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Rethinking EMU Institutions

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RETHINKING EMU INSTITUTIONS*

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Abstract

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 European Parliament and an internal reform of the ECB, will limit undue nationalistic influences within the ECB governing bodies.

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1. Introduction

EMU macroeconomic institutions have been widely criticised in the last few months. 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, where the NCBs' Governors would behave as representatives of national interests (Casella 2000a, 2000b; Gruner 1999). Moreover, the ECB stabilisation policy appears weak and incoherent in comparison to the Fed's one, as if its decision-making procedures were not up to the task[1]. Also, the Stability and Growth Pact (henceforth SGP) reputation appears tarnished two years after its adoption. Revisions of the Pact are recurrently suggested[2] and politicians have begun to float their interest for more flexible arrangements despite routine statements of their commitment to the SGP[3]. In this paper, we present a reform proposal for EMU macroeconomic institutions. Our proposal rests on two cornerstones. On one hand, we advocate the generalised adoption of targets, for both monetary and fiscal policies, to be integrated by a system of checks and balances. On the other hand, we suggest that the role and composition of supranational institutions such as the ECB and the European Commission be made consistent with the new policy regime. As for fiscal policy, we propose specific institutional arrangements designed to strengthen the governments commitment and, at the same time, to facilitate "well-behaved" stabilisation policies. In this regard, the key ingredients of our institutional recipe are a stronger role assigned to the European Commission – as supervisor and auditor of national fiscal policies – and a peer review mechanism, necessary to ensure governments accountability at the Union level. The new arrangements 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. Turning to monetary policy, institutional design should strengthen accountability and weaken national influences. To this purpose we propose the adoption of inflation targets, the assignment of ex-post assessing powers to the

[1] As a matter of fact, some observers (Favero, Freixas, Persson and Wyplosz, 2000b) have pointed out that financial markets penalised the ECB's scarce transparency and insufficient communication by requiring a risk premium on Euro denominated assets, with the result of a weakened exchange rate.
[2] See "Il Sole 24 ORE", 21/8/2001 p. 2. The Economist (2001b, p. 13) is even in favour of scrapping the SGP.
[3] See the recent remarks by the German Finance Minister Eichel, (The Economist 2001c, p. 60).

European Parliament and an internal reform of the ECB. The latter should limit undue nationalistic influences within the ECB governing bodies.

Because of its emphasis on check and balances, our proposal stands in contrast to the market solutions advocated by Casella (1999, 2000a, 2000b)[4], as alternative to the "explicit co-ordination required by the collective decision-making procedure …" (Casella 2000a, p. 9). Casella's approach denies the very essence of the European integration process, which relied on co-ordination and agreement among the member states over far more numerous issues than macro-economic policies. Unlike Casella, we do not reject but rather advocate collective decision-making procedures. This makes our proposal consistent with the deepening[5] as well as the enlargement of the Union. Casella's "new" markets will work better in an enlarged EMU, but their adoption can only forestall any deepening of the Union.

The paper is organised as follows. Section 2 briefly reviews the criticisms addressed at European macroeconomic institutions since their coming into force through the signing of the Maastricht and Amsterdam Treaties. Section 3 sketches the approaches to reforming such institutions discussed in the economic literature. Section 4 contains our own reforming proposal. Section 5 concludes.

2. EMU Macroeconomic Institutions: A Critical Assessment

2.1 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 combination of goal independence and national representation can adversely affect EMU monetary policies, and probably lies at the heart of the serious difficulties the Bank met in establishing a reputation *vis-à-vis* the financial markets.

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

[4] Casella suggests the creation of an explicit market for tradable deficit permits, and of an implicit market for voting rights within the ECB Governing Council.
[5] The Treaty of Nice is a first step toward an ever closer Union.

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, releasing information useful to justify ex-post its operations, but of no avail in assessing ex-ante how it intends to achieve its objectives[6]. 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).

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 (Lohaman 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 democratic 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'

[6] This criticism is partly attenuated by the recent decision to publish the forecasts.

votes in the ECB Governing Council may exert a distorting influence[7]. In case of serious cyclical asymmetries across EMU countries, such influence may take place either through prevailing coalitions of national interests or through paralysing conflicts[8]. Both cases would be highly detrimental to the credibility of the ECB as a European institution (Baldwin, Berglöf, Giavazzi, and Widgrén 2000).

The ECB actual conduct of monetary policy seems to confirm the above criticisms. In fact, it appears to be inspired by multiple (implicit) objectives[9]. To some extent, 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 consensus, as the Bank 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 a cyclical divergences affecting member states. To see that, recall the ECB's official position on the divergence of regional inflation rates. The Bank (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). have criticised this claim, arguing that 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, lack of consideration for the interregional differentials in inflation rates is unlikely to be accounted for by the irrelevance of the issue *per se*, but rather – in our view –by the attempt to somehow prevent potential conflicts among members of the Governing Council. In the present institutional set-up, such an attempt may be regarded as second-best policy to preserve the ECB reputation

[7] 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).

[8] 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.

[9] In this regard, the ECB (changing) attitude towards the external value of the currency provides an illuminating example. Over most part of the year 2000, several members of the Governing Council released official declarations characterised by a sort of benign neglect with respect to the Euro depreciation vis-a-vis the Dollar. However, in October 2000 interest rates were officially raised in support of the exchange rate. On that occasion, the ECB gave explanations hinting that the exchange rate was no longer a simple indicator to look at, but rather a policy target in itself.

as a European institution, but is likely to generate inefficiencies in the conduct of monetary policy.

2.2 The Fiscal Institutions

In the words of the European Commission (2000), the SGP is “the concrete expression of the shared need for fiscal discipline”. By adhering to the Pact, EMU members commit themselves to pursuing a balanced budget or a surplus as their medium-term objective, in order to be able to implement countercyclical fiscal policies , without exceeding the deficit ceiling. This commitment translates into the yearly submission of Stability or Convergence Plans to the European Commission and into the implementation of appropriate fiscal policies. Moreover, it is supported by a monitoring and sanctioning activity on the part of the EU, through the actions of the European Commission. The SGP presupposes a link between fiscal discipline, monetary stability and growth. The economic literature identifies different channels through which this relation can work.

1. Excessive deficits and the accumulation of debt occur because governments tend to 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. To the extent that taxation is distortionary, output losses will be incurred. The ECB might therefore be pressured into offsetting output losses by means of an accommodating monetary policy (Artis and Winkler 1998). Beetsma and Uhlig (1999) illustrate the argument within a logically consistent framework, showing that union membership raises governments’ incentives to issue debt. In fact, by acting non-cooperatively each national fiscal authority underestimates the equilibrium debt levels and the ensuing inflationary pressures. As a consequence, fiscal discretion with a monetary union will generate larger debt levels than without a union[10]. To prevent this outcome, Beetsma and Uhlig advocate the adoption of institutional mechanisms that make it costlier to issue public debt.

2. The ECB may be tempted to monetise a country's debt in order to prevent a systemic financial crisis (Eichengreen and Wiplosz 1998). It would be straightforward

[10] This may explain why only EMU members agreed to sign the Pact.

to proof that even in this case the incentive to issue debt increases when a country joins a monetary union and national fiscal policies are set non-cooperatively.

3. If the transmission of fiscal shocks is negative, unco-ordinated national fiscal policies are exceedingly expansionary, inducing the ECB to raise interest rates. This would imply an undesirable policy mix from the standpoint of stabilisation, characterised by high levels of government spending and taxation, high interest rates and an excessive appreciation of the external value of the Euro (Eichengreen and Wyplosz 1998). In a similar vein, Debrun (2000) examines the case where each country uses fiscal policy as an instrument to systematically stimulate aggregate demand, with the only result of higher expected inflation for the monetary union[11]. In this framework, fiscal discipline is achieved by setting deficit ceilings.

As widespread in the economic literature is the consensus on the existence of strong externalities due to fiscal policies, so there is dissatisfaction with the remedies to these externalities proposed in the SGP. The most important criticisms moved to the SGP are the following:

One size fits all. 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. This implies that the ability of many governments to use fiscal policy during the cyclical downturns will be much reduced for a long time. As a result, adherence to the Pact may induce a procyclical fiscal policy during slowdowns (Eichengreen and Wiplosz 1998). After the adoption of the Pact, several studies have tried to identify circumstances under which the SGP might allow the implementation of at least an embryo of a countercyclical fiscal policy, leaving room for the correct functioning of the automatic stabilisers. Since the Pact does not contain precise operational instructions about the medium-term objective of a deficit "close to balance or in surplus", the European Commission has calculated the so-called minimal benchmarks for national medium-term deficits, which are in turn function of structural factors[12], of volatile budgetary components[13], and of the cyclical safety

[11] 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 to underestimate the overall deficit level that will occur in a monetary union.

[12] These include the stock of debt, the generosity of the welfare system, and the progressiveness of the tax system.

margin[14]. Work by the European Commission (Buti and Sapir 1998) shows that the same ceiling requires very different minimal benchmarks across EMU countries[15].

All stick and no carrot. While the Pact penalises the creation of deficits, it does not envisage incentives to the creation of surpluses during economic expansions (Bean 1998), so increasing the risk of inducing a procyclical fiscal policy. It could be argued that the risk of being forced to implement a procyclical policy in the presence of a recession is incentive strong enough to implement a symmetrical fiscal policy. But, were it so, one of the reasons for the adoption of the Pact should not be there! In fact, adverse electoral incentives, often pleaded to foster myopic deficit spending, will induce national governments to systematically underestimate the future consequences of an asymmetric development of fiscal policy[16]. Conversely, some phenomena – like those analysed by Buti and Martinot (2000), in relation to the foreseeable increase in the ratio of retirees over the active population – suggest a worsening of political distortions in the conduct of fiscal policy[17]. Finally, it is possible that the respect of the constraints set by the Pact becomes an objective *in itself*, so inducing governments to choose institutional set-ups that limit the volatility of the debt service rather than the cycle (Missale 2000).

Excessive emphasis upon debt. The SGP focuses on the size of the budget deficits and ignores other elements, such as the distortions caused by excessive taxation when fiscal policy is run under a balanced budget rule[18]. Balanced-budget policies are in fact prone to time-inconsistency and may prove to be beggar-thy-neighbour policies as well. The first effect is described in Beetsma and Bovenberg (1998), whose results crucially

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[13] These components reflect the likelihood of sudden falls in the revenues or increases in the expenses.

[14] The estimated cyclical safety margin is the product of the budgetary sensibility to the cycle and the estimated output gap, which measures the size and frequency of the cyclical fluctuations in each country. As budgetary sensibility to the cycle and economic fluctuations grow, the value of the cyclical safety margin increases.

[15] There are economies that have such a high minimal benchmark that they normally require a budget surplus (this is the case, for example, of Finland and Sweden) or in any case a deficit of less than 1% (Belgium, Denmark, Spain, Ireland, Luxembourg, Portugal, and the United Kingdom).

[16] The ECB has repeatedly expressed its concern over the apparently asymmetric conduct of fiscal policies in the EU. Buti and Martinot (2000) seem to share such a concern.

[17] These authors analyse the effects of an increase in the ratio of retirees over the active population, outlining two extreme scenarios. In the first, it is assumed that pay-as-you-go systems remain unchanged. In the second, the changeover to a system by contribution is considered. In the fist scenario, the Pact inability to induce adequate surpluses would lead to excessive levels of taxation as retired population grows. In the second scenario, the strong penalties for excessive deficits would limit the immediate margins of manoeuvre and the reforming ability of governments.

[18] Nevertheless, it must be recognised that successive interpretations of the Pact provided by the European Commission emphasise excessive fiscal pressure within the Euro area, so implicitly hinting at the importance of the issue.

depend on the sequence of actions involving wage setters, the national fiscal authorities and the ECB. In setting the tax rate, the fiscal authorities anticipate that the ECB monetary policy will accommodate a tax increase in order to reduce output distortions but ignore the adverse effects of monetary policy on inflation expectations. Therefore, the discretionary use of fiscal policy will lead to an excessive tax burden. 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[19]. Therefore, in the absence of co-ordination, tax and public spending levels would systematically be too high.

But how did the SGP perform so far? Since 1999, European fiscal policies have been run for the first time within the SGP, based on Stability and Convergence Plans submitted and discussed between the end of 1998 and the beginning of 1999, in compliance with the Broad Economic Policy Guidelines. Although a number of countries have experienced slower-than-expected growth, in 1999 the announced targets were hit and, in some cases, exceeded (European Commission 2000). The Euro area on the whole reached a 1.2% deficit, 0.8 percentage points less than in 1998, while in 1999 the overall deficit reached 0.7% of GDP, 0.5% lower than in 1999 (European Commission, 2001). Budget balances should deteriorate in 2001 – for the first time since the beginning of the process of fiscal consolidation in 1993. According to the estimates of the European Commission (2001), an overall deficit of 0.8% of GDP should materialise, due to some reduction in the tax burden and the postponement of expenditure reforms. Moreover, the lower than expected growth is likely to worsen this forecast.

Unfortunately, this picture is incomplete: it ignores the evolution of the primary structural budget balance, which represents the proper indicator of the fiscal policy stance; it fails to consider in detail the performance of single countries; it overlooks the issue of the policy mix prevailing in the Euro area.

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[19] 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 appear in the presence of positive transmission, given fiscal authorities acting as Stackelberg leaders vis-à-vis the ECB, and the latter being able to control the inflation rate.

As for structural budget balances (European Commission 2000, 2001) in 1999 many countries used fiscal policy in a contractionary fashion, notwithstanding negative output gaps, in the presence of a monetary expansion smaller than that prevailing on average within EMU (this is the case of France, Germany and The Netherlands). A country like Ireland used instead an expansionary fiscal policy, despite a positive output gap and a monetary expansion greater than the average within EMU[20]. By contrast, in the year 2000, the primary structural balance did not change at all, while it is expected to worsen during 2001 by 0.4% of GDP. Moreover, the large economies (Germany, France and Italy) still have relevant, cyclically adjusted, government deficits (close or above 1.0% of GDP), making – as stressed by the European Commission (2001) – the consolidation effort necessary in spite of the current economic downturn[21].

Thus, fiscal policy has been for most of recent times largely procyclical. This is especially dangerous, not only for those countries that are not yet “close to balance”, but also for those countries like Ireland that – although able to produce a surplus providing a wide safety margin against the risk of exceeding the limit of 3% – are in danger of overheating their economy, with negative effects upon the average inflation within EMU (Ecofin 2001).

Moreover, a detailed examination (European Commission 2000) of the Stability and Convergence Plans confirms that countries set objectives on the basis of very cautious growth forecasts. The underestimation of actual growth rates makes the assessment of the Plans more difficult, undermining their credibility and making the budgetary targets less stringent. The European Commission (2000) remarks also that quite often the measures taken or planned within the Plan are not successfully explained, so preventing an effective process of peer review within Ecofin.

3. Alternative Approaches to Reforming EMU Macroeconomic Institutions

In the Common Market of the early 90's, national monetary policies imposed significant externalities on the partner countries (Dornbusch, Giavazzi and Favero 1998). This problem was solved by centralising monetary policy through the creation of the ECB.

[20] Among the countries with a positive output gap, only Finland conducted a contractionary fiscal policy, trying to compensate the stimuli coming from the monetary sector.

[21] The consolidation effort is unavoidable, to reach the “close to balance or in surplus” condition consistent with a fast reduction of public debt below the 60% of GDP and with unforeseen budgetary variability.

However, the inception of EMU has paved the way to new externalities, due to the national conduct of fiscal policy in the presence of a single currency. Instead of explicit policy co-ordination, to deal with such externalities the EU member states rely upon constraints to the use of fiscal policy instruments. This choice is questionable, as it addresses only some of the externalities, and limits flexibility in the use of fiscal stabilisation policies. In the economic literature, the search for different and more satisfactory institutional arrangements has proceeded along two alternative directions.

3.1 Exploiting market mechanisms to remove externalities

Casella (1999; 2000a; 2000b) argues that it is possible to create a market for some – if not all – the externalities affecting fiscal policies in a monetary union. The simplest implementation of this idea provides a potential alternative to deficit ceilings. In analogy with some recent developments in the field of environmental protection, Casella advocates the creation of a market for tradable deficit permits[22], alongside with a system of sanctions for those countries which hold fewer permits than deficit units at the closing of the market. This arrangement allows to equalise across countries the marginal benefit of deficits, without exceeding a pre-set ceiling on the Union deficit. Moreover, the system does not present problems of credibility as the price of permits would collapse if sanctions were not imposed, damaging all countries owning permits.

Casella (2000a) argues that even the ECB decision-making rule within the Governing Council might rely on similar mechanisms. Consider a typical decision, either to modify the interest rate or to leave it unchanged. It is possible to take such a decision by asking the representatives of each country to announce the amount they would be willing to transfer to the Union to change the interest rate. If the sum of the declared amounts is non-negative, the proposal is implemented and each country pays a contribution equal to what declared; otherwise, the *status quo* is maintained. Casella shows that by imposing very weak restrictions on truth telling, the mechanism delivers only efficient outcomes[23].

[22] However, Casella is vague about who may modify the overall supply of permits and how.

[23] To the criticism that countries subject to liquidity constraints would be damaged by the adoption of this scheme, Casella (2000a) replies that money transfers might be replaced by a system of storable votes to endow each country with. A proposal is approved if it obtains a majority of votes (and not of voters). Thus, a country expresses the intensity of its own preference through the number of votes it casts.

Although the use of market mechanisms for the conduct of economic policy in Europe appears innovative and interesting, it is highly questionable that efficient markets may be set up for the externalities and the public goods in question. As for the deficit permits market, the overall supply of permits should increase (fall) during recessions (expansions) in the whole Euro area, to allow the prices of the permits themselves to fall (rise). But if supply fluctuates, speculative phenomena may emerge (Søresen 1999). Moreover, the market for permits is bound to have a small number of operators and thus the risk of collusive behaviour by participants is very high (Pagano 1999). As regards the conduct of monetary policy, Casella's approach grants constitutional legitimacy to the NCBs Governors as champions of national interests. Were the number of voting members in the Governing Council large, the equilibrium outcome might be expected to reflect Union-wide preferences. Unfortunately, the number of participants will be small, even in an enlarged Union. Therefore strategic use of voting rights may favour – via coalition formation – a nationalistic bias in monetary policy, strengthening those undesirable effects it is designed to correct and increasing inefficiency with respect to the status quo.

Moreover, the approach proposed by Casella (1999, 2000a, 2000b) rests on the presumption that the gains of a single currency can be obtained without recourse to the "explicit co-ordination required by the collective decision-making procedure …" (Casella 2000a, p. 9).This denies the very essence of both the history of European integration and of the current intergovernmental relationships within the Union. In fact advancements in the European integration process have been obtained through continuous bargaining and search for agreement over a set of issues far wider than macro-economic policies.

3.2 Explicit co-ordination

Explicit fiscal policy co-ordination is a standard alternative to the SGP. Such co-ordination would take the form of a supra-national agency responsible for the definition of the Union fiscal policy. No doubts, such a proposal allows tackling some externalities associated with the conduct of fiscal policy in a monetary union better than the SGP[24].

Nevertheless, there are externalities linked to the conduct of the national fiscal policies in a monetary union that are worsened by fiscal co-ordination. For instance, in the

Beetsma and Bovenberg (1998) contribution discussed above, co-ordination is not desirable as it worsens time inconsistency. To solve this problem, Catenaro and Tirelli (2000) argue that the Walsh-Svensson contractualist approach to Central Bank policy should be extended to the fiscal domain. They show that public spending targets would bring about the benefits from policy co-ordination, and yet free fiscal policy from the expansionary bias outlined in Beetsma and Bovenberg (1998). Our proposal draws inspiration from this approach.

4. A Proposal

Before proceeding to a detailed discussion, let us recall that our proposal is based upon two cornerstones. On the one hand, we advocate the generalised adoption of targets, to be integrated by a system of checks and balances, necessary to preserve the *accountability* principle. On the other hand, we suggest that the role and composition of supranational institutions such as the ECB and the European Commission be made consistent with the new policy regime. For a matter of clarity, we present our proposal as a reform plan for the ECB and for the adoption of new measures to ensure fiscal discipline. The reform plan for the ECB aims at improving the conduct of monetary policy but it is also made necessary by the redesign of fiscal institutions.

Finally, a word of caution: a fully detailed reform proposal is beyond the scope of this paper. Our present aim is simply to identify the criteria that should guide institutional reforms in EMU and suggest some applications, albeit sketchy, of the latter.

4.1 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 Bank 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.

[24] This would be the case for the beggar-thy-neighbour policies discussed in Levine and Pearlman (1998)

New Jurisdictions for the NCBs. To simplify decision-making within an enlarged EMU and to prevent the over-representation of specific economic 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[25]. 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 them[26], limiting the risk of a structural polarisation of the votes within the Governing Council.

A new appointment mechanism for selecting NCBs Governors. Such procedure should be stripped down of any "nationalistic" nature and standardised across EMU countries, privileging competence over political characterisation. As it will become clear in the following, we envisage a new role for the NCBs Governors in the Governing Council, for which political characterisation should be kept at a minimum.

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[27]. 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[28]. Moreover, assigning monetary policy to a body whose members are 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

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and for countercyclical policies.

[25] 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. We comment on both these proposals later in the paper.

[26] 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.

[27] 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.

shifting political 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.

A staggering of appointments. At present, Executive Board members are assigned staggered, even if non-renewable, terms. Instead, a NCBs Governor' term of office has a minimum length of five years and it 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[29]. 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 NCBs Governors.

An agenda setter role for the ECB chairman. This would define his "political" leadership during the meetings of the Governing Council.

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[30]. This leaves ample room for influence activities by NCBs. On the contrary, to prevent such undue influences from regional banks, the FOMC receive information processed only by the staff of the Board of Governors (Cecchetti 2001). One might argue that, as long as NCBs can provided better or cheaper information than the ECB staff, there is a cost in curbing national 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 Bank. Following Svensson's (1997) version of the contractualist approach developed in Walsh (1995) and Persson and Tabellini (1993), we advocate the adoption of explicit inflation targets. Given the relative weakness of the ECB political principals, this should strengthen ex-post control and anchor monetary policy to EMU-wide objectives, helping to sterilise undue national influences. The practical implementation of inflation targeting requires

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

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

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

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? *iii*) Should the ECB pursue one or more objectives? Following Tabellini (1999) and Baldwin, Berglöf, Giavazzi, and Widgrén (2000)**,** the European Parliament should be charged with the power of assessing the consistency between: *i)* announced policies and the ECB constitutional mandate *ii)* announced policies and their actual implementation. By contrast, the sequence of inflation targets and the associated output growth forecasts should be left to the ECB. As for the definition of multiple objectives, the short-term trade-off between inflation and output-gap dynamics would be implicit in the Bank policy announcements and forecasts. The pursuit of financial stability, alongside with price stability, characterise many Central Banks[31]. By statute, the ECB is supposed just to co-ordinate the banking policies of the NCBs. Both scholars and laymen have pointed out that the centralisation of banking policies would instead be desirable (Begg, De Grauwe, Giavazzi, Uhlig, and Wyplosz 1999; Lossani, Natale and Tirelli 1999). Absent a strong political principle, the issue has been settled in Frankfurt. Not surprisingly, the NCBs Governors opted to retain their powers. These events testify that the ECB *de facto* pursues multiple objectives, which are only implicitly mentioned in its Statute. In our view, the identification and ranking of policy objectives should unambiguously rests in the hands of the political principle.

Finally, conflicts may arise between the ECB and its political principal. This requires the adoption of some sanctioning procedure. The latter may take the form of public and motivated censorship of the Bank policies or (possibly) the imposition of fines on the Bank.

4.2 Reshaping national fiscal policies

The principles inspiring our proposal may be condensed in the following propositions.

Proposition 1**:** Decentralised and fully discretionary fiscal policies are undesirable, due to adverse "political" incentives, to the missing internalisation of unfavourable effects on expectations, and to spillovers affecting the economies of other member states.

[31] It is enough to mention the discrete but determined intervention of the Fed during the LTCM crisis.

Proposition 2**:** Fully discretionary and co-ordinated fiscal policies would worsen the time inconsistency of fiscal policy, strengthening the public expenditure bias. On the other hand, co-ordination of countercyclical fiscal policies is always desirable, provided that appropriate institutional design removes the expenditure bias.

Proposition 3**:** The SGP is an effective barrier to unsustainable public debt, so limiting possible inflationary pressures on the ECB. However, the Pact imposes restrictions on discretionary fiscal policies that are excessive and insufficient at the same time. On the one hand, fiscal responses to serious downturns might be too weak and be implemented too late. On the other hand, incentives to implement symmetric policies are at best feeble. The Pact places excessive emphasis on the need for limiting public debt, and completely neglects the choice of taxes and expenditures. In this regard, the first two years of implementation of the Pact are instructive. Governments have maintained deficits well below the threshold of 3%, countercyclical stimuli have been weak and clearly asymmetrical. The peer review mechanism may have had an important role in limiting upward revisions of the deficits, but has failed to induce symmetric policies. On the bright side, Ecofin has emerged as the potential catalyst of fiscal policy co-ordination, and the European Commission has played a stimulating role for the governments, despite the evident inadequacy of effective powers.

Proposition 4**:** The widespread endorsement of fiscal policy targets, adequately supported by a system of checks and balances, is more effective and efficient than the SGP. As argued below, the flexible implementation of targets combines a more effective control on the alleged expansionary bias of national fiscal stances with the use of countercyclical policies. The obvious challenge is how design those checks and balances to achieve a desirable combination of rigour and flexibility.

Our proposal is organised as follows:

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 among them and across countries. Such targets are a necessary requisite for policies precommitment, since they are used to ex-post assess the actual behaviour of the national governments.

i. *Budget deficit targets*: The sequence of announced budget balances will have to be consistent with the SGP objectives, i.e. the pursuit of "close to balance or in surplus" budgets over the medium run.

ii. *Spending and taxation targets*: The emphasis on countercyclical balanced-budget policies should not come as a surprise, since incentives to exploit the re-modulation of taxes and expenditures are likely to increase in consequence of deficit ceilings.

It must be noticed that we are simply recommending a stronger and more consistent use of an instrument that is already available to the Union. In fact member states define their spending, taxation and deficit targets in the Broad Economic Policy Guidelines, but such announcements are not binding constraints[32].

Targets harmonisation. Macro-economic efficiency may be attained only if each country internalises the consequences of its own choices on EMU conditions. For example, the non-cooperative setting of taxation targets might generate excessive inflationary pressures[33]. We identify Eurogroup (and not Ecofin) as the institution deputed to harmonise national fiscal stances. In fact, Ecofin members who are not in the Union would face substantially different incentives from Union members[34]. In our view, Eurogroup should also be concerned with the macroeconomic consequences of the foreseeable structural reforms of the welfare state. It is well known that structural reforms are bound to affect the macroeconomic policy stance and typically require a prolonged adjustment period. Such effects cannot be ignored, because of the existence of externalities on the economies of other countries[35].

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[32] The European Commission (2001) 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 Stability programs must be improved and standardised across countries; *iii*) the Stability and Convergence Programs must be submitted to the competent authorities in autumn of each year. The degree of transparency and consistency and co-ordination as well of fiscal policies should increase as a consequence.

[33] This conclusion can be intuitively demonstrated, by comparing the behaviour of a country maintaining monetary sovereignty with that of a member state of the Union. The first, in selecting the taxation target, will take into account the impact of a distorting taxation on output losses, and therefore on the consequent inflationary pressures. The second, on the contrary, 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.

[34] On the other hand, Ecofin might take on a co-ordination function between *ins* and some *pre-ins*.

[35] The Irish transition to a low-tax regime is a good case in point.

Checks and balances to ensure credibility. 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 typically 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. Our proposal takes in part this view, but is mainly based on the definition of checks and balances among different institutional levels, whereby governments are induced to internalise the consequences of their own choices. *First*, targets credibility requires that governments be made *accountable* at the Union level. *Second*, there must be absolute transparency over the management of fiscal policies. *Third*, it is necessary to minimise the possibility that "political" conflicts be disguised as "technical" controversies over the consequences of governments' actions. Therefore, we suggest that the European Commission should be appointed as supervisor and auditor of national fiscal policies, by taking and extending Article 99 (Par. 3) of the Maastricht Treaty. Such appointment implies: *i)* assessment of the accounting procedures; *ii)* public notification of impending or expected deviations from announced targets[36]; *iii)* assessment of the Union-wide effects originating from such deviations. The country under scrutiny may request that observed deviations from targets be declared admissible. Such request will have to identify the underlying causes and the consequent macro-economic impact. Moreover, it will have to spell out the consistency with the announced medium-term objectives.

Peer review. To induce each country to internalise the effects of its own choices, the Eurogroup will then be called upon to express a binding opinion about (proposed) deviations from announced targets. Should a country disregard the Eurogroup opinion, it would be subjected to monetary sanctions of the kind defined in the SGP. In contrast with the current arrangement (Artis and Winkler 1998; Casella 1999), the implementation of the latter should be devoid of any discretion. Since each decision is likely to have significant and asymmetric effects on the welfare of each member country, hegemonic coalitions might bias Eurogroup decisions in favour of specific national interests. It is therefore important to regulate the Eurogroup discretionary

[36] The emphasis on expected deviations from targets is required to favour a prompt correction or a possible revision of the targets. At present, the European Commission warns countries of expected deviations from their deficit target. We extend the Commission's intervention to all other targets.

power. The European Commission – whose objective function should reflect the interests of the Union as such – should be appointed as agenda setter for the Eurogroup meetings. Moreover, 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. Finally, any decision should be based on publicly disclosed motivations concerning the Union-wide effects of national policies and should take into account the ECB[37] opinion about the inflationary consequences of fiscal policies.

Specific provisions concerning deviations from deficit targets. The crux of the matter obviously is represented by requests to exceed the 3% ceiling. Our proposal contemplates an important distinction. A country (a group of countries) should be allowed to exceed the 3% ceiling if the remaining Eurogroup members agree to implement policies such that the Union-wide deficit does not exceed the 3% ceiling. As for decisions entailing a breach of the 3% deficit at the Union level, the ECB's approval would automatically become binding. To ensure transparency, the ECB would be required to publicly motivate its view with reference to the impact on price stability and to the overall macroeconomic conditions of the Euro area. As shown in Onorante (2001) this simple provision would entirely remove the spending bias and leave enough flexibility in the hands of EMU policymakers. Critics might object that in bad times this would favour undue political pressures on the Bank, weakening its position. Bearing in mind that the enforcement of the SGP ultimately rests in the sole hands of national governments, a viable alternative might be to require that Eurogroup and the Bank issue a public statement arguing the case for their preferred policy stances, leaving the final decision in the hands of Eurogroup, possibly requiring a qualified majority. This would clearly reduce political pressures on the Bank, but would effectively restrain national fiscal policies only to the extent that transparency sufficiently raises the costs of running time-inconsistent fiscal policies.

Summing up. The appointment of Eurogroup as "clearing house" for the instances submitted by national governments should induce countries to internalise the external effects of their own policies. On the other hand, co-ordinated discretionary fiscal policies may have adverse effects on monetary policy. To avoid this, we constrain any

[37] This clause extends the accountability mechanism and favours co-ordination between monetary and

decision in this regard to take the form of a publicly motivated deviation from announced targets, subject to the public scrutiny of independent bodies such as the European Commission and the ECB. This introduces a reputational factor that binds governments actions. In comparison with the SGP, our proposal is more flexible and more restrictive at the same time. We advocate tighter constraints on some variables not regulated by the SGP, but allow for greater flexibility in the use of deficit ceilings. The latter point deserves some comment. On one hand, the possibility of exceeding the ceiling is desirable under adverse economic conditions for the whole area; on the other hand, discretionary use of debt should not generate excessive inflationary pressures. We have outlined two alternatives for solving the potential conflicts between the Eurogroup and the ECB: Both limit the Eurogroup discretionary power and assign an important role to the ECB[38]. Bearing in mind that even a "conservative" Central Bank may deem useful a relaxation of the fiscal stance under unfavourable economic conditions, our proposal is more flexible than the SGP.

5. Conclusions

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

- Do the elements constituting our proposal 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?
- Is co-ordination between fiscal and monetary policies desirable?

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. Tighter discipline on public expenditures is not to be understood as “compensatory” for less rigour in the enactment of the budgetary rules. However, we see no obstacles to introduce the suggested changes to the SGP once the new regime of targets is in place. In this regard, a notable exception concerns the possibility of exceeding the 3% ceiling for the whole area. For what concerns ECB reform, stripping down the NCBs of their national character, albeit highly desirable,

fiscal policy.

[38] One might argue that this would expose the ECB to unsustainable political pressures. If this were the case, the whole EMU architecture would lack credibility because such influences could be used to affect ECB decisions at any time.

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[39].

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 and the stronger role for the Commission[40]. To the contrary, the new clauses regulating budget deficits would certainly require a formal revision of the SGP. 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.

As for the third issue, some recent studies (Lambertini and Dixit 2000; Buti, Roeger, and in't Veld 2001) have shown that co-ordination between the fiscal and monetary authorities is desirable, provided that they have no conflicting objectives about output and/or inflation. Vice versa, in the presence of such conflicts, the adoption of explicit co-ordination procedures would be inevitably doomed to undermine the ECB's independence, with counterproductive results. Alesina, Blanchard, Galì, Giavazzi, and Uhlig (2001) argue that political incentives would generate inevitable conflicts with the ECB about the output bliss points. These authors therefore advocate the adoption of simple behaviour rules as a surrogate for co-ordination. On the one hand, the Central Bank should pursue its own inflation target; on the other, the fiscal authorities should maintain a balanced budget. We propose a reorganisation of national fiscal policies which is more ambitious and far reaching. In our set-up, the scope for conflicts between the fiscal authorities and the Bank is greatly reduced as the adoption of fiscal targets, increasing transparency of both monetary and fiscal policies, will effectively prevent excessive spending. As a consequence, co-ordination of stabilisation policies will emerge spontaneously.

[39] Still, national interests might unduly affect the ECB choice of targets. To avoid this, the ECB should also be made accountable for the consistency between announced policies and the institutional mandate.

[40] It goes without saying that the procedure of enhanced co-operation should include all the main economies in the Union.

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