

THE BUNDESBANK: A MODEL FOR  
THE EUROPEAN CENTRAL BANK ?

A THESIS PRESENTED BY BERTUNGA BILGIC  
TO  
THE INSTITUTE OF  
ECONOMICS AND SOCIAL SCIENCES  
IN PARTIAL FULFILMENT OF THE REQUIREMENTS  
FOR THE DEGREE OF M.A.  
IN THE SUBJECT OF INTERNATIONAL RELATIONS

BILKENT UNIVERSITY  
FEBRUARY, 1995

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*Ertunga Bilgiç*  
*tarafından hazırlanmıştır*

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Dr. Seymen Atasoy



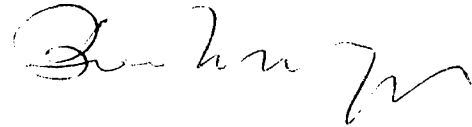
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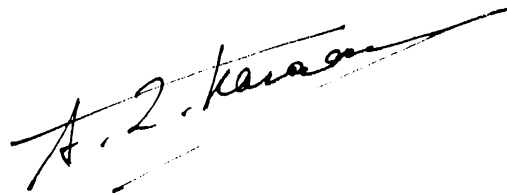


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Asst. Prof. Dr. Bahri Yılmaz



Approved by the Institute of Economics and Social Sciences.



## **ABSTRACT:**

As a common European institute of the monetary issue, the European Central Bank, will have to emerge as a new entity within the European Community. In particular, the bank will be the ultimate target of an European Monetary Union and seems to be so acknowledged by a clear majority of European Community governments.

Starting from the creation of the Bundesbank, the thesis goes on with the situation of the Bundesbank in the European Monetary System and the European Monetary Union. Then the German economic, social and monetary union is covered.

The European Central Bank's organization is analyzed and compared with that of the Bundesbank. The constitutions of both the European Central Bank and the Bundesbank spell out the principal objective as monetary policy.

A future central bank for a common European currency will look much like the Bundesbank, following its model of Independence from government, and it has many similarities in administrative structure.

## ÖZET:

Avrupa Merkez Bankası, Avrupanın parasal konularda ortak bir müessesesi olarak, Avrupa Topluluğu içinde yeni bir varlık oluşturacaktır. Bu banka bilhassa Avrupa Para Birliđinin nihai bir hedefidir ve Avrupa Topluluđunu oluřturan bir çok üye ülke tarafından da tasdik edilmiřtir.

Bu tez Alman merkez bankası Bundesbank'ın kuruluřundan bařlayarak, bankanın Avrupa Para Sistemi ve Avrupa Para Birliđi içindeki konumu ile devam eder. Ayrıca Almanya'nın kendi ekonomik, sosyal ve parasal birleřimi ele alınmıřtır.

Avrupa Merkez Bankasının organizasyonu analiz edilmiř ve Bundesbank'ın organizasyonu ile mukayesesi yapılmıřtır. Her iki bankanın teřkilatları, kendilerine parasal politikaları esas hedef olarak almıřlardır.

Avrupa ortak para birliđinin gelecekteki merkez bankası, Bundesbank'ın devletten bađımsız ve yönetim yapısına bir çok yönden benzeyen modelde bir banka olacaktır.

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## I- INTRODUCTION

From a country in ruins at the end of the Second World War, West Germany grew into one of the world's most powerful economies. A leading world exporter, the Federal Republic sits with Japan and the United States among the informal 'Group of Three' industrial nations, which have more de facto power over the international economy today than the larger and more formal 'Group of Seven' . Before the economic, monetary and social union of the two Germanies on July 1 1990, the Deutschmark had become an international reserve currency. The Bundesbank will control vital aspects of the development of the united Germany within the European Community (EC), soon to be the world's largest internal market, the Bundesbank can sometimes exercise decisive power over items on the economic and political agenda. Having created a stability bloc of low-inflation countries in Europe through its influence within the European Monetary System (EMS), Bundesbank policies can directly affect the domestic economic policies of Germany's EC partners. By any standard, then, the Bundesbank belongs to the small elite of national institutions that, for the foreseeable future, will influence the course of international politics.

Despite Germany's key importance in the world economy, the political culture and institutions of the Federal Republic remain largely unfamiliar to outsiders. Outside Germany the Bundesbank often appears as a monolithic structure unwavering in the fight against

inflation, and excessively influencing the economies of other EC countries.

Inflation problem in the 1920s, put the German economy in a bad situation. Because of this negative experience, in order to protect the stability, German's organized their economic actions on low inflation rate. The Bundesbank is a federal institution and its institutional characteristics make it quite different from other central banks in Europe. No other central bank in Europe and not even the United States Federal Reserve, on which the Bundesbank was modelled, enjoys the same degree of autonomy over monetary policy. Chapter II focuses on the Bundesbank policies starting from its creation up to the 1980s.

The reasons for the Bundesbank's unique character must be sought for in the German state tradition and the practical lessons of recent German history. The Bundesbank is no exception to the overall pattern of public institutions in the Federal Republic. In a world where public policy is increasingly affecting economic policy, it is hardly surprising that constitutional government extends to the monetary as well as the political areas. So, as a federal institution, the Bundesbank's organization and powers reflect the norms of the rule of law, or *Rechtsstaat*, in today's Germany and its institutional practice centers on a basic norm: protecting the currency against inflation.

At home the Bank faces no serious challenge to its authority, but the growing importance of largely uncontrollable international factors, arising directly from Germany's prominence in the international

economy and its leading role in the European Community, affects the successful pursuit of its objectives.

In the wider international sphere the Bundesbank norm constitutes a significant limitation of Germany's political flexibility, but as Germany's importance in the global economy and in Europe increases, the Bundesbank's situation is also changing. Its behaviour during the 1980s reveals a national institution struggling to manage sometimes anarchic international pressures without sacrificing its own institutional identity. That is especially so in the context of European politics, where the Deutschmark's role as 'anchor currency' in the EMS and the size of its economy give Germany the leading role. These issues are studied in Chapter III of the thesis, with the situation of Bundesbank in the European Monetary Union (EMU).

International cooperation in monetary matters has usually been of limited interest to scholars and students of International Relations. It is highly probable that monetary matters while entering to the twenty-first century are going to gain more importance for EC and for other countries in the world. Within the EC, monetary cooperation has increasingly become a vehicle for political integration. The Treaty on European Union, signed at Maastricht on February 7, 1992, the so called Maastricht Treaty, consists of social, political, economic and monetary elements. The provisions regarding economic and monetary policy are by far the most ambitious, developed and important because in this field the EC has a decade of momentum. The Maastricht Treaty explicitly relies on the existent exchange rate mechanism of the European Monetary System to provide a smooth

transition to economic and monetary union. As common European Institute of issue, the European Central Bank (ECB), will have to emerge as a new entity within the EC which will continue to be the ultimate target of an EMU and it is very well acknowledged by a clear majority of EC governments. Chapter IV discusses the European Central Bank, its organization, objectives and independent structure.

Finally, Chapter V tries to predict whether or not the Bundesbank is going to be a model for the European Central Bank.

## **II - BUNDESBANK**

### **2.1 Creation of the Central Bank:**

Germany's division into four zones of occupation in 1945 effectively ended the existence of the Reichsbank. In its place, the western allies created a Land Central Bank for each state in their respective zones. By 1948, the need to implement currency reform and to lay the foundations for reconstruction led the allies to conclude that a common central bank was necessary for the planned West German State.

Negotiations over the new central bank continued for a number of years as the government sought a compromise which could satisfy its various constituencies. That compromise was finally reached and on 26 July, 1957 and the Deutsche Bundesbank was created. The Land Central Banks retained their name but were merged within the Bundesbank becoming its main offices in each state. <sup>1</sup>

## **2.2 The Element of the Bank:**

Its principle elements are the definition of monetary sovereignty in Germany and the definition of its fundamental norm is shortly as the establishment of the relationship between the Bank and the federal government and finally the organizational arrangement of itself in relation to other federal agencies.

There are three statutory elements of the economic constitution: the Bundesbank Law of 1957, the Credit Law of 1964 and the stability and Growth Law of 1967. The Bundesbank Law is the primary legal source of Bank's and powers.

## **2.3 Economic policy and the division of powers:**

The Bundesbank Law incorporates checks intended to insulate the central bank from improper political pressures and this law assigns responsibility for general economic policy to the federal government, but it places monetary policy within the jurisdiction of the Bundesbank. This definition of institutional authorities creates the political field of the Bundesbank's activities.

The Bundesbank's monetary sovereignty in the Federal Republic is established by its statutory definition as 'protector of the currency' and by creation of the Bank as a 'legal person' with a unique relationship not subordinate to the Federal Government. Also the Bundesbank Law gives the Federal government authority to determine general economic policy and binds the Bundesbank to support it while also

making the Bank independent of governmental direction in the use of its monetary and credit powers.

Some of the paragraphs of the Bundesbank Law imply a silent presumption of governmental co-responsibility for monetary affairs, but appear to leave their relation to each other unbalanced. While the Bundesbank is independent of the government, government is responsible for the Bank's monetary policy which is an arrangement that follows from the statement of a norm and the political importance of economic decisions in a modern democratic state. <sup>2</sup>

#### **2.4 The Central Bank Council:**

The Central Bank Council is the supreme policy-making body of the Bundesbank. Its organization follows the pattern of the federal government established by the Basic Law, adhering to the federal principle of 'one land one vote', whereby each of the landers, regardless of its size or wealth in the Federal Republic as a whole, can cast only one vote. The "Laender" Central Bank Presidents, the Bundesbank President and Vice-President, and up to eight members of the Frankfurt Directorate sit on the Central Bank Council.

The Deutsche Bundesbank Act maintained an important role for the states in the selection of the Land Central Bank Presidents. By stipulating that the Central Bank Council would consist of the eleven

Land Central Bank presidents and a maximum of ten directors-including the President and Vice-President mentioned before, the act ensured that the federal government would never be able to nominate a majority on the Central Bank Council. Even more important, it maintained the central bank's independence vis-a-vis the government.

The Council meets fortnightly to discuss current issues and future policy and sets monetary and credit policy for the Bundesbank. The Council's policy decisions can virtually veto the economic and fiscal plans of elected German Officials. Within its own parameters, the Council is democratic and takes decisions according to the parliamentary rules.

## **2.5 The Bundesbank and the Federal Government:**

German public law frames the relations of the Bundesbank and federal government as a set of rights and duties. Although the Bank's monetary policy-making is largely autonomous of government, political leaders in Bonn do have certain powers over it. Its Directors are appointed by the Federal President on the advice of the government, and members of the cabinet are entitled to attend sessions of the Central Bank Council. Government officials have no vote in the Bundesbank Central Council, but they can make proposals, and the government has a suspensive veto over Central Bank Council Policy. At the government's request a decision can be deferred for up to two weeks. While such a delay is not a genuine veto



on the government's part, its use would send a powerful political signal to the political economy in Germany and in the world.

The Bundesbank is legally obliged to advise government on matters of monetary policy and supply it with information as required, and informal communication between the two goes on continuously at virtually every level. A branch of the International Division usually prepares position papers for the federal government of the funds policy of the International Monetary Fund.

The government's powers over the economy mean that the Bundesbank has less real control than it appears to have formally and must seek the constant or active participation of the government on a variety of matters ranging from nomination of the Bundesbank Directorate and the issue of small banknotes to its international obligations. The Bundesbank has no similar institutional authority over the federal government's economic policy, but on occasion the Bundesbank's right to be consulted on proposed legislation can give it real political power over the government policy, because the Bank must be informed by the government whenever major policy initiatives are planned.

Independent of the federal government, the Bundesbank is also independent of review and control by the Bundestag, which has never questioned the bank's position in Germany's economic constitution. Although the Bank's formulation of monetary policy often provokes domestic criticism and political controversy, this has not weakened its institutional position. Its legal status, however, engenders a degree of political power that often constrains an elected government. Although

bound formally to support the government's economic policy, it has been able to assert a monopoly over the final interpretation of what support any given case means. The bank's real power derives from its ability to make monetary policy without consulting Bonn.

## **2.6 Bundesbank's policies during the 1960s and the 1980s:**

The international dimension of Bundesbank policy-making is long-lasting and dates back to Bretton Woods, but the form of conflicts over imported inflation has changed under the regime of floating rates. From the early 1960s to the mid-1970s, the Bundesbank viewed inflation generated outside Germany as the main threat to monetary stability and Bank officials believed their control over this factor would increase once they were released from mandatory intervention. Interdependence proved that expectation vain. Since the 1970s, economic relations have been internationalized through autonomous capital movements and market expectations that are beyond the control of states to a greater degree than ever before.

The external value of the mark and sensitivity to foreign demand for its goods created Germany's central dilemma, a situation which Bundesbank policy-makers saw as compounded by fixed exchange rates. The formal obligation to buy and sell dollars and marks under the Bretton-Woods system generated additional monetary management problems. The lack of external security meant that

German monetary policy was disturbed over a long period of time by interest rate induced and speculative inflows of capital and finally had to limit itself to endeavoring to neutralize the expansive influence from abroad by contractive processes at home.

The end of Bretton-Woods removed the constraint of obligatory intervention to support official exchange rates. With its external flank secured, the bank was free to develop its post-1973 paradigm; priority for domestic stability and constancy in monetary policy. But this period of relative international independence was short-lived.

The introduction of the European Monetary system on 13 March 1979 placed new intervention responsibilities on the Bundesbank, ultimately creating a European Bretton Woods with the German currency as anchor.

Internationally committed once again via the Plaza and Louvre agreements, as well as the EMS, the Bundesbank standard continued to guide policy through the turbulence of the late 1970s and the 1980s, a period when the Germans came under increased pressure to take a greater economic lead.

From 1977 onwards, the Germans came under American and British pressure to stimulate their domestic economy and act as the 'locomotive' of Western economic recovery. They resisted from the start with arguments from the Bundesbank arsenal: domestic growth, projected at 4.5-5.5 %, was high enough and further stimulus would undermine the country's monetary stability. But despite this resistance, the Germans were beginning to shift their position.

As Germany emerges as the pre-eminent European economic power, international attention on the Bundesbank is generating new pressure on it. Defined essentially in terms of its domestic legislation, the Bank is a national institution increasingly subject to international demands.

Institutional changes in the past two decades are one aspect of these transformations; as the number of participants in international monetary policy-making decreases, the political power of those still involved increases. During a period of intensifying interdependence, the number of those who really matter in the international system has remained very small. The more exclusive circles of G-7 and G-3 leaders have supplanted the International Monetary Fund, which has more than 100 member countries, within the framework, the Deutschmark is now the world's second reserve and intervention currency. This has inevitably enhanced the power of the Bundesbank.

Bundesbank policy-makers throughout 1986-7 felt themselves backed into a corner and simply isolated. As inflation and the money supply figures began to get out of control towards the end of 1988 a sense of Schaden Freude among Bundesbank policy-makers made itself felt. For one faction, now possibly the most powerful in the Bundesbank, the experience of 1985-8 confirmed the central element of the Bundesbank paradigm: protect the currency at all costs.<sup>3</sup>

The Bundesbank tends to balance domestic responsibilities against the international pressures, consistently emphasizing the priority of the former. Its domestic and international policy choices in the years 1961, 1979-82 and 1985-7 are likely to remain the formative cases for its attitude in the future. International issues have greatly complicated the Bank's field of political action, and its rhetoric has to be seen in the context of its pragmatic responses to Germany's political interests and to pressure from its trade partners.

### **III - BUNDESBANK'S SITUATION IN THE EMS AND THE EMU**

#### **3.1 The European Monetary System (EMS) and the Bundesbank:**

The European Monetary System (EMS) was viewed by its creators as an intermediate step towards monetary unification. The Conclusion of the Presidency of the European Council of 4 December 1978 stated that: The purpose of the European Monetary System is to establish a greater measure of monetary stability in the Community and should be seen as a fundamental component of a more comprehensive strategy aimed at lasting growth and stability, a progressive return to full employment, the harmonization of living standards and the Community. The Monetary System would also facilitate the convergence of economic development and give fresh impetus to the process of European Union.

The EMS started functioning in March 1979 as an arrangement among the central banks of the EC member countries to manage inter-community exchange rates and to finance exchange market interventions. Its basic features are an exchange rate mechanism (ERM) with the rules of intervention, the European Currency Unit (ECU) and several credit facilities. In practice, both the ECU and credit facilities have lost their function, and the operating part of the EMS is the ERM. Characteristic features of the ERM are fluctuation bands around bilateral central parities, a possibility of realignments of the parities, and, although initially designed symmetric, the use of the DM as the 'anchor' of the system.

The EMS includes all members of the EC, whereas in the beginning only a group of countries participated in the ERM, namely Germany, France, Italy, Belgium, Luxemburg, Denmark, the Netherlands and Ireland. Spain and Portugal joined in 1989 and the United Kingdom in 1990.

The ECU is a composite unit of account, made up of a basket of a fixed number of each Community currency. The composition of the basket depends solely on EC membership. Each currency has a certain weight in the basket, initially set according to the economic size of each country. The weight of the DM in the basket has been around % 30.

Each Community currency has an ECU central rate. A divergence indicator shows when a currency departs too much from the central rate. Consequently, bilateral central grids have become the determining feature of the ERM. The grid is formed by calculating the ratio of any two central rates and assigning margins from this bilateral central parity. The bilateral margins are set at 2.25 % on each side of the central parity, allowing a fluctuation band of 4.5%. Whenever a currency goes beyond its fluctuation band there is an obligation to intervene by joint action of the two respective central banks. This can be done either by the "stronger" central bank buying the "weaker" currency or by the selling of the "stronger" currency by the "weaker" central bank through credit from the "stronger" central bank.

An important attribute of the ERM is the possibility of realignments to correct imbalances, i.e. over- or under-valuation grown by time for external reasons, in the system. In the beginning, realignments were

mostly unilateral, either involving only one currency or initiated by only one country asking for complete new set of parities.

Although often cited as one of the main goals of setting up the ERM, there is no explicit rule governing inflation control. Inflation rate convergence toward low inflation member countries was not agreed on or even implied initially.

However, different rates of inflation affect the stability of foreign exchange rates as it directly makes some currencies appreciate and others depreciate and hence provoke competitive devaluations. After 1983 an implicit agreement on convergence toward the low German inflation rate was adapted.<sup>1</sup>

"This was connected with the French government's decision to apply tighter monetary policy."<sup>2</sup> Consequently Germany was in a position to determine the anchor inflation rate of the system. It sets its monetary growth target according to its own desired inflation rate, while the other members have to adjust their monetary policy to Germany's. Thus the Bundesbank's low inflation targets have gained Germany a position of "monetary anchor" for the whole system.

Consequently since 1983 the other member countries of the ERM started to peg their currency to the DM, and the bilateral central grids were calculated between any given currency and the DM. The DM emerged as the numeraire for the



ERM, and Germany as the "anchor" or "center" of the system. <sup>3</sup>

The confusion between the existence of ECU central parities and bilateral parity grids based on the DM is a result of a debate over the advantages of a symmetric system as opposed to European experiences during the asymmetric Bretton Woods system, and the distrust of weak "imaginary" currency unit on the behalf of Germany who had a "strong" currency. The Bundesbank resisted joining a system with only ECU central parities. Although the DM has consistently had a weight around % 30 in the ECU basket, the Bundesbank was able to foresee that within the system the DM was bound to appreciate against other currencies, and interventions to support other currencies or to keep the DM down would mean loosing its monetary stability for Germans. The DM is a question of national pride and domestic stability. This is understandable in terms of Germany's historical experiences with hyperinflation and later on a feeling of being left alone when the snake was in trouble in late 1970s. There was also a strong opposition from the Bundesbank's point of view to enter an exchange rate system before there was more cooperation in economic policies.

The Bundesbank initially opposed the EMS. The European Monetary Cooperation Fund (EMCF) was a particular obstacle. The Bank feared that obligatory intervention and a joint financing mechanism would bring back the familiar problems of Bretton Woods. The Bundesbank feared that these would turn the EMS into an

artificial exchange-rate system divorced from economic fundamentals, thus generating inflationary pressures in Germany.

From the Bundesbank's perspective, the EMS is a balancing act in which the Bundesbank standard is juggled with international and European responsibilities. Exchange-rate policy is sensitive because of the postulated link between money supply targets and inflation; systems such as the EMS constrain the Bank's pursuit of the domestic stability goal. Though central banks are obliged to intervene when currencies hit the top or bottom of their bands, their intervention before that stage remains discretionary. Conflicts of judgements and interest over when to intervene shape the politics of EMS management and carry implications for the Bundesbank's strategy of controlling inflation.

As a side effect of securing exchange-rate targets, intervention changes the domestic money supply. Thus a devaluing country buys up its currency in exchange for foreign reserves. This reduces liquidity in that country, forcing up domestic interest rates, tightening monetary policy and reducing inflation. The effects for the economy of the appreciating country are the reverse. Appreciation creates more purchasing power, which is used to accumulate foreign exchange, thus increasing money supply in the medium term and hence inflation. Theoretically, then, the exchange values of two or more currencies represent the ratio of their money stocks. If the price of currencies is fixed; as it is under international mechanisms such as the ERM, then the stocks will have to be adjusted to maintain the ratio. "That holds true for each of three types of EMS intervention: 1) Marginal

intervention, 2) Intramarginal interventions, and 3) Intramarginal intervention in US dollars." <sup>4</sup>

While the technique of EMS interventions involves relatively simple operations, their practice is another story in political terms. Central banks may try to offset changes in domestic liquidity brought about by foreign exchange market interventions through open market activities. The increases or decreases in liquidity are thus sterilized, and consequently the exchange rate has to change in the medium term.

"Throughout 1970s Germany suffered from DM/USD fluctuations which were harmful for its competitiveness. Germany wanted to "limit the detrimental effects of dollar disturbances." <sup>5</sup> Now as a regional block around Germany the ERM gives more stability for DM real exchange rates, and consequently better terms of trade for Germany. It did not need to trade off this enhanced competitiveness with monetary independence, because the ERM uses Germany as the anchor country. Hence, Germany has kept its independence and stability while gaining improved competitiveness, a strong current account and more stable real exchange rate.

The leading role of Germany in the ERM does not stem from its economic size compared to other member countries, but is derived directly from Bundesbank's reputation of adhering to price stability and its low inflation targeting. It has been commented that the ERM is "an arrangement for France and Italy to purchase a commitment to low inflation by accepting German Monetary policy." <sup>6</sup> And when the United Kingdom was considering joining the ERM, the main

advantages mentioned in the debate were associated with the reputation of the Bundesbank.

The German dominance in the ERM is a widely acknowledged fact. At least since the implicit agreement on anti-inflation targeting in 1983 Germany and the Bundesbank have been a hegemonic center-setting its own monetary policy so as to achieve internal price stability while the other members hold on to the DM "borrowing" its reputation. <sup>7</sup>

This also implies that Germany is isolated from the rest of the countries, i.e. not affected their policy choices. There is a considerable number of studies pointing to this direction. First, DM interest rates usually remain relatively stable in periods of speculative pressure which indicates that Germany's Monetary policy is largely unaffected by events in European exchange market. Second, other ERM countries follow German monetary policy especially in the timing of interest rate changes. "They wait for the Bundesbank to decide on interest rate adjustments, and follow that in a matter of hours." <sup>8</sup> Third, most of the intra-ERM currency interventions are carried out by other central banks than the Bundesbank. Moreover, other central banks intervene in ERM currencies and increasingly in the DM. This shows that countries other than Germany take most of the adjustment pressure and the cost of intra-ERM stability is asymmetrically shared. Germany usually intervenes only when the US dollar starts moving and does it in dollars. It may act either from

an " altruistic" motive of trying to prevent the strains within the ERM associated with fluctuations of the dollar, or from a desire to avoid fluctuations in relative prices and competitiveness against the United States.

Whatever the reason, Germany effectively takes care of the " external " stability of the ERM and leaves most of the interventions within the system to other member countries. This implies that the Bundesbank's preoccupation is the exchange rates of ERM currencies vis-a-vis the dollar, whereas other central banks focus on stabilizing the position of their currencies vis-a-vis the DM. <sup>9</sup>

The German tendency to intervene in dollar fluctuations can have detrimental effects on the rest of Europe, especially if it is in recession. Normally, declining dollar would mean a boost to European economy, but when Germany 'sterilizes' the capital inflow motivated by fear that the cheap dollar inflates its money supply and thus produces inflation, this stimulus disappears and recovery in Europe is hindered.

Contrary to the Bundesbank's initial fears, the EMS has proved manageable within its anti-inflationary framework, and the Bank is generally satisfied with its working. EMS membership ties Germany's partners to the DM-and thus to the Bundesbank's monetary course. Dependence on the German currency has produced unwanted political effects for some EMS members particularly France and there have been recurrent demands that European 'asymmetry' be reduced.

The disagreement turns on German power in the EMS. At one level, debate focuses on how a common goal of economic convergence should be measured and attained. Complaints about present 'asymmetry' refer to national differential of size, efficiency and productivity as well as differences in their balance of payment position. Demands for increased symmetry most often come from representatives of the weaker economies in the EMS, and the most important conflict stems from Franco-German imbalances. France's persistently negative trade relationship with Germany spilled over into the EMS by generating exchange-rate pressures which must be stabilized through market interventions and domestic deflation.

At another level, the asymmetry issue is one of fairness. Full economic integration assumes that greater convergence can be achieved between countries with strong currencies and those whose currencies are weak. The question is whether interest and exchange rates should reflect divergent price and cost differentials or be used to further domestic fiscal and economic policy and the long-range goal of European integration. Majority opinion in the Bundesbank, assuming that exchange rates must represent a country's underlying economic position, has argued against efforts to use monetary policy to further Europe's political goals.

The EMS has made relatively little impact on the German money supply over the past ten years. Nevertheless, severe short-term fluctuations in bank liquidity and money supply aggregates are caused by EMS interventions.

Overall, in a single decade, the EMS fulfilled its purpose of creating 'a zone of monetary stability in Europe ' : But in other respects - equitable distribution of financial burdens and substantial convergence of the European economies - the system fell short of expectations.

### **3.2 The Bundesbank and the European Monetary Union (EMU) :**

When the debate on financing mechanisms for the EMS was carried over into other areas, the most far reaching development was started. This is the beginning of a plan to replace the EMS with a European Monetary Union ( EMU ).

This was contained in the Report on Economic and Monetary Union in the European Community; the so called Delors Committee Report. This report was delivered to the European heads of government in Madrid in June 1989. The report addressed four central questions.

- 1) Is a single European currency feasible?
- 2) Could the ECU serve that function?
- 3) What if a European central bank were to replace the national central banks, with responsibility for a single European currency?
- 4) If such steps were agreed upon, how might the transition be organized?

The president of the European Commission, Jacques Delors, submitted the so called Delors report in April 1989. This report followed an agenda set by the questions listed above and proposed

that monetary union could be reached through three stages of development.

The first step was to include all community members in the ERM and to establish the free movement of capital along with goods and labour. At this first stage, parity realignments remain possible; the member central banks merely commit to keeping exchange rates within bands of  $\pm 2.25$  percent ( $\pm 6$  percent for Spain and the United Kingdom) around the central parities. Already in June 1989 the European Council accepted the date set by the Delors Commission, July 1, 1990, for the beginning of the first stage.

In Stage Two, the transition would begin from the coordination of independent national monetary policies to the formulation and implementation of a common monetary policy. Exchange rate realignment within the ERM framework would not be ruled out, but there would be a growing preference for other adjustment mechanisms. As part of this process, there would be increasing co-ordination of official foreign exchange operations involving non-member currencies, leading eventually to a common Community approach. Simply, Stage Two in the Delors Report would add the European System of Central Banks (ESCB) to the EMS. The completion of both economic and monetary union would not be final until Stage Three.

In Stage Three, exchange rates would be locked irrevocably and ultimately a single European currency could replace national currencies. This would require that the transition to a single monetary policy be completed. This last step, at once eliminates the possibility



of imposing capital controls, terminates the EMS, irrevocably fixes exchange rates, and transfers full authority for monetary policy to the European Central Bank (ECB).

Although proposing three stages for EMU, the Delors Report does not establish a time table for their realization, insisting only that Stage One should begin on July 1, 1990.

The treaty of Maastricht, negotiated in December 1991 and formally signed on February 7, 1992 sets the path for EMU. Maastricht Accord lays down the Community's strategy to achieve EMU by the year 2000; it sets up the institutional framework for European monetary union; and, while accepting a gradual approach to EMU, it alters the strategy suggested by the Delors Committee in several important ways.<sup>10</sup>

First it drops the principle of parallelism entirely. The Accord foresees the completion of economic union, with total and unconditional freedom of capital movements within the EC, beginning by January 1, 1994.

Second, the Accord outlines the institutional developments leading to EMU. At the beginning of Stage Two, a new European Monetary Institute (EMI) will be created, which will administer the EMS and prepare the ground for the ECB by coordinating national monetary policies and creating the instruments and procedures for the ECB in Stage Three. The EMI in turn will be liquidated when the ECB begins operations in Stage Three.

Third, the Accord sets up conditionalities and a precise timetable leading to EMU. These conditionalities address the entry to Stage Three and aim at the convergence of inflation rates, the performance of public finances, and the development of the monetary institutions in the EC.

To be eligible for EMU, a country's inflation rate must not exceed the lowest three EC inflation rates by more than 1.5 percentage points; its interest rate on long-term government bonds must not exceed by more than 2 percentage points those of three member states with the best inflation performance; its total government deficit must not exceed 60 percent of GDP. <sup>11</sup>

For at least two years, the country's exchange rates vis-a-vis other EMS currencies must have remained within its EMS band without a devaluation of its central parities. Finally, the statutes of its national central bank must be compatible with the ECB Statute as established by the Accord.

To prepare for Stage Three, the EC heads of state or government will assess, by December 31, 1996 whether a majority of the EC members meet the entry conditions and whether the community is ready for Stage Three. If so, a date is to be set for its beginning. Countries that do not meet the conditions; technically, 'countries with a derogation', are placed on a waiting list to be reconsidered for membership in subsequent years. Those that do meet the conditions will form the core of EMU. If by the end of 1997, however, no date

has been set for the start of Stage Three - that is, if a majority of countries cannot fulfill the entry conditions or the heads of state or government decide it is not appropriate to start EMU - Stage Three will begin anyway on January 1, 1999 and will include all those countries meeting the entry conditions.

Finally, the Maastricht Accord recognizes that individual members of the EC may for political reasons, not wish to join EMU. In the separate Protocol on the Transition to the Third Stage of Economic and Monetary Union, the European heads of state determined to address this potential problem by promising that no member will keep the Community from entering EMU.

The Maastricht Accord drops altogether the concept of a learning period and provides a much cleaner solution to Community institution building in the transition period. It leaves monetary policy entirely in the hands of the national authorities until the start of Stage Three. During Stage Two, the EMI is set up as a transitional institution preparing the way for the ECB. " The ECB, which will be created at the start of Stage Three, will not be burdened with public memories of the political or economic quagmires that may be encountered during the transition phase." 12

The EMI has three main functions. To begin with, it will inherit the EMS and administer its operation. During Stage Two, it is charged with strengthening cooperation between the central banks of the Member States and the coordination of the monetary policies. In exercising this function, the EMI is explicitly committed to price stability. Its role is to organize the exchange of information among the

national central banks and to monitor monetary developments in the member states. Recalling that, from the start of Stage Two, the EMS can no longer rely on capital controls as safety valves, this coordinating function will be much more important than policy coordination in the current EMS. The EMI Council has the right to formulate and publish opinions about such developments and to rebuke governments for too profligate monetary policies. The fact that such opinions and their formulation require a qualified majority to pass the EMI Council assures, however, that the six most-price-stable countries of the EMS will not be able to use the EMI as an outlet for public admonitions to EMS members with less stringent monetary discipline.

Looking to the future, the EMI will oversee the development of the ECU and prepare 'the instruments and procedures necessary for carrying out a single monetary policy in the third stage and the rules for operations to be undertaken by the national central banks in the framework of the ESCB. One of the articles of the EMI Statute directs the EMI to specify a 'regulatory, organizational and logical framework for the ESCB to perform its tasks in the third stage.' These specifications will be submitted for decision for the ECB at the beginning of Stage Three. In setting the operating procedures for the ECB, the EMI will take a major responsibility for the initial performance of the new central bank. The unanimity requirement in the EMI Council for the main decisions in this field gives even those countries that will not join Stage Three by 1999 significant influence on the design of the future ECB. This, again, underlines the federal character

of the EMI. The timetable established by the Maastricht Accord implies that, at the beginning of Stage Three, some EC members may have a derogation and may therefore not join the ESCB. Because the EMI disappears at the start of Stage Three, an institutional arrangement will be necessary to facilitate the continuation of an exchange - rate agreement between members of EMU and those countries with a derogation. It was the last two stages of the Delors Report that created most discussion and the Bundesbank was one of the main discussants. The discussion focused on the three points: the independence of the envisioned European Central Bank and the timing of its establishment, the stability of the common currency, and whether economic convergence should happen before or after going forward in the plan.

The Bundesbank strongly argued that convergence in economic policies and performance should be achieved before monetary union. It maintained the view that "sufficient and durable convergence among the member states had to precede EMU. This led to discussion on 'two-speed Europe' which means that EMU should start functioning only with a core of countries that have good enough economic performance.

The Bundesbank was aware that Germany had also domestic problems: German Monetary Union had not been a smooth transition, and the east structural transformation in Eastern Laender was a heavy burden. It was reluctant to make a commitment to support economies in Europe it considered weak or lacking resolution to economic convergence while having to deal with domestic responsibilities.

### **3.3 The German Economic, Social and Monetary Union (GEMU)**

As the Bundesbank entered the 1990s, it faced the familiar dilemma of having its domestic priorities under increasing international pressures. The unification process itself made the pursuit of domestic anti-inflation objectives more difficult.

For more than three decades, the institutional character of Germany's central bank has been defined by its legal norm: 'protecting the currency ' which has meant preventing inflation. That criterion of monetary policy was assured by the lessons the West German public drew from their history in this century. Part of the story of the Bundesbank's security at home and monetary success has been its ability to persuade Germans that domestic growth cannot be pursued at the expense of stable money.

While the Bundesbank retains its domestic focus, the Federal Republic of Germany has become a regional and global power. The foremost economic nation in Europe, Germany successfully allies its foreign policy interests in the European Community to those of its main trading partners.

The 'Treaty on European Union ' which was approved by the EC Heads of State and of Government on December 10, 1991, and signed by the governments of the member states on February 7, 1992, is intended to create the basis needed for rapid headway in the process of European Integration.

The completion of the single European market, with the free movement of goods, labour and services and capital, is to be followed by the end of this decade by the further development of the Community into an economic and monetary union and what is more - as also propogated by the German side, in particular - a political union. <sup>13</sup>

The public debate which commenced in Germany in response to the decisions of Maastricht confirms impressively that a threat to monetary stability, which is firmly associated with the Deutsche Mark in the minds of the population and which is obviously regarded as a 'public commodity', would not simply be accepted, irrespective of its source. " In contrast to what occurred in other Community member states, the general public in Germany started relatively late seriously to discuss the pros and cons of a European economic and monetary union." <sup>14</sup> In the course of negotiations the Bundesbank had repeatedly submitted statements to the Federal Government. It attempted in manifold ways to contribute to the necessary process of clarification at an early stage, focusing attention on the need for a stable currency and for an effective monetary policy geared to achieving this end.

Those processes of international change now ensnare the Bundesbank and carry profound implications for its position in a new Germany and a new Europe. Some of these processes have been explored as the liberalization of capital markets and volatile exchange-rate structures which forge sometimes unwanted linkages between

the Bank's domestic monetary factors and the economies of other nations. There are two cases which hold the possibility of revolutionary changes in store: the prospect of European Monetary Union, and the reality of German Economic, Social and Monetary Union.

The Treaty between the Federal Republic and the German Democratic Republic that came into effect on 1 July 1990 and marked the beginning of German unification has already enhanced the Bundesbank's domestic perspective. Though anxious not to suggest an obvious conflict between the goals of European integration and German unification, the Bundesbank, like all institutions of German government, focuses on a difficult task of setting national priorities and balancing those against European and international commitments. German monetary and economic union is different from European integration in one important respect; the eastern Laender have now been absorbed legally by the Federal Republic and, unlike Europe's nation-states, the sovereignty of the German Democratic Republic was already partly extinguished when the GEMU came into effect. But the political and financial demands German unification will make on Germany's wealth and political culture are far greater than those it has yet faced from the pressures of European Unity.

As monetary and economic union between the two Germanys takes effect, there are signs that workers in the eastern Laender are not so disciplined and that, for them, wage demands may come before monetary stability. In addition to the potential discrepancy



between East and West German 'stability consciousness', financing the economic restructuring in the east will certainly strain German monetary management.

When the Bundesbank was put in charge of monetary policy for the whole of the east, it stressed its standard of sound money in the weeks preceding the introduction of the Deutschmark in the German Democratic Republic. Now that monetary union is completed, it has reverted to a modified version, stressing the need to keep wages in the line with productivity in East German enterprises, but accepting that only a radical break with the socialist economic system could liberate the forces of capital creation and productivity on which a rebuilt social system in the eastern Lander depends.<sup>15</sup>

Now that Germany is reunited, there are no signs of significant change in the Bundesbank paradigm for monetary management. On the contrary; reviewing its work in 1989 and looking forward to the demands of unification; the Bundesbank offered a familiar analysis of the situation Germany would soon face: An exposed flank - inflationary pressures from outside - and domestic demand that exceeded capacity - inflationary pressures from within. In order to manage those demands within the Bundesbank paradigm, interest rates and the external value of the Mark would have to stay high. Wages and prices in the east had to be realistic and most importantly

from the Bank's perspective restructuring should not be financed through new credit. German unity, so the Bundesbank's prescription reads, cannot be borrowed against future productivity, but must be paid for now through savings and taxes.

#### **IV- THE EUROPEAN CENTRAL BANK**

As a common European institute of issue, the European Central bank, will have to emerge as a new entity within the EC in order to render community wide central enactments with regard to monetary policy in its entirety, its jurisdiction will comprise matters of principle as well as particulars. In particular, the European central bank will continue to be the ultimate target of an EMU and seems to be so acknowledged by a clear majority of EC governments. National central banks will retain their legal personality under domestic law.

However, to secure the compatibility of national central bank legislation with the European system of Central Bank statute and the EEC Treaty, pertinent domestic constitutional and statutory provisions, including the statutes of the national central banks, will have to be adapted accordingly.<sup>1</sup>

The ECB and the national central banks but not the ESCB itself can own, buy and sell assets, contract and sue or be sued. The term 'system' thus has to be understood as referring to the existence of the ECB and the national institutes of issue as parts of the ESCB which, as an ensemble, are governed by a common set of rules and committed to the objectives and tasks assigned to it. It has become known that most of the EC national central banks consider that a participating central bank would be one whose national sovereign

appertains to the EMU or has fully accepted its objectives and has pledged to become a member as soon as possible.

The performance of EMU will depend critically on the institutional design of the ECB, one important aspect of which is its independence from the European governments. Central bank independence from government is not only necessary to achieve lasting price stability; empirical evidence suggests also that long-run inflation rates are lower in countries with independent central banks.

The Delors Committee described the future European central bank simply as ' independent ' without further explanation. The Maastricht Accord, however, is very specific on the subject.

#### 4.1 Table 1. The Proposed European Central Bank Compared To The Bundesbank

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##### **European Central Bank (ECB)**

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<b>OBJECTIVES</b>	The primary objective of the System shall be to maintain price stability. Without prejudice to the objective of price stability, the System shall support the general economic policy of the Community. The System shall act consistently with free competitive markets.
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<b>INDEPENDENCE</b>	Neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and
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bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision making bodies of the ECB and of the national central banks in the performance of their tasks.

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BOARD	President, vice-president, and four other members
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COUNCIL	Members of the Board plus governors of the twelve national central banks
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APPOINTMENT LENGTH	Eight years, not renewable
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APPOINTMENT PROCEDURE	European Council; Governing Council and European Parliament are consulted.
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VOTING	Each member has one vote. The president has a tie-breaking vote. Weighted voting applies to issues dealing with capital, transfer of foreign resource assets, and distribution of income.
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INSTRUMENTS	<p>the ECB shall be entitled to</p> <ul style="list-style-type: none"><li>*operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement claims and marketable instruments, whether in Community or in foreign currencies, as well as precious metals.</li><li>* conduct credit operations with credit institutions and other market participants.</li><li>* establish general principles for open-market and credit operations carried out by itself or the national central banks, including the announcement of conditions under which the ECB stands ready to enter into such</li></ul>
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transactions.

\* require credit institutions to hold minimum reserves on accounts with the ECB and national central banks, with the regulations concerning the calculation and determination of the required minimum reserves to be established by the Governing Council.

\* levy penalty interest in cases of noncompliance impose other sanctions with comparable impact.

\*conduct foreign-exchange operations consistent with the provisions of Article 109 of the Treaty. The Council can decide on unspecified operational methods of monetary control.

\* the ECB and national central banks shall not grants overdrafts or any other type of credit facility to Community institutions, governments or other public entities of Member States or purchase debt instruments directly from them.

### **Bundesbank**

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#### **OBJECTIVES**

The Bundesbank regulates the circulation of money and the provision of credit to the economy, using the authority given it by the Bundesbank Act, with the objective of safe guarding the currency and providing for the settlement of the banking aspects of payments domestically and with foreign countries. The Bundesbank is required to support the general economic policy of the federal government subject to fulfilling its own task.

<b>INDEPENDENCE</b>	Independent of the federal government in exercising the authority given to it by the Bundesbank Act..
<b>BOARD</b>	President, vice-president, and up to eight other members.
<b>COUNCIL</b>	Members of the Board plus presidents of the eleven land central banks
<b>APPOINTMENT LENGTH</b>	Eight years, renewable
<b>APPOINTMENT PROCEDURE</b>	President of the Republic; proposal by federal government (Board) or Bundesrat (Land); Council is consulted
<b>VOTING</b>	Each member has one vote. The president has a tie-breaking vote. Weighted voting applies to issues dealing with capital, transfer of foreign resource assets, and distribution of income.
<b>INSTRUMENTS</b>	<p>The Bundesbank</p> <ul style="list-style-type: none"> <li>* fixes the interest rates and discount rates applicable to its transactions and determines the guide lines for its loan and open-market operations.</li> <li>* purchases or sells trade bills or checks for which three guarantors, known to be solvent, are liable; bills must have a maturity of less than three months and must be good trade bills.</li> <li>* purchases or sells treasury bills issued by the federal government or a federal state with a</li> </ul>

maturity of less than three months.

\* grants interest-bearing loans against collateral for a minimum of three months and with the collateral meeting specific requirements.

\* purchases and sells means of payment denominated in foreign currency, including trade bills and cheks, claims and securities, gold, silver, and platinum.

\* grants short-term credit to the federal government, the special funds, and the federal states in the form of book credits or treasury bills.

\* purchases or sells trade bills fulfilling specified requirements, treasury bills, and treasury notes issued by the federal government, special funds, and federal states; bonds and debentures issued by specific debtors; and other bonds admitted to trade at the official exchange.

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SOURCE: European Council (Maastricht Accord), 1991 (Protocol on the Statute of the European System of Central Banks and the European of Central Bank).

## **4.2 Central Bank Organization:**

There are strong similarities in the structure of the decision making bodies and processes of the ECB and the Bundesbank. Both have councils formulating the general guidelines of monetary policy to be discharged by their executive boards. Both councils are composed of the members of their respective boards - six for the ECB and up to ten



for the Bundesbank - and either the central - bank governors of countries without a derogation or the presidents of the eleven land central banks. Members of both Councils have one vote each, and only in specific cases may the ECB call for weighted voting. In the event of a tie, the presidents of both councils may cast two votes. Actions before both councils require a simple majority vote, unless specified otherwise.

One important aspect of the composition of the central - bank council in the Community system is the weight given the representation of central, or Community, interests relative to that given the member states in monetary - policy decisions. With a common currency, the objectives of monetary policy will necessarily be defined in terms of Community aggregates, that is, a European price level and European output and employment. The governors of the national central banks, however, will have little interest in Community variables and will be primarily concerned with price stability and output and employment in their own regions.

Realizing that a common monetary policy is not suited to meet regional output and employment targets, the Governing Council will naturally be inclined to give higher priority to the low - inflation target of the common monetary policy than will be the ECB Executive Board, which, because it represents a Community institution, will define its responsibilities in terms of Community aggregates.

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The Executive Board members will therefore push more strongly in the Governing Council for active, discretionary output and employment stabilization at the Community level that will the governors of the national member banks.

Although the weight of the ECB Board on the Governing Council will be one - third when EMU is complete with twelve EC members, Community interests may be expected to be represented disproportionately before that. Under normal circumstances, the number of ECB Board members will be six; initially, it may be four but no fewer. Should seven countries qualify for Stage Three in 1997 - a very optimistic scenario - the weight of the Board on the Governing Council will be no less than 36 percent but perhaps as much as 46 percent. If Stage Three starts in 1999, instead, with fewer than seven members, the Board members might have 50 percent of the votes - 6 out of 12 - or might even form a majority on the Governing Council. In comparison, there have been either six or seven Executive Board members on the Bundesbank council since the 1970s, accounting for either 35 or 39 percent of the Council's total votes. Thus, in time, the ECB is likely to be a less federalist institution than the Bundesbank.

One of the articles of ECB statute foresees the establishment of general principles for open market and credit operations. It allows the ECB to purchase and sell claims and marketable instruments in transactions with virtually anyone - governments, corporations, or individuals. Also another article of the ECB statute allows the ECB to introduce new methods of monetary control at its own discretion, provided only that they be consistent with an open market economy

with free competition. In contrast to the ECB, the Bundesbank Act is more restrictive. It limits credit operations to those with credit institutions and permits open-market operations only in certain types of assets. The Bundesbank Act is also more specific than the ECB statute on maximum - reserve requirements. This greater specificity effectively protects the Bundesbank from pressures of groups attempting to use or incent new instruments - such as cheap financing opportunities for government - owned financial institutions to serve their own financial interests.

#### **4.3 The Objective of the Central Bank:**

The constitutions of both the ECB and the Bundesbank spell out the principal objective of monetary policy and subject this objective to a condition. The ECB Statute is much more specific in this regard than is the Bundesbank Act. Article 2 of the ECB Statute, which repeats Article 103 of the Maastricht Accord, declares price stability to be the primary objective of the ECB. The Bundesbank Act has no such specific provision.

Its Article 3 gives the Bundesbank a mandate to safeguard the stability of the currency, a much broader notion than price stability. In fact, the authors of the Bundesbank Act made it very clear they did not want to commit the bank specifically to price stability. Although the bank itself interprets its mandate in terms of price stability, it is clear

that output and employment stabilization and external considerations are also important." 3

The Bundesbank Act leaves much more for discretionary policies than does the ECB Statute.

The tasks normally associated with the activities of a central bank will be the exclusive responsibility of the ECB, its major power being the formulation and implementation of monetary policy in the EC. It will also conduct the foreign exchange operations in accordance with the EMU exchange rate regime, and hold and manage the official foreign reserves of the participating states. With one exception the EC central banks agreed on the need to bring all foreign reserves assets of the participating countries into the ESCB - i.e. into the national central banks - not later than at the beginning of the third phase. Foreign reserve assets held by official non-central bank bodies would have to be transferred to national central banks in order to ensure that exchange rate and monetary policy operations are not affected by transactions in official foreign reserve assets undertaken by official bodies outside the system. Other tasks set forth in the EC Central Bank Governors Committee Draft entrust the ESCB with functions in the context of a clearing and payments system and envisage for it share in the prudential supervision of the financial system for the purpose of safeguarding its structural and operational stability. As a matter of principle, the tasks incumbent on the ESCB will be carried out by the ECB. In conjunction with the prerogative to decide whether the ESCB shall be represented by the ECB or national central banks for the purpose of international monetary institutions, unless it

approves that national central banks remain members of such entities, the ECB has a sweeping jurisdiction over the monetary domain in its entirety.

In sum, therefore, the EC Central Bank Governors Committee's draft responds to the need that the federal structure of the ESCB must not be an impediment limiting the efficiency of monetary policies and their implementation throughout the EC and in international monetary relations. Indeed it is common knowledge, born out by the monetary history both of states and international institutions, that monetary sovereignty is and has to remain indivisible. It must also have a uniform and central direction. There is no room for regional differentiations nor for the operation of the subsidiarity principle if the latter is unduly understood as an option for particular, divergent interests within the EC. While fortunately affirming these tenets, the draft is equally well advised in requiring that the ESCB 'speaks with one voice'. Accordingly it insists that if the ECB, in representing the EC in international monetary institutions, is to conclude agreements on behalf of the EC, a provision to this effect would need to be introduced into the EC Treaty or the protocol setting forth the ECB statute.

Article 12 of the Bundesbank Act requires the Bundesbank to support the general economic policies of the German government, subject to the requirement of Article 3. Similarly, article 2 of the ECB Statute requires the ECB to support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community. In the absence of an EC government,

however, the Community's objectives for economic policy exist in broad and vague formulations at best; Article 103 of the Maastricht Accord foresees that the Council of Ministers will draft a report describing the broad guidelines of the economic policies of the Member States and the Community to be adopted after discussion by the European Council. Thus, the ECB will not find it difficult to defend its own policies against requests to support vague policy goals. The Bundesbank, by contrast, has often been asked to support specific policies to raise output and employment or to support the government's fiscal stance.

#### **4.4 Central-Bank Independence:**

If the System is to achieve the primary objective of price stability the ECB decisionmaking bodies should be able to act on their own responsibility and not be subject to the instructions of political instances, as these might be in conflict with the pursuit of its objectives. Indeed, persons and institutions with political functions generally are not devoted exclusively to the maintenance of monetary value. As a rule they are not under an obligation of allegiance to price stability, nor do they feel that they owe such allegiance. It is a common experience that political authorities prefer the policy of giving easy access to monetary liquidity in order to attain economic policy targets.

In refreshing clarity, the draft statute submitted by the EC Central Bank Governors Committee therefore states that the ECB, the national central banks, and the members of their decision-making bodies shall be independent from instructions by political authorities or any other bodies. The text goes on to require that Community institutions and bodies as well as the governments of Member States undertake to respect this principle and not to seek to influence members of the decision-making bodies of the ECB and the national central banks in the performance of their task. <sup>4</sup>

Central-bank independence simply means that monetary policy can be carried out without government interference and even, if necessary, against the wishes of the government. By removing monetary policy from the domain of political interests, the central bank's ability to commit itself to long-run low-inflation policies is improved. This requires, in addition to institutional independence, personal independence for individual decisionmakers at the central bank. <sup>5</sup>

One way to sever the link between government and the central bank is to cut off all channels of communication between the central bank and other government agencies; they cannot create mischief if they cannot talk to each other. Although seemingly extreme, this is

essentially the solution adopted by the ECB Statute ruling that neither the ECB nor the national central banks shall seek or take instructions from Community institutions or member governments, and that member governments shall not try to influence the ECB. One interpretation of this ruling is that the ECB Statute was written to accommodate concerns of those countries that had no experience with central-bank independence and that independence rules out neither auditing nor the central bank's requirement to report regularly to the European Parliament, the Council of Ministers, and the European Commission.

One important reason for creating an independent central bank is to prevent a government from using the money supply to finance public spending, transfer payments, and tax reductions to interest groups in exchange for votes. One way to achieve this is to keep the central bank from buying too much government debt or from overextending credit to government in other ways. The Bundesbank Act limits the extension of credit to the government to small overdrafts and prohibits altogether the purchase of public debt in primary markets. The Bundesbank's ability to finance the government indirectly is limited by the absence of a secondary market for short-term government debt. Purchases of long-term government bonds play only a small role in German money supply.

The ECB Statute goes a step further and prohibits any direct monetary financing to the Community or to national or local governments. The Maastricht Accord rules that the Community shall not be liable for or assume the commitments of member governments



or purchase debt instruments directly from them. The ECB may conduct open-market operations, however, for there are no restrictions on the purchase of government debt in secondary markets.

A crucial feature of an independent central bank is that it generates its own revenues and does not rely on a fiscal authority for its operations. The ECB will be constructed in this regard like a private bank. Each national central bank will provide capital and will transfer foreign assets to the ECB, and the property of the ECB will be exempt from all forms of requisition or expropriation. The ECB will earn income on specifically designated assets and will distribute it to the member banks according to their capital shares. It will, in sum, be financially independent.

"Personal independence relates both to the relations between central bankers and the administrations in office, and to partisanship on the part of the central bankers. The appointment process is the most important channel for political and partisan influence in this regard." <sup>6</sup> If a government can freely appoint and dismiss board members, the members have good reason to conduct policies in the government's interest. Similarly, in countries where parties alternating in government have different views on monetary policy, the party in power is likely to appoint central bankers who share its ideology.

In order to prevent the undoing of institutional independence by frequent change of the persons appointed to the decision-making bodies of the ECB, its President, Vice-President and the other members of the Executive Board shall be appointed for a period of

eight years, while the governors of the national central banks appertaining to the ECB Council as members shall have a term of office of no less than five years. Only the EC Court of Justice may compulsorily retire a member of the Executive Board from his office, on application by the ECB Council or by the Board itself, if that member no longer complies with the requirements of his high function or if he has been guilty of serious misconduct.

Central-bank independence requires freedom from any obligation to finance government deficits or monetize public debt. Because the central bank remains part of the public sector and governments can change central-bank laws to regain access to monetary financing, such freedom can ultimately be credible only if the government's financial position promises to remain stable. From this perspective, sound fiscal policies are a necessary condition for central-bank independence.

The Maastricht Accord recognizes this necessity and includes several provisions regarding fiscal policy in the member countries. Accordingly, the Community shall not be responsible for any financial obligations incurred by member governments or other public authorities. This same principle is reinforced which states also that a member state shall not be liable or assume any kind of public debt of another member state. Member states in a debt crisis will continue, however, to have the right to be bailed out by the Community or by other members.

Yet, the EC is a community of solidarity, and the equalization of standards of living across member states is one of its official goals.

This means that the members will likely see it as a moral right, if not a legal obligation, to help a fellow member in financial trouble. Furthermore, policymakers will surely prefer crisis management, including a rise in the rate of monetary expansion in EMU, if the alternative is to impose additional taxes and massive spending cuts on a troubled country. In short, EC membership implicitly provides insurance against debt crises, a provision that may compromise the quality of EMU.

## V - THE BUNDESBANK: IS IT A MODEL FOR THE ECB?

A future central bank for a common European currency will look much like the Bundesbank, following its model of independence from government and dedication to monetary policy.

There is a strong economic case for transforming the EMS into a monetary union, though the desire of some EC countries to replace the current overlordship of the Deutsche Bundesbank as being a major driving force behind moves towards an EC Central bank. <sup>1</sup>

If present trends continue, Europe's central bank will also be federal, distributing its policy-making powers throughout the Community, with representatives from all its members on the central council. The conceptual path towards monetary union in Europe increases the prospect that, however phase three of the Delors Committee's recommendation is implemented, it will succeed only if it meets the Bundesbank's demands for a Eurofed much like itself. Given its skill in reading European doctrine - especially when it comes to the fine points of monetary integration- the Bundesbank is poised to interpret the final Eurofed document until the contents suit its own norm of monetary stability.

Once monetary policies are linked, it becomes necessary to start talking about a European central bank if one does not want the German Bundesbank to become the de facto central bank

for Europe. Since each country will want to have some influence on monetary policies, and since this influence is only to be had if there is a European central bank, it is only a question of time until a European central bank comes into existence. <sup>2</sup>

The Bundesbank demanded that both the national central banks of the members of EMU and the European central bank should be independent from government influences, i.e. modelled more closely after the institutional structure of the Bundesbank. It is said that it would not let Germany to enter the union if this was not the case. In the current state of European central banks the Bundesbank objected to the inclusion of a system of European central banks into Stage Two, as it was planned by the Delors Committee.

Furthermore, it saw that the main purpose of the European central banks should be to safeguard the stability of the European currency. Overall, the Bundesbank wanted the European central bank and the European common currency to resemble itself and the DM as much as possible. <sup>3</sup>

On the other hand, most of German politicians considered European monetary integration as a political objective. "An extreme interpretation of this is that Germany saw European integration as a means to deliberately contain its increasing power into a framework acceptable for other European countries." <sup>4</sup>

In the general European discussion, Italy and France saw the establishment of European central bank at Stage Two as an impetus for adaptations in economic policies and performance, whereas the Bundesbank put them in opposite order.

The future European central bank will be modelled after the Bundesbank, and the strict criteria ensure that economic convergence will have to be realized before starting Stage Three. However, it is notable that the transformation in the end is automatic. This procedure was introduced by France to make sure that the European central bank will be established latest in July 1998 and at least a core of countries will move to Stage Three in 1999.

The first commentaries of the Maastricht Treaty were mostly concerned about the fact that Germany did not meet the economic performance criteria because of unification costs. "The countries qualifying were Denmark, France and Luxemburg. EMU without Germany would be virtually inconceivable, and it was anticipated that Germany's uncharacteristic weakness would indeed complicate the transition." <sup>5</sup> However, trust in Germany's economic strength was unrelinquished and its recovery in order to be a center of at least a core of states by 1997 was considered highly probable.

In terms of price stability, the Bundesbank has undoubtedly been the most successful European central bank in the past four decades, a success credit to its institutional framework. It is now commonly agreed that price stability should be the most important goal of the ECB. Has, then, the Bundesbank served as a model for the ECB and

is the ECB of the Maastricht Accord simply a tighter edition of the Bundesbank?

The ECB and the Bundesbank share a formal status of independence, similarities in administrative structure, and explicit commitments under conditionality clauses. But the institutions follow two distinct models. The Bundesbank model is restrictive in the choice of instruments, and has a well-defined conditionality clause. The ECB has an unrestricted choice of instruments, a concrete objective, and a vague conditionality clause. The weight of 'central' interests is small and the definition of institutional independence is simple and operational in Bundesbank decisions as compared to the ECB. In addition, the Bundesbank's independence is weakened by its lack of control over the exchange-rate regime and by shortcomings with regard to personal independence. The ECB's position is the opposite.

The ECB will thus have less discretionary power than the Bundesbank to pursue an optimal monetary policy. It can be expected to focus more on price stability and less on output and employment stabilization. For lack of explicit provisions, the ECB will find it harder, in comparison to the Bundesbank, to defend itself against pressures to apply specific instruments and harder, therefore, to use only those most suitable for its policy. The ECB will be more strongly exposed to political pressures than the Bundesbank is once a common European economic policy follows further political integration. In addition, the Accord relies much more on personal independence than does the Bundesbank, and the control it places on exchange-rate policies

reflects the influence of political pressures on European monetary policy.

A Central Bank Council majority believes that a European Central Bank can come into existence only after substantial European financial and economic integration. The position of this majority conforms to established Bundesbank theory : real factors and forces drive the economy, and these are beyond the reach of monetary policy.

It is clear that the ECB constitution promises much better outcomes than most existing central-bank constitutions in Europe. The fact that we know little about the empirical link between the constitutions and performances of central banks suggests, however, that the Bundesbank model should have a predictive power for the future performance of the European Central Bank.

The Bundesbank will continue to judge every plan for European monetary integration against its stability and its first concern will continue to be defending domestic price stability. These facts, combined with Germany's size, wealth and the asymmetric results of monetary Realpolitik, seem to secure the Bundesbank's present position as monetary hegemon of the European Community for the foreseeable future.



## NOTES

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