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A Reform Proposal for EMU Institutions*

By *Marco Lossani, Piergiovanna Natale, and Patrizio Tirelli*

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I. Introduction

EMU macroeconomic institutions have been widely criticised. The ECB lack of transparency and accountability has been often remarked in the press. Commentators have pointed out that some national interests might have excessive influence within the ECB Governing Council (Casella 2000a, 2000b; Gruner 1999). Moreover, the ECB stabilisation policy appears to some observers weak and inconsistent, as if its decision-making procedures were not up to the task (Favero, Freixas, Persson and Wyplosz 2000a, b). The Stability and Growth Pact (SGP) reputation appears tarnished and revisions are recurrently suggested.¹

Instead of the SGP, Casella (1999) advocates the creation of a market for tradable deficit permits. In the same vein, Casella (2000a) proposes a reform of the ECB decision-making rule within the Governing Council. The market solutions approach is presented as an alternative to the "explicit co-ordination required by the collective decision-making procedure ..." (Casella 2000a, p. 9). In our view, such an approach denies the very essence of the European integration process, which relies on co-ordination and agreement among the member states over far more numerous issues than macro-economic policies (Von Hagen and Mundschenk 2001, p. 1).

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¹ The Economist (2001b, p. 13) is even in favour of scrapping the SGP. Politicians have begun to float their interest for more flexible arrangements despite routine statements of their commitment to the SGP (The Economist 2001c, p. 60).

In this paper, we discuss a reform proposal for EMU macroeconomic institutions which rests on the generalised adoption of targets, for both monetary and fiscal policies, to be integrated by a system of checks and balances. The new arrangements for fiscal policies should induce EMU countries to internalise the external effects of their own policies, therefore allowing a partial relaxation of the SGP limits to national debt policies. As for monetary policy, we propose the adoption of an inflation target, the assignment of ex-post assessing powers to the Euro12-group and an internal reform of the ECB. The latter should limit undue nationalistic influences within the ECB governing bodies.

The paper is organised as follows. Section II and III discuss the institutional design for fiscal policies and monetary policy, respectively. Section IV concludes.

II. Reshaping National Fiscal Policies within EMU

To begin with, we recall the key aspects of EU institutional arrangements. The Maastricht Treaty posits that EU fiscal policies are run nationally, following EU-wide objectives defined on a yearly base by the Council of Economic and Finance Ministers in the Broad Economic Policy Guidelines (BEPGs) and within the limits set by the SGP. According to Art. 99 of the Maastricht Treaty, the Council of Economic and Finance Ministers (Ecofin) approves by majority voting the adoption of guidelines and recommendations proposed by the European Commission on matters of deficits, taxation and spending. National fiscal policies are regularly scrutinised to assess their conformity with the BEPGs. The supervision task is assigned to the European Commission, which co-operates with the Economic and Financial Committee and reports to the Ecofin. In 1997 the European Council established what is now known as the Euro12-group. The latter provides a forum where, in connection to Ecofin meetings, the EMU finance ministers gather to assess EMU macroeconomic developments. The Euro12-group has no legislative powers.

The SGP sets an upper limit on national deficits as a proportion of GDP (3%). Countries are required to submit yearly their Stability and Convergence Programmes (SCPs) to the European Council. The European Commission evaluates each SCP consistency with the medium-term objective of a budget close to balance or in surplus. On these matters the Commission reports to Ecofin. Countries failing to comply with the BEPGs or the SCPs are subject to censorship by the other EU members. Only unjustified breaches of the 3% ceiling set in the SGP cause the adoption of sanctions towards a country.

Out of this complex arrangements, the SGP has received most of the attention by commentators as well as academics. The SGP presupposes a link between fiscal discipline, monetary stability and growth. The economic literature identifies different channels through which such a relation can work.²

² For a comprehensive survey, see *Beetsma and Debrun (2002)*.

1. The Pros and Cons of the SGP

Excessive deficits and the accumulation of debt occur because governments underestimate the future consequences of current deficits (Alesina and Tabellini 1990) and have an incentive to use debt strategically (Persson and Svensson 1989). High levels of debt service force a country to increase its fiscal pressure over time. To the extent that taxation is distortionary, output losses are incurred. The ECB might therefore be pressured into accommodating monetary policy (Artis and Winkler 1998). Beetsma and Uhlig (1999) show that, by acting non-cooperatively, each union member underestimates the equilibrium debt levels and the ensuing inflationary pressures. As a consequence, fiscal discretion within a monetary union will generate larger debt levels than without a union.

If the transmission of fiscal shocks is negative, uncoordinated national fiscal policies cause an undesirable policy mix (excessive deficits, taxation and interest rate) and raise inflation expectations (Eichengreen and Wyplosz 1998; Debrun 2000).³

The *Fiscal Theory of the Price Level* (Woodford 1995, 1998) identifies a third channel: if both the monetary and fiscal authority stick to inconsistent paths for their policy instruments, the price level adjusts to ensure that the inter-temporal government budget constraint is fulfilled. Hence, in a "fiscal dominance" regime, the monetary authority loses control over the price level. In this framework, rules such as the SGP are needed to avoid a situation of fiscal dominance.⁴

Despite the consensus on the need for fiscal constraints, the specific features of the SGP have been widely criticised.

The adoption of a uniform deficit ceiling does not take into account structural differences across countries, such as different stocks of outstanding debt or the asymmetric output effects of national fiscal stimuli. Buti and Sapir (1998) give operational content to the notion of medium-term deficit objectives that would at least allow for the correct functioning of the automatic stabilisers. They show that adherence to the Pact requires very different structural balances across EMU countries. In defence of the Pact, it might be argued that some asymmetries will disappear once debt levels have been harmonised below 60% and automatic stabilisers are reformed and made more effective where necessary. However, correcting excessive debt levels in countries like Italy and Belgium will probably take a long time even if one takes at face value the official stabilisation plans. Furthermore, it is not obvious that the SGP provides sufficient incentives to induce a re-organisation of national welfare systems consistent with a flexible use of fiscal policies.

³ Under these circumstances, current deficits are too high for two reasons. On the one hand, governments are not able to internalise the adverse consequences of their actions on expectations. On the other hand, non-cooperation with the other national fiscal authorities causes a deficit bias.

⁴ Leith and Wren-Lewis (2002) investigate the specific features of fiscal constraints designed to ensure price stability in a monetary union. They argue that the SGP ceilings are exceedingly restrictive.

Focusing on the size of the budget deficits, the SGP provides at best limited discipline for national fiscal policies that do not breach the 3% ceiling. This criticism is based on two arguments. The first is that the Pact does not envisage adequate incentives to the creation of surpluses during economic expansions (Bean 1998, CESifo 2002, Canzoneri and Diba 2001). One could argue that the risk of being forced to implement a procyclical policy in the face of a recession should induce governments to adopt symmetric fiscal policies. Unfortunately, adverse electoral incentives – one of the very rationales for the Pact – induce national governments to underestimate the future consequences of an asymmetric development of fiscal policy. In the present institutional set-up, the BEPGs should provide guidance to national fiscal policies within the limits imposed by the SGP. Von Hagen and Mundschenk (2001, p. 24) argue that the BEPGs enforcing mechanism relies only on moral suasion or reputation-damaging peer pressure. They also point out that the connection between the typical budgetary cycle and the discussion of national SCPs is at best feeble. As a result, countries like France and Germany have been able to undertake significant tax adjustments without mentioning them in their SCPs. The European Commission (2000) remarks that quite often the measures taken or planned within the SCPs are not thoroughly explained, preventing an effective process of peer review within Ecofin. The above arguments are confirmed by the actual behaviour of national fiscal policies between 1998 and 2000, when, despite the good growth record, the progress towards fiscal consolidation was very slow (CESifo 2002).

The second argument is that the SGP apparently ignores the fiscal distortions which may occur under a balanced budget rule. Excessive taxation may in fact arise as a consequence of time-inconsistent as well as beggar-thy-neighbour policies.⁵ The issue of time inconsistency is described in Beetsma and Bovenberg (1998), whose results crucially depend on the order of moves by the wage setters, the national fiscal authorities and the ECB. In setting the tax rate, the fiscal authorities foresee that the ECB will accommodate a tax increase. However, they do not internalise the fact that, being completely anticipated, such a policy is ineffective. Another strand of literature (Levine and Pearlman 1998) highlights that unco-ordinated fiscal policies are systematically characterised by the incentive to relax the fiscal stance, in order to achieve an output expansion through the appreciation of the real exchange rate.⁶ This result is typically obtained in a symmetric framework, but it is easily extended to the realistic case of asymmetries concerning national preferences and the economic structure of EMU members. The common theme to these two contributions is the implicit emphasis on the importance of commitment to announced tax/spending levels, which may well differ across EMU member states.

⁵ Successive interpretations of the Pact provided by the European Commission point at the excessive fiscal pressure within the Euro area, implicitly confirming the importance of the issue.

⁶ This effect is normally described in models that assume a negative transmission of fiscal shocks to the foreign demand. *Catenaro and Tirelli (2000)* demonstrate that the same incentives exist in case of positive transmission if the fiscal authorities act as Stackelberg leaders vis-à-vis the ECB, and the latter controls the inflation rate.

The issue of how should national fiscal policies be implemented within the SGP limits has quickly turned into a unco-ordination versus co-ordination debate. In this regard, the main results emerged in the theoretical literature are easily summarised. Unco-ordinated and fully discretionary fiscal policies are undesirable, due to adverse “political” incentives, the missing internalisation of unfavourable effects on expectations, and spill-overs affecting the economies of member states. Fully discretionary and co-ordinated policies have ambiguous effects. On one hand, co-ordination worsens the time inconsistency of fiscal policy, strengthening the public expenditure bias (Beetsma and Bovenberg 1998). On the other hand, the argument in favour of co-ordination is twofold. First, co-ordination induces national fiscal authorities to internalise the transmission effects discussed in Levine and Pearlman (1998). Second, co-ordination of countercyclical fiscal policies is always desirable, provided that appropriate institutional design removes the expenditure bias. To this end, Catenaro and Tirelli (2000) propose the adoption of public spending targets.

Policy-oriented contributions have been characterised by opposing views. Those who favour unco-ordination claim that governments should run a cyclically-adjusted balanced budget (Alesina, Blanchard, Gali, Giavazzi and Uhlig 2001; CESifo 2002). In contrast with this approach, Von Hagen and Mundschchenk (2001) argue that fiscal co-ordination is a necessary prerequisite to obtain EMU club-goods such as price stability. The authors criticise the present institutional set-up, where BEPGs must be unanimously approved by the European Council (Art. 99 of the Maastricht Treaty) but only a subset of EU members share EMU club-goods. The Commission (2001b) has explicitly recognised the need for stronger co-ordination within the Euro area, and has put forward a proposal. The latter is based on a stronger role for the Euro12-group, who should articulate the policy responses to specific shocks. On the other hand the Commission's proposal does not entail any enforcement mechanism and entirely relies on unanimous consensus within the Euro12-group to put pressure on “deviant” members.

2. A Proposal

Our proposal rests on the view that significant externalities arise when national governments retain full discretion in the setting of tax/expenditures rates. Thus, there is a presumption that institutional arrangements which limit the discretionary power of national policymakers enhance efficiency. In particular, we claim that:

Proposition 1: In addition to deficit ceilings, the endorsement of national tax/expenditure targets, adequately supported by a system of checks and balances, will efficiently preserve the EMU-club good of price stability and induce the internalisation of traditional spill-over effects. Moreover, commitment to fiscal targets will prove consistent with more flexibility in the enforcement of deficit ceilings than is currently envisaged in the SGP.

Discussion: EU allocation of powers is based on the subsidiarity principle, according to which the powers of EU institutions should be limited to those tasks

that cannot be adequately performed by its member states. Hence, we do not argue that some governing body should interfere with national sovereignty in fundamental decisions such as the choice of the welfare system by imposing, for instance, an identical tax level across EMU countries. Institutions should instead be designed to prevent the manipulation of fiscal stances aimed at achieving short-term macroeconomic effects.

The centrepiece of our proposal is the adoption of fiscal policy targets. Each government will be bound to announce a multi-year sequence of target levels for public spending, taxes and deficit that are mutually consistent. Such targets are a necessary requisite for policies precommitment, since they are used to ex-post assess the actual behaviour of the national governments. The flexible implementation of targets for expenditures, taxation and deficit combines a more effective control on the expansionary bias of national fiscal stances with the use of countercyclical policies. Several contributions have emphasised the importance of fiscal stabilisation policies. Some authors (Canzoneri and Diba 2001; CESifo 2002) propose that the focus of the Pact be shifted from actual to structural deficits. Others (Alesina, Blanchard, Galí, Giavazzi and Uhlig 2001) argue that, within the SGP limits, countries should commit to stabilise the budget over the cycle. Both suggestions are open to criticism. On one hand, although commitment to a balanced structural budget rule would provide the appropriate mix of fiscal discipline and flexibility, defining such a rule in practice may prove difficult because short run measures of the structural balance are subject to a tremendous uncertainty about the trend level of output.⁷ On the other hand, the suggestion in Alesina, Blanchard, Galí, Giavazzi and Uhlig (2001) apparently ignores that SGP deficit ceilings would clearly become superfluous if countries were able to individually commit to a symmetric countercyclical fiscal policy rule. Therefore, instead of defining a constitutional policy rule, we sketch a system of checks and balances, which should induce national governments to implement a countercyclical rule.

Expenditure/tax targets have received much less attention than deficit objectives in the EMU institutional set-up. In our view, both deficits and tax/expenditure targets are important in preserving EMU price stability and should thus be granted "equal treatment". This requires that all targets are credible and hence governments be made accountable for them at the Union level. There must be absolute transparency over the management of fiscal policies. Finally, it is necessary to minimise the possibility that "political" conflicts over the consequences of governments' actions are disguised as "technical" controversies. To achieve these goals, we propose that: *i*) national targets be co-ordinated ex-ante and turned into binding announcements; *ii*) specific enforcement powers be assigned to EMU peers; *iii*) the surveillance procedure be strengthened.

Ex-ante targets coordination. Macro-economic efficiency may be attained only if each country internalises the consequences of its own choices on EMU conditions. This basic principle applies also to the definition of tax/expenditures targets. For example, the non-cooperative setting of taxation targets might gener-

⁷ This is the reason why central banks never announce explicit output targets.

ate excessive inflationary pressures.⁸ In our view, ex-ante co-ordination should also be concerned with the macroeconomic consequences of foreseeable structural reforms of the welfare state. It is well known that structural reforms affect the macroeconomic policy stance and typically require a prolonged adjustment period. Such effects cannot be ignored, because of externalities on other economies. Thus each country should retain the right to undertake structural reforms at its own choice, but the macroeconomic implications of transition periods should be matter for ex-ante policy co-ordination⁹. The Irish transition to a low-tax regime is a good case in point. Another good case in point is the hot and somewhat confused debate that followed the EC recommendations to the Irish government, showing that in this regard EMU policy co-ordination is still in a flux (Alesina, Blanchard, Gali, Giavazzi and Uhlig 2001).

Binding announcements. Targets credibility requires an institutional set-up such that announced objectives are not systematically disregarded. On the other hand, the flexible implementation of targets allows to stabilise the economy. The literature on the optimal trade-off between credibility and flexibility suggests that ex-post deviations of actual policies from announced targets should be made "costly" (Lohmann 1992). This is essentially the spirit of the SGP and we agree with it. Still, deviations from announced targets can be made costly without giving up flexibility. This is obtained designing a system of checks and balances among different institutional levels, whereby governments are induced to internalise the consequences of their own choices. We turn now to the main elements in such design.

Enforcement powers. A country willing to deviate from announced fiscal policy targets should submit a request to proceed to the Union members. The request will identify the underlying causes and the consequent domestic impact of the proposed change in policy. Moreover, it will spell out its consistency with the announced medium-term objectives.

We propose that enforcement powers on specific intra-EMU matters, currently entrusted to Ecofin, be handed over to the Euro12-group.¹⁰ The Euro12-group will then be called upon to express a binding opinion about (proposed) devia-

⁸ This conclusion can be intuitively demonstrated, by comparing the behaviour of a country maintaining monetary sovereignty with that of a member of the Union. The first, in selecting the taxation target, will take into account the impact of a distortionary taxes on output, and therefore on the consequent inflationary pressures. The second will ignore the symmetric behaviour of the other members of the Union and will underestimate the inflationary impact of its own choices. As a result, the non-coordinated setting of the taxation targets in the Union will lead to excessive levels of fiscal pressure. The same conclusion is drawn by taking into consideration the possibility of increasing production through appreciation of the real exchange that could be attained with a unilateral increase in the public spending level.

⁹ This issue was implicitly acknowledged in the Lisbon meeting of the European Council, when it was agreed that countries should present a yearly report discussing the interactions between the domestic macroeconomic policy stance and the structural policies.

¹⁰ Our proposal is akin to the one put forward in *Von Hagen and Mundschenk* (2001), who argue that coordination powers should be handed over to an Economic Policy Council: "With an appropriate institutional design, such a council would enhance policy coordination by developing judgements about policy trade-offs and the distribution of adjustment costs." (*Von Hagen and Mundschenk* 2001, p. 23).

tions from announced targets. Such opinion will be based on EMU-wide macro-economic implications of the new policy course. As the Irish case clearly shows, countries are unlikely to implement symmetric policies along the cycle, (e.g.: they may not reduce taxation during a boom). The Euro12-group should monitor countries for their compliance with the announced targets in good as well as bad times. Finally, should a country disregard the Euro12-group opinion, it would be subject to pecuniary sanctions.¹¹

Since each decision is likely to have significant and asymmetric effects on the welfare of each member country, hegemonic coalitions might bias Euro12-group decisions in favour of specific national interests. It is therefore important to regulate the Euro12-group discretionary power. Hence we propose that any decision should respect an equal treatment principle, i.e. countries experiencing similar cyclical conditions should be allowed a symmetric adjustment of their fiscal stance if they wish so. Decisions should be based on publicly disclosed motivations concerning the Union-wide effects of national policies and should take into account the ECB's opinion¹² about the inflationary consequences of the policy change. Finally, the European Commission – whose objective function reflects the interests of the Union as such – should be appointed as agenda setter for the Euro12-group meetings.¹³

Improved commitment to a broader set of targets allows to introduce new provisions concerning deviations from deficit targets. The crux of the matter obviously is represented by requests to deviate from the 3% ceiling set in the SGP. In our view, a country (a group of countries) should be allowed to increase its deficit beyond the ceiling if: *i*) this is consistent with a balanced budget in the medium term; *ii*) the remaining Euro12-group members agree to implement policies such that the Union-wide deficit does not exceed the 3% limit. This rests on the important argument that EMU price stability depends on the global fiscal stance (Von Hagen and Mundshenk 2001; Casella 1999). Thus, if current rules allow for a global deficit close to 3% there is no need to sanction countries that breach the SGP rule provided that EMU peers agree to co-ordinate the global EMU stance within the SGP limit. As for decisions entailing a breach of the 3% deficit rule at the Union level, Onorante (2002) shows that empowering the ECB with the right to choose the excess deficit would entirely remove any spending bias and leave room for enough fiscal flexibility. This solution may in fact be unfeasible, as it would cause undue political pressures on the ECB. Bearing in mind that the enforcement of the SGP ultimately rests in the sole hands of national governments, i.e. to the extent that transparency sufficiently raises the

¹¹ In contrast with the current arrangement (*Artis and Winkler 1998; Casella 1999*), the implementation of sanctions should be devoid of any discretion.

¹² At the present, the ECB plays a role in the policy coordination process via the Economic and Financial Committee (EFC). The latter consists of representatives of national administrations and central banks, of the European Commission and the ECB itself. The EFC has an advisory and preparatory role for the European Council meetings. Our proposal strengthens the ECB role in the policymaking process, extending the accountability mechanism and favouring co-ordination between monetary and fiscal policy.

¹³ At present, the Euro12-group meetings are chaired by one of the finance ministers of EMU members. We agree with the European Commission's request (2001b) of granting it the right to advance economic policy measures and to participate into setting the agenda for the European Council meetings.

costs of running time-inconsistent fiscal policies, a viable alternative is to require that the Euro12-group and the ECB issue a public statement arguing the case for their preferred policy stance, leaving the final decision to a qualified majority within the Euro12-group.

Surveillance procedure. The Amsterdam Treaty assigns the European Commission the task of monitoring economic developments and policies in member states. Given our emphasis on a broader set of policy targets, the Commission surveillance tasks should be extended accordingly. As mentioned above, the effectiveness of the surveillance procedure is currently impaired by the wide-spread timing mismatch between the writing of SCPs and the national budget cycle. The European Commission (2001a) itself has recently put forward some practical suggestions aimed at improving EU budgetary surveillance. Three are noteworthy: *i*) partners must be “pre-informed” in case of important policy measures; *ii*) the information content of the SCPs must be improved and standardised across countries¹⁴; *iii*) the SCPs must be submitted to the competent authorities in autumn each year. We favour the outright adoption of such proposals.

III. The Monetary Institutions

The following discussion focuses on two key aspects of EMU arrangements concerning the monetary policy. The first is the ECB status as a goal-independent Central Bank; the second is the composition of the ECB governing bodies, where national interests are directly and explicitly represented. We will argue that in principle such a combination of goal independence and national representation can adversely affect EMU monetary policies, and probably lies at the heart of the serious difficulties the ECB met in establishing a reputation *vis-à-vis* the financial markets.

1. A Critical Assessment

The Maastricht Treaty assigns to the ECB price stability as its primary objective. Without prejudice to the primary objective, the ECB is committed also to support the general economic policies of the Community and to promote the smooth operations of the payment system. The assignment of lexicographic preferences to the ECB can be interpreted as a device to enhance efficiency, transparency and accountability in the conduct of monetary policy. However, the ECB statute and the Bank's interpretation of it have been subject to sharp criticisms, well summarised in Tabellini (1999). First, being goal-independent rather than instrument-independent, the ECB enjoys excessive discretion. Second, the endorsement of a monetary policy strategy based on the two pillars of consumer price inflation and M3 growth may seriously hamper the effective accountability of the Bank's actions. Third, the ECB has *de facto* shown little transparency, re-

¹⁴ This requires the adoption of standardised statistical procedures across countries and, more important, the elaboration of appropriate Union-wide indicators (*European Commission* 2001a).

leasing information useful to justify ex-post its operations, but of little avail in assessing ex-ante how it intends to achieve its objectives.¹⁵ To improve transparency, the publication of the minutes of the Board meeting has been often invoked (among others, see Begg, De Grauwe, Giavazzi, Uhlig, and Wyplosz 1999; Eijffinger 2001). However, no decision has been taken in this direction, causing also negative judgements by renowned Central Bank watchers (ABN AMRO 2001).¹⁶

The large degree of independence enjoyed by the ECB Governing Council is acceptable in principle. In fact, goal-independent central banks – notably the Fed and in the past the Bundesbank – indeed retain a substantial degree of discretion. In particular, the Fed has often surprised markets (Mishkin and Posen 1997), and the Bundesbank has repeatedly accommodated substantial deviations of the money supply from the announced objectives (Issing 1997). There is a fundamental difference, however, between pre-EMU Bundesbank and the Fed on one hand and the ECB on the other. In fact, EMU political fragmentation impairs an ex-post assessment of the ECB actions. To the contrary, in the US controlling powers are firmly in the hands of the central bank political principal (Chang 2001), so as they were in Germany before EMU (Lohmann 1997). Therefore the current ECB institutional set-up does not fit well with the global architecture of EMU macroeconomic institutions, simply because there is a striking imbalance between its degree of goal independence and the strength of ex-post control. Furthermore, such imbalance leaves room for a potentially excessive influence of national interests within the ECB Governing Council. This may happen as a consequence of the peculiar arrangements characterising the ESCB, where the NCBs constituting the ESCB are nation-based institutions and their Governors' votes in the ECB Governing Council may exert a distorting influence.¹⁷ In case of serious cyclical asymmetries across EMU countries, such an influence may take place either through prevailing coalitions of national interests or through paralysing conflicts.¹⁸ Both cases would be highly detrimental to the credibility of the ECB as a European institution (Baldwin, Bergl f, Giavazzi, and Widgr n 2000).

EMU monetary policy has been subject to several criticisms. According to Gali (2001), it is simply difficult to interpret it in relation to the ECB self-declared objectives. The uncertain and ambiguous conduct of monetary policy is seen as the consequence of internal conflicts. Market analysts seem convinced that decision-making within the Governing Council is unlikely to rely on unanimous

¹⁵ This criticism is partly attenuated by the recent decision to publish the forecasts.

¹⁶ The words of Baldwin, Bergl f, Giavazzi and Widgr n (2000, p. 40) well represent dissatisfaction with this state of affairs: "The detailed study of EMU reform [concerning the ECB statute] is difficult at this point because we do not know how the system works now....".

¹⁷ Thomas Mayer, an economist at Goldman Sachs in Frankfurt, stresses this point by observing that Mr. Greenspan is a "strong leader who has managed to steer markets' expectations skilfully. Mr. Duisenberg is more of a "moderator" of the ECB's 18-strong governing council..." (The Economist 2001a).

¹⁸ According to Eichengreen (1991), the Fed faced troubles of this sort in the years before the '29 crisis because of an institutional framework very similar (i.e. biased towards an excessive influence of national interests) to the present ECB.

consensus, as the ECB insists to be the case (The Economist 1999, 2000). To the contrary, the Council appears – plausibly – characterised by contrasting views among its members, due to the structural and cyclical divergences affecting member states. To see that, recall the ECB's official position on the divergence of regional inflation rates. The ECB (1999) insists that monetary policy in the Eurosystem must be oriented to price stability for the Euro area as a whole, and that possible phenomena of persistent divergence in the growth rates of prices require structural policies. Favero, Freixas, Persson and Wyplosz (2000a, p. 3 and p. 44) have criticised this claim: higher inflation in a region might be accompanied by localised real expansions that – without proper stabilising actions – can favour a “boom and bust” development of asset prices, with possible negative repercussions over systemic financial stability. Consequently, neglect for the interregional inflation differentials is interpreted as the attempt to prevent potential conflicts within the Governing Council. In the present institutional set-up, such an attempt may be regarded as second-best policy to preserve the ECB reputation as a European institution, but it is likely to generate inefficiencies in the conduct of monetary policy.

2. Independence, Transparency and Accountability for the ECB

The aim of our proposed reform is twofold. We suggest measures to increase transparency and ex-post accountability in the ECB decision-making procedures. At the same time, we propose to strengthen the ECB insulation from political influences that do not manifest themselves in the classical forms of appointment power and ex-post policy assessment. To this end, we identify institutional arrangements such that the ECB governing bodies are made largely immune from nationalistic influences, and NCBs simply act as ECB “local” branches, providing “privileged” information about the actual state of EMU regions.

New Jurisdictions for the NCBs. To prevent the over-representation of national interests within the ECB Governing Council, the NCBs should be turned into regional banks as in the Federal Reserve system, and should be fewer in number than EMU members.¹⁹ This implies that the jurisdictions of the reformed NCBs should no longer coincide with national borders. Instead they should be redefined so as to reduce structural asymmetries among them²⁰, limiting the risk of a structural polarisation of the votes within the Governing Council. Moreover, in light of the foreseeable EMU enlargement, re-design of jurisdictions could prevent the dominance of small countries feared in Baldwin, Berglöf, Giavazzi and Widgrén (2000).

¹⁹ In view of the enlargement, Baldwin, Berglöf, Giavazzi and Widgrén (2000) suggest either weighting NCBs' voting rights by the country GDP shares or assigning monetary policy to the Executive Board only. In the following we comment on both these proposals.

²⁰ See Graboyes (1990) for a similar view. It is interesting to observe that the federation of the local central banks in the US Federal System was preceded by a redefinition of jurisdictions which cut across state borders and local economies, so as to limit the risk that representatives on the Fed Board could be captured by specific economic interests.

Our proposal is likely to raise two objections. The first concerns the organisation of banking policy. In fact, in many countries NCBs have traditionally played quite an important role for prudential supervision. By statute, the ECB is supposed just to co-ordinate national banking policies and the Maastricht Treaty is ambiguous about the allocation of powers. Perhaps not surprisingly, the NCBs Governors opted to retain their powers. However, the ever growing integration of European financial markets calls instead for the centralisation of banking policies (Prati and Schinasi, 1997; Begg, De Grauwe, Giavazzi, Uhlig, and Wyplosz 1999; Lossani, Natale and Tirelli 1999; Von Hagen and Mundschenk 2001, Uhlig 2002). Our proposal is likely to meet the stiff opposition of those who fear the complete integration of national financial markets and see the survival of national regulators as a prerequisite for the protection of national champions in the banking sector.²¹ In our view, this strengthens the case for a re-design of NCBs jurisdictions. The second objection concerns the legal status of the regional banks. At the present, the NCBs are the shareholders of the ECB. Each national bank contributes to the capital of the ECB in proportion to national GDP. Seigniorage revenues are apportioned by a system of weighted votes assigned to the NCBs Governors only. This should change, with all proprietary rights shifted to EMU national governments. As for seigniorage, its distribution is a matter for governments to discuss and should be assigned to the Euro12-group.

A new appointment mechanism for NCBs Governors. Following the re-design of jurisdictions, NCBs turn into regional banks. Thus their Governors should be selected according to a competence principle. The appointment power should be entrusted to the ECB Governing Council.²²

A rotation rule for the NCBs Governors right to vote. At the present, coalitions forged by converging national interests can command a majority of votes in the Governing Council. To remedy it, Baldwin, Berglöf, Giavazzi, and Widgrén (2000) recommend assigning monetary policy decisions to the Executive Board exclusively.²³ Such proposal postulates that Executive Board members represent Union-wide rather than national interests. Given the current selection procedures this may well not be the case.²⁴ Moreover, assigning monetary policy to a body whose members are entirely appointed by elected governments may trigger electoral cycles in monetary policy. Following the Federal Reserve example, we would retain a role for the Governors of the newly designed NCBs. Being non-political appointees, they should counteract the effects of shifting po-

²¹ In this regard a good example is provided by the Bank of Italy, who retains the power to discipline competition in banking sector.

²² In steady state, the ECB Governing Council will be composed by the Executive Board members and by the Governors of the new regional banks. One could imagine several transition rules consistent with the steady state.

²³ Baldwin, Berglöf, Giavazzi and Widgrén (2000) contemplate also maintaining the present arrangement while weighting the NCBs' Governors vote by their country GDP share. Unfortunately, the weighting cannot prevent a nationalistic bias in policy making. Consider an asymmetric shock which leaves Union-wide output unchanged but adversely affects the largest economies in the Union. If the latter contribute for more than half of the Union GDP, expansionary policies would be adopted, absent any need for them at the Union level.

²⁴ In support of this view, one has just to mention the controversy over the appointment of Duisenberg as ECB President.

litical majorities in the Union and thus in the composition of the Executive Board, to prevent a nationalistic bias in monetary policy. However, given their presumably large number relative to the “political” appointees, we favour the adoption of a rotation-voting rule for the NCBs Governors.²⁵

A staggering of appointments. At present, Executive Board members are assigned staggered, even if non-renewable, terms. Instead, a NCBs Governor's term of office has a minimum length of five years and is renewable. It follows that members of the Governing Council change in an un-coordinated fashion and some of them do not leave at all.²⁶ In line with established theoretical results (Waller and Walsh 1996), we favour the adoption of a proper staggering of appointments for Executive Board members as well as for NCBs Governors.

A re-design of information flows. Successful monetary policy depends on timely and accurate information about the working of an economy. At the present, the Governing Council relies on NCBs' informational inputs in making policy decisions.²⁷ National interests would lose importance within a reformed ECB. However, one cannot rule out the case where some local interests might affect policy decisions. Even in the US Federal System FOMC members receive information processed only by the Board of Governors staff (Cecchetti 2001). One might argue that, as long as NCBs can provide better or cheaper information than the ECB staff, there is a cost in curbing local influences. However, whether or not such cost is large, is an open question. Thus, following Cecchetti (2001), we advocate for the ECB more centralisation of information gathering and processing than there is at the present.

Procedures for ensuring the ex-post accountability of the ECB. The ECB's “two-pillar strategy” assigns a prominent role to money growth targets as the first pillar. This strategy has been widely criticised, either because it is of no practical relevance, or because it might generate confusion and ambiguity. We take the view that the ECB should discard the two-pillar strategy in favour of inflation targeting. Following a contractualist approach (Walsh 1995, Persson and Tabellini 1993, Svensson 1997), we suggest that inflation targeting be supported by institutional arrangements designed to increase the Bank's accountability. Given the relative weakness of the ECB political principals, the endorsement of an inflation target should *per se* strengthen ex-post control and help to anchor monetary policy to EMU-wide objectives. Holding the ECB accountable by means of an inflation target requires that some key issues be settled: *i*) Should the ECB autonomously select the target, or should it be agreed upon, and with whom? *ii*) To whom should the ECB account for the actual implementation of monetary policy?

²⁵ Rotation will naturally have to be implemented at least by the time the new accession countries will enter EMU. The Nice Treaty (2000) simplified the procedure for changing the voting system for the ECB governing bodies.

²⁶ One of these is the Governor of the Bank of Italy, whose term length depends on his/her retiring age.

²⁷ Cecchetti (2001) argues that ECB economic forecasts are based on information explicitly provided by NCBs.

We propose the following:

- i. By statute the ECB pursues price stability. We suggest that the ECB retains the task of defining the medium-term inflation target consistent with price stability.²⁸
- ii. As in Tabellini (1999), a political principal should be charged with the power of assessing the consistency between: *a*) announced policies and the ECB constitutional mandate; *b*) announced policies and their actual implementation. Following a conflict with the ECB, the political principal is allowed to adopt a sanctioning procedure. The latter may take the form of public and motivated censorship of the ECB policies or (possibly) the imposition of fines on the Bank. If the political constituencies of the European Union and of the EMU coincided, the European Parliament would be the natural ECB principal. However, only a subset of EU countries share the EMU club-good of price stability. Thus we propose that the Euro-12 group takes up the job. Should EU and EMU eventually overlap, this choice should obviously be reversed.

IV. Conclusions

Our proposal for a revision of EMU institutions leaves two issues open:

- Do the elements constituting our scheme need a simultaneous implementation or is it possible to proceed to a “piece-wise” implementation?
- Would the proposed reform require a formal revision of existing treaties?

As regards the first issue, the adoption of fiscal targets obviously requires the contemporaneous design of checks and balances necessary to ensure both credibility and flexibility in their implementation. For what concerns ECB reform, stripping down the NCBs of their national character, albeit highly desirable, may prove too difficult in the short term. In any case, the adoption of an explicit inflation targeting regime coupled with stronger ex-post accountability would be a first necessary step to curb national influences.

As regards the second issue, it is a delicate matter to establish how much of our proposal can be implemented within the framework provided by the existing treaties, perhaps exploiting the procedure of enhanced co-operation. This would be the case for the new arrangements concerning the adoption of fiscal targets.

²⁸ Baldwin, Berglöf, Giavazzi, and Widgrén (2000) suggest that Ecofin be entrusted with the power of setting the inflation target. This proposal closely resembles institutional arrangements in the UK, where the government sets the year-to-year target in the budget law. We disagree with them for two reasons. First, by including non-EMU countries Ecofin cannot be an appropriate political principal for the ECB. Second, this approach leaves room for the manipulation of the target for short-term purposes. In fact, the credibility of their proposal would ultimately rest on the political costs of unexpectedly raising the target. In our proposal, separation of powers supplements the transparency inherent to an inflation targeting regime.

To the contrary, the new clauses regulating budget deficits and the new arrangements proposed for the ECB would certainly require a formal revision of the Maastricht Treaty. In any event, our proposal is meant as a sketch rather than a detailed blueprint for institutional reforms. The investigation of this issue is left for future research.

Summary

Building on widespread criticisms of current EMU institutional arrangements, we sketch a reform proposal for EMU macroeconomic institutions. We advocate the adoption of targets for both monetary and fiscal policies, to be integrated by a system of checks and balances. As for fiscal policy, expenditures, taxation and deficit targets will strengthen the governments commitment and, at the same time, facilitate "well-behaved" stabilisation policies. Turning to monetary policy, inflation targeting, alongside with the assignment of ex-post assessing powers to the Euro12-group and an internal reform of the ECB, will limit undue nationalistic influences within the ECB governing bodies.

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