure, the explanatory and prescriptive power of alternative policy ideas, and policy change outlined above should exercise a powerful influence over policy choices in Britain. Here macroeconomic policy is of most interest to large constituency groups such as political parties or labor unions. The reason is that the economic effects of macroeconomic policy, especially monetary policy, cannot be easily disaggregated. Many narrower interest groups have interests in macroeconomic policy that cross-cut each other. They also face important collective action problems; smaller groups that might benefit from a particular orientation of macroeconomic policy, for example, may have few incentives to deploy their political resources to achieve this outcome if most of the benefits go to others.[3] Few interest groups and other constituency groups thus take a direct interest or lobby the government on broad issues of foreign or macroeconomic policy, such as the design or participation in European institutions, although some such groups do try to influence specific policy decisions. This arrangement of societal preferences and policymaking institutions means that the government has considerable freedom to consider and to implement new policies. Groups such as unions, employers, and rival political parties often find it difficult to develop clear preferences regarding monetary policy, and even when they do so are inhibited by collective action problems from devoting much effort to lobbying for policies consistent with these preferences.

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APPLYING THE ARGUMENT

This understanding of the relationships between failure and policy change accounts for the major changes in British monetary policy since the 1970s. It also accounts for those cases in which policy failure occurred but was not followed by the adoption of a new policy idea. Three such changes have taken place: the adoption of strict monetary targeting by the Thatcher government in 1979, known as the Medium-Term Financial Strategy (MTFS), the informal targeting of the exchange rate in the mid-1980s culminating in the entry into the European Monetary System (EMS) in 1990, and the exit from the EMS and subsequent creation of an independent central bank combined with a floating exchange rate. During periods in which the authorities judged policy to be producing successful outcomes, they devoted little attention to alterative policy ideas and focused on marginal improvements to the status quo; examples include the early membership in the EMS in 1990 and 1991, and central bank independence after 1997. All three episodes of major change – the introduction of the MTFS, entry into the EMS, and granting the Bank of England independence – were preceded by the failure of extant policy to achieve the government's goals, and each of the new policies was backed by an ideational component that explained past failure and suggested new actions. Other cases of policy failure in which such an alternative idea was not available – such as between the failure of the MTFS and entry into the EMS–were characterized by subsequent drift in policy.

Monetary targeting and the MTFS

Conservative and Labour governments encountered serious economic problems in the 1970s. Particularly difficult was the simultaneous occurrence of higher inflation and higher unemployment. This 'stagflation' was unexpected by what was arguably the dominant understanding of the macroeconomy at the time, which held that there was a trade off between inflation and unemployment. It convinced many politicians in both parties that the status quo policies based on this trade off had failed, and led them to search for alternative frameworks for economic policy. They found that many such alternatives were circulating among professional economists and in the economic policy community. These included granting independence to the central bank, a policy which seemed to be containing inflation without sacrificing growth in Germany, participating in the new European exchange rate system, which promised to provide an external anchor for monetary policy and halt the large currency depreciations that occurred in the 1970s, strict rules for minimizing budget deficits, which would reduce inflationary pressures, actively coordinating wage demands and increases with employers and unions as occurred in many continental countries,

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as well as targeting the rate of growth of the money supply, which some economists believed had a direct and positive influence on the inflation rate.

Why did politicians find monetary targeting more attractive than the alternatives? The decisions involved have been subjected to a great deal of scholarly scrutiny, and addressing these questions fully could consume an entire article or book. Here I will simply note that the outcome is consistent with the analysis of policy failure and change advanced here. A crucial ingredient was that targeting offered a coherent explanation of the economic problems of time (see especially Hall, 1993). All of the other alternatives either had been tried in the recent past and failed (such as fixing the exchange rate or wage concertation) or offered only theoretical promises of improved policy without directly addressing recent sources of failure (such as central bank independence). The Labour government of James Callaghan first introduced targets for the rate of growth of the money supplyin the mid-1970s as a guide for monetary policy. The Conservative Thatcher government elected in 1979 made such targets the centerpiece of its economic policy in the form of the Medium Term Financial Strategy (MTFS). The idea of monetary targeting had circulated among professional economists for many years. But it was only in the context of the high inflation, unemployment, and slow economic growth of the 1970s that it gained any political attention. Politicians were attracted to monetary targeting because it provided both a coherent explanation for the failure of contemporary policy and a guide to policies that would be successful in reversing these failures. In terms of explaining past failures, the argument for monetary targeting had two advantages. First, it boiled down to a simple positive relationship between the amount of money in circulation and changes in prices that could be explained to non-expert audiences and that posited a general relationship that could explain with one causal mechanism many of the economic problems of the day. Second, monetarist economists such as Terry Burns and Alan Budd produced empirical studies that showed a close relationship between increases in the money supply and in subsequent prices changes during the 1970s. The theoretical argument linking these two variables, then, seemed confirmed by recent experience. The prescriptions of monetary targeting were also more appealing to politicians. The policy idea held that the authorities only had to control the rate of growth of the money supply in order to contain inflation. This prescription seemed far simpler and easier to grasp than some alternatives, whose prescriptions would be politically difficult to implement (such as negotiating comprehensive wage restraint with employers and unions), had failed in the recent past (such as a fixed exchange rate), or which promised that institutional changes would in a not very well-defined way translate into superior economic outcomes (such as central bank independence). Monetary targeting, in comparison, had the advantage that if had never been

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fully implemented in the past, which meant that it had never failed, and of offering a seemingly straightforward way to measure and control the money supply and thus inflation.

Monetary targeting also delivered political advantages to the new Conservative government elected in 1979. The Conservatives were elected on a platform promising to 'solve' the inflation problem, and the government's leaders understood that their credibility with voters and capital markets depended on reducing inflation sharply well before the next general election. Monetary targeting made achieving this goal easier than alternative policy ideas. The government was able to use monetary targets to justify very sharp increases in short-term interest rates. This in turn led to a rapid appreciation of sterling against most other currencies. Appreciation placed downward pressure on inflation by reducing the sterling price of imports and exposing British producers of tradable goods to sharper international competition in domestic and foreign markets. The government recognized that many of the costs of high interest rates and fiercer international competition fell on industrial firms and labor unions. While the complaints of industrial firms, which naturally supported the Conservatives, did create some political problems for the government, this was balanced against the advantages of being able to weaken organize labor and to blame the trade unions, which of course supported the opposition Labour party, for many of Britain's economic troubles (Lawson, 1993: 59; Moravcsik, 1998; Talani, 2000).

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Targeting the exchange rate

While monetary targeting reduced inflation quickly, it soon encountered substantial problems of its own as a guide to policy. Two difficulties were particularly important. First, changes in the financial system made the behavior of the monetary aggregates more difficult to predict and target. The government's removal of capital controls shortly after taking office, substantial growth and reform of major markets in the City, as well as technical disagreements about which measure of the money supply best reflected underlying economic activity, made it impossible to base interest rate policy on the movements of the money supply alone. The second difficulty with monetary targeting was the exchange rate. Sharp sterling appreciation after 1979 helped reduce domestic inflation. But sterling was by 1981 at an unsustainably high level and began to depreciate. Monetary targeting was little use as a guide to policy in this environment. In principle, monetary aggregates would eventually respond to exchange rate depreciation, but in practice the relationship between the aggregates and the exchange rate was characterized by lags of uncertain duration. Furthermore, politicians worried that sterling would depreciate as quickly and sharply as it had appreciated. This would require an immediate reaction in terms of interest

rate policy and would undermine the government's economic credentials with the public.[4]

The failure of monetary targeting to develop a consistent relationship between the money supply and economic outcomes, and to provide a guide for exchange rate policy, meant that by about late 1982 the conduct of monetary policy was divorced from changes in monetary aggregates. While the government continued to justify such changes to the public and the financial markets in terms of controlling the rate of growth of the money supply, in reality the authorities changed interest rates largely in response to changes in the exchange rate, cutting rates as sterling appreciated and, more often, raising rates as the currency fell.

This failure of the MTFS prompted ministers and senior officials to search for alternative frameworks beginning in 1982. Policy would drift until they decided to prioritize the exchange rate later in the decade. They seriously considered two rival policy ideas. One was to grant the Bank of England the independent authority to set interest rates. Under the direction of the Chancellor, Nigel Lawson, a team of Treasury officials drew up a proposal for an independent central bank in the summer and autumn of 1988. The proposal argued that the advantage of an independent Bank of England was that it would provide 'an alternative way of entrenching the commitment to stable prices' that would not be prey to the difficulties that monetary targeting had encountered. This was because it would be 'locking a permanent anti-inflationary force into the system, as a counterweight to the strong inflationary pressures which are always lurking' (Lawson, 1993: 868). Monetary targeting, of course, had been developed with the same idea of creating a rule for governing monetary policy. Central bank independence, in contrast, was an institutional rather than a direct policy solution, and so would be more adaptable to changing and unforeseen circumstances. This would provide the central bank with the credibility that a government could not achieve.

Many inside and outside of the government concluded that a formal target for the exchange rate by joining the European Monetary System would provide a superior framework for policy. Chancellor Nigel Lawson himself preferred this step to that of creating an independent central bank, although he argued that both would be superior to the status quo. He argued, first in private and then in public, that directly targeting the exchange rate would eliminate most of the short-term depreciation pressure that sterling encountered in the early 1980s and would provide a clearly visible public expectation for the goals of policy. The European Monetary System, created in 1979, had a proven low-inflation 'anchor' in the form of the German central bank, the Bundesbank, and joining the system would allow the British authorities to import some of their German counterparts' credibility with financial markets (Lawson, 1993: 461–9; Smith, 1979: 50–1; Thatcher, 1993: 694).

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The Prime Minister, Margaret Thatcher, initially rejected joining the EMS, largely out of concerns that this would effectively remove her influence over monetary policy and because of her personal opposition to European integration (Moravcsik, 1998). But the government did in effect join the EMS by adopting an informal target for the sterling-mark exchange rate, and adjusting interest rate policy to stabilize this rate (Lawson, 1993: 731–49; Smith, 1992: 118–9). Thatcher's successor, John Major, did take sterling into the EMS in late 1990 (Thatcher had reluctantly agreed to this move in principle 'when the time is right' but did not authorize membership before leaving office). EMS entry addressed the government's short-term economic problems. By late 1989 Britain faced high inflation, already high interest rates, and the beginnings of what would become a deep recession. Major concluded while still Chancellor of the Exchequer that EMS entry would be the best way to address these problems, and brought sterling in soon after he replaced Thatcher. The move was based on the consensus in the government and outside it that exchange rate stabilization was the most effective rule for monetary policy. It thus built on the arguments made earlier by Lawson and others that a currency target was the best way to enhance the authorities' credibility (Financial Times, 24 February 1990; Independent, 12 March 1990: 22). EMS entry also had a powerful political logic. The key difficulty that the government faced was high inflation combined with already-high interest rates. Raising interest rates further would contain inflation but would slow stagnant economic growth and reduce the government's popularity before the next general election, due by 1992 at the latest. Joining the EMS, and in effect formally pegging sterling to the low-inflation German mark, would allow the British authorities to import the credibility of their German counterparts. The key cost of such a move would be that the Bank of England would have to match changes in German interest rates. But this posed no political problem in the short-run, as interest rates in Germany were lower than those in Britain; indeed, the government cut interest rates immediately upon entry in late 1990 and continued to do so until mid-1992 (Financial Times, 6 October 1990; Independent, 17 June 1990; Thatcher 1993: 722–3).

Why did the authorities eventually endorse the policy idea that called for fixing the exchange rate rather than the idea that advocated an independent central bank? An important reason was that fixing the currency directly addressed an important cause of the failure of the MTFS. Politicians understood that responding to downward movements of sterling was the immediate problem that they faced by 1982. An exchange rate target was a simple and straightforward solution to this problem. Entry into the EMS, then, addressed what politicians identified as a major cause of the failure of the MTFS and offered a solution that would avoid such failure in the future. The alternative policy idea, central bank independence, addressed these issues in a much less satisfying way. It did not deal directly with

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the problem of exchange rate instability, as a politically independent Bank of England would face the same between higher interest rates and higher inflation that the government faced when sterling depreciated. And it was more difficult for politicians to envision how an independent monetary authority could be created or how it would behave. Ministers, officials, and commentators expressed more and earlier interest in an exchange rate target than in central bank independence. Serious and public debate about entering the EMS started in 1985 and became a regular feature of the public debate about monetary policy for the next five years. Lawson kept his proposal for an independent central bank secret until he resigned from office in 1989. But even after this widely-publicized revelation, the idea behind central bank independence did not gain much traction. The Labour party, then out of power, opposed the idea. The ruling Conservative party never endorsed the proposal, although one senior party member – Michael Heseltine – did adopt it when he campaigned unsuccessfully to succeed Margaret Thatcher as prime minister in late 1990. It is true that the Major government carefully managed and timed its entry into the EMS so that it received maximum short-run political benefit from the move. This interest in shoring up its political support help us to understand the choice of when to enter the system and the exchange rate chosen when doing so. But it does not help very much in explaining why interest in a fixed exchange rate was seriously debated consistently after 1985, nor why the government chose this option rather than others such as simply changing interest rates in response to immediate economic or political developments. But the framework introduced here does address these issues, as it shows how the specific cause of an episode of failure makes some alternatives more attractive and plausible than others.

Creating an independent Bank of England

Sacrificing monetary policy autonomy by joining the EMS soon imposed substantial costs on the government. The Bundesbank raised interest rates through early 1992 to counter domestic inflation. Inflation in Britain fell in the early 1990s but growth and employment remained low, calling for further interest rate cuts (see Figure 1). But EMS membership placed a floor under British interest rates. By mid-1992 the government faced a serious dilemma – maintaining sterling's peg in the EMS would choke economic growth and reduce the government's popularity with voters and MPs, but exiting the EMS would undermine the credibility of the government's policy promises.

External developments resolved this drift in policy. The combination of a the rejection of the Treaty of European Union by Danish voters in a referendum in June 1992 and increases in German interest rates in July led sterling and other European currencies to depreciate against the mark.

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The government intervened heavily on the foreign exchange market to maintain the peg, then unsuccessfully pressed German authorities to cut interest rates, and on 'Black Wednesday', September 16, gave up the battle by pulling sterling from the EMS and allowing the currency to float (Cameron, 1993).

Black Wednesday destroyed the Major government's credibility with voters and investors. Ministers and officials spent most of late 1992 and 1993 considering alternative policy ideas. Any idea that prioritized exchange rate stability – such as rejoining the EMS or negotiating a more global monetary agreement – received little consideration. This was despite the fact sustaining an exchange rate peg may very well have been much easier after Black Wednesday for two reasons. First, sterling could have reentered the system at a more sustainable parity. Second, after the summer of 1993 the other members of the EMS widened its fluctuation bands from ±2.25 to ±15 percent around central parities. This reduced expectations of devaluations and created less tension in the EMS. But the analytical ideas behind proposals for exchange rate stability had been discredited in the eyes of British leaders by their humiliating exit from the EMS. They focused most attention on policy ideas that would give precedence to domestic macroeconomic stability and would promise to restore the authorities' credibility with the financial markets. Such ideas were avoided the problems that exchange rate stabilization had created. They also would serve the useful political function of allowing the government to give priority to creating economic conditions preferred by voters and potential rebels in the Conservative party in Parliament. And they would address the fact that the government lacked credibility, which made it much more difficult to influence private-sector economic activity and expectations.

Two such ideas were considered and debated. The first was inflation targeting, in which the authorities declare a public target for the inflation rate and pledge to adjust interest rates to achieve this target. In the post-Black Wednesday context, inflation targeting has three principal advantages. First, it prioritized the domestic objective of low inflation. Second, it gives the authorities the flexibility to respond to unforeseen developments that influence the inflation rate. This was a considerable advantage over the EMS experience, when unexpected sterling depreciation forced the government to maintain high interest rates at a time of slow economic growth. Third, the fact that an inflation target is public is intended to increase the credibility of the government's promise to achieve it. Governments know that they will be criticized for exceeding their inflation target if it has been announced in advance, and thus will work harder to avoid this outcome, a conclusion supported by some recent academic research (see, for example, Fischer, 1995).

The Major government adopted this policy idea, and announced inflation targets beginning in 1993. But they soon decided that inflation

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targeting alone was not an adequate solution to the policy failure of Black Wednesday. While inflation targeting usefully focused on the domestic economy, it did too little to augment the government's credibility. The reason was that inflation targets amounted to a promise of the outcomes the government wanted to achieve, but did not explain how the government would do this. So the government soon linked the inflation target to moves that gave the Bank of England greater voice over monetary policy, while continuing to allow the currency to float. Academic research produced at the time, with which many officials and advisors were familiar, concluded that central bank independence was a 'free lunch' that provided lower inflation at no cost in terms of output or employment (key works included Cukierman, 1992; Grilli *et al.*, 1991; Alesina and Summers, 1993). The key advantage that the policy idea of central bank independence had over inflation targeting was that it posited a plausible institutional and political mechanisms that would realize this goal. On the institutional side, contemporary independent central banks are typically charged with giving priority to keeping inflation low. This statutory requirement is intended to create in the bank the organizational objective of maintaining low inflation. On the political side, independent central bankers are usually selected, or become upon assuming their office, 'conservative' in the sense that they place priority on low inflation (Rogoff, 1985). Furthermore, the major force in society that interacts with, and supports the independence of, the central bank are banks and other financial firms. This private sector coalition should support the objective of low inflation and lobby other branches of government that the central bank's ability to achieve this objective be maintained (Henning, 1994).

Initial steps in the direction of central bank independence included directing the Bank to publish an independent inflation forecast, institutionalizing monthly meetings between the Chancellor and the Governor of the Bank, and releasing the minutes of these meetings with a six-week lag. While the government retained authority over interest rate changes, it did give the Bank considerable room to effectively criticize policy decisions that it thought were inflationary (Cobham, 1997; Stephens, 1996: 294–5). The Labour government elected in May 1997 took these reforms to their logical conclusion, and granted the Bank full political independence and operational authority over interest rate policy. While the government continued to set an inflation target, the Bank now had free rein to change interest rates in the manner it thought would best achieve this target. Full independence would further increase the credibility of monetary policy, and the 'new' Labour party, having been out of office for 18 years, was very keen to prove to voters and investors that it could be trusted to manage economic policy responsibly. Furthermore, the limited implementation of this policy idea by the Major government had produced successful outcomes compared to the past (see Figure 1), making it seem to the authorities

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quite reasonable to take the idea's prescriptions to their logical conclusion (see especially Burnham, 2001, and King, 2005).

This case also demonstrates that it is principally how the content of a policy idea relates to recent failure, rather than its content alone, that determines the extent to which it is found persuasive. The content of the policy idea of central bank independence did not change substantially between when it was first seriously injected into policy discussions by Lawson in 1988, and when it was adopted by first the Major and then the Blair governments. What had changed, however, was the context in which it was considered. The failure of the MTFS raised questions about which policy tool would provide the best rule for maintaining low inflation. Central bank independence did not create such a rule, but membership in the EMS did. After Black Wednesday, the failure of EMS membership raised the issue of how the authorities could most effectively increase their credibility. The policy idea of central bank independence directly addressed this problem, which made it much more interesting and persuasive to politicians.

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HOW AND WHY BRITAIN MIGHT JOIN MONETARY UNION

To this point, I have argued that policy failure leads to the implementation of a new policy idea only if this idea can successfully explain past failure and generate plausible prescriptions for how to produce more desirable outcomes in the future. Such policy ideas existed and were implemented after the failure of demand management in the 1970s, the MTFS in the 1980s, and the EMS in the 1990s. If this understanding is correct, Britain might join the euro under the following sequence. First, the current policy framework of central bank independence with a floating exchange rate must begin to produce undesirable outcomes. While it is impossible to predict when such failure might occur, it does seem reasonable to expect failure at some point in the future. Few would argue that the innovation of central bank independence has permanently stabilized the economy, especially in the face of external shocks. And there are numerous cases in which independent central banks took steps that actually aggravated such shocks, including the Bank of England at the onset of the Great Depression, the United States Federal Reserve in the 1970s, and the German Bundesbank after German reunification.

This policy failure would create strong incentives for the government to seek out alternative ideas for monetary policy. The government might consider seriously membership in the single currency as an attractive new policy framework if joining the euro was seen as addressing the cause of recent policy failure. We can imagine two situations in which this might be the case. The first would be a rapid and sustained fall in sterling's value. This would have two negative effects. It would feed into domestic inflation, the key problem that central bank independence is intended to prevent. It

also would indicate that an independent central bank alone can do little to control such depreciation. Both of these difficulties could be resolved by joining the euro. This step would impose the presumably now more credible authority of the European Central Bank, which should reduce inflation expectations in Britain. It also would remove the exchange rate problem, as Britain would no longer have a national currency or national exchange rate. A second scenario that would make euro membership attractive is a combination of high inflation and slow growth in Britain with lower inflation, reasonable economic growth, and low interest rates in the eurozone. Here joining the single currency would also reduce inflationary expectations while at the same time allowing for lower interest rates, which would spur British economic growth. Recall that this was exactly the circumstances that led the anti-monetary union, Conservative government of John Major to decide to join the European Monetary System in 1990, since doing so both shored up the government's anti-inflation credibility and allowed it to reduce interest rates. Euro membership would be less attractive after other sorts of policy failure. For example, unexpectedly higher unemployment in Britain than in the eurozone alone would not make euro membership more attractive, unless this step was consistent with an explanation for the unemployment difference and held the promise of ending it. If an episode of policy failure convinces the government of the day of the advantages of euro membership, it would then make the case to business leaders, international investors, and the voting public that euro membership will improve the state of the British economy. As we have seen, none of these groups has a solid majority committed to preventing the country from joining the euro. This means that majorities in favor of membership might materialize if the government were to make a strong and convincing case in favor. For government advocacy of monetary union to be effective, it must be able to show how the policy framework of the eurozone would solve the problems that previous national policy had created.

One might question the extent to which the policy ideas informing the current monetary policy regimes in Britain and the eurozone actually differ from each other. Central to the policy regimes in both Britain and the continent are a politically independent central bank charged with keeping inflation low. The key difference is that the eurozone is essentially a permanently fixed exchange rate regime, while the British authorities manage a floating exchange rate. Member states participating in the euro must match the monetary policy produced by the European Central Bank, which does not and is unlikely to alter its policy stance enough to offset even a serious economic problem such as recession in a single member state. In other words, adoption of the euro would mean that British authorities are abandoning the ability to revalue or devalue sterling (and thus the ability to conduct an independent monetary policy) to a supranational authority. This would mark a very substantial change in policy.

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I am not arguing that this sequence of events is the most likely outcome or attempting to predict when such a sequence might occur. It is easy to imagine that events might prevent this sequence from unfolding. For example, the British economy may continue to outperform that of the eurozone in many respects. This has been the pattern for the last decade or so, during which Britain's unemployment rate has been much lower, and its inflation, growth, and borrowing rates have been about equal to or better than, those of the countries that have adopted the euro (see Figure 1). Even if the economy falters, the government in office (particularly a Conservative government, as the party remains divided on relations with the European Union) may resist pressure to advocate joining the single currency. Or the government may push for membership but have this move rejected in a public referendum. Instead, my point is that the preferences of the public and of elites, and therefore policy, may shift much more quickly and radically than structural explanations, such as trade patterns or political or social institutions, would have us think. The recent history of British monetary policy and especially of exchange-rate policy indicates that dramatic policy changes can occur in a short period of time. The reason for this is that while policy is of course influenced by slowly-changing structural factors, it is also influenced by policy ideas, which can achieve political prominence far more rapidly than structural factors change (see also Blyth, 2002).

One implication of this line of thinking is that most of the advice proffered by advocates of entry is either ineffective or counter-productive. Many favoring euro entry urge the government to emphasize the costs of exclusion for British business and British influence in the European Union (see, for example, Leonard and Arbuthnott, 2001). But it is difficult to make the case that the British economy has suffered outside of the euro. And counterfactual claims that Britain would have more influence in the European Union if it joined the single currency are difficult to substantiate in a compelling way to the public and politicians. Sadly for euro enthusiasts, British politicians, business leaders, and the public are unlikely to be convinced of the merits of joining the single currency unless the British economy begins to suffer from serious problems that cannot be addressed quickly or adequately with the current policy framework of national central bank independence. Only then might the alternative of abandoning sterling for the euro look politically and economically attractive.

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NOTES

1 The key early papers are Kyland and Prescott (1977) and Barro and Gordon (1983).

2 The scholarly literature on each of these alternatives is enormous. A good introduction is (Bernhard *et al.*, 2002).

3 McNamara (1998) and Moravcsik (1998) both reach this conclusion, which is consistent with the focus on things such as partisanship, government cohesion, and electoral timing much of the comparative research on the determinants of macroeconomic policy. Others, such as Hall (1993) and Henning (1994), argue that the interests and influence of narrower interest groups depends largely on the institutional context. In the case considered here, this institutional context tends to minimize the importance of producer groups and other interest groups for the determination of macroeconomic policy for the reasons mentioned in the text.

4 Keegan (1989: 157), Riddell (1991: 18–22), Smith (1987: 90), and interviews with former minister and former director of the Bank of England.

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