Mr. Issing discusses the European Central Bank as a new institution and the problem of accountability Paper delivered by Prof. Otmar Issing, a member of the Directorate of the Deutsche Bundesbank, at the Symposium on "Challenges for Highly Developed Countries in the Global Economy" in Kiel on 20/3/98.

Preliminary remarks

European monetary union is an important milestone on the road to Europe. The long and winding road of European integration is accurately described by **Siebert and Koop** (1993, p. 1)[1] as follows:

"The road Western Europe took from the end of World War II to its current state has been one with lots of steep and sometimes blind curves, with harsh speed limits and frequent detours. But still it has been one that attracted more and more traffic."

Siebert and Koop interpret the competition among governments in a fashion similar to Tiebout (1956)[2], as a market for institutional arrangements. In institutional competition, the national governments strive to find ever better institutional arrangements in order to keep mobile factors at home or to attract them.

With the establishment of the European Central Bank (ECB), competition among the participating countries to have the "best central bank constitution" will be over; the introduction of the euro will eliminate competition to see which one has the "best currency". The political decision in favour of this radical institutional change was taken when the Maastricht Treaty was ratified. As is shown not least by the debate on the ECB's accountability which has just begun, the new institution will not find it easy to hold its own in a critical environment.

I. The Bundesbank model

Exactly fifty years ago, on March 1, 1948, the *Bank Deutscher Länder* was created as a central banking system for post-war western Germany - to be succeeded in 1957 by the Deutsche Bundesbank. No one could possibly have had an inkling at the time what a success story this institution would become. The D-Mark has become one of the most stable currencies in the world and, to that extent, the Bundesbank has set a standard for monetary policy.

It thus seemed fitting to investigate the reasons for this success. Time and again, it has been shown to be the case that the stability of the D-Mark is founded on two factors: first, the statute of the central bank, and second, the Germans' especially marked aversion to inflation, considering that the currency had been destroyed twice within a generation.

1 Siebert, H. and M.J. Koop (1993): *Institutional Competition versus Centralization: Quo Vadis Europe?*, Kiel Institute of World Economics, Working Paper No. 548 .

2 Tiebout, C.M. (1956): „A Pure Theory of Local Expenditures", *Journal of Political Economy,* Vol 64, pp. 416-24.

Independence

For a long time, this marriage of statute and public support was perceived to be a typically German, and thus specific, phenomenon, no importance being attached to it as an example for others to follow. This assessment only changed significantly in the wake of the worldwide acceleration of inflation during the 1970s. Soon, whole libraries were full of studies on the causes and effects of inflation and how to combat it. Finally, interest also became focused on the institutional background of monetary developments. The degree of central bank independence was soon found to be a key variable for real-life monetary policy action.

The findings of a wealth of studies boil down to the following two generalities (for an overview, see Eijffinger and de Haan, 1996):

- The higher the degree of central bank independence, the lower the rate of inflation generally is.

- The higher degree of price stability does not necessarily have to be bought at the price of losses in economic growth or major fluctuations in output.

For a long time, institutional questions were quite generally neglected. It has now become evident that institutions do matter - not least in the area of monetary policy, too. In a standard volume on this subject, the author tersely states: "*Institutions such as the legal framework within which policy operates are important determinants of policy outcomes. In particular the independence of central banks from their respective political authorities can influence the degree of policy activism and the distribution of inflation.*" (Cukierman, 1992, p. 5.)

That realisation was already common knowledge in Germany. However, in an international context, central bank independence was for a long time neither widespread in practice nor popular among economists - i.e., if they were interested in the subject in the first place. There was thus a fundamental change in the second half of the 1980s. When preliminary work on the establishment of European Monetary Union (EMU) started, the intellectual environment for an appropriate solution had already been prepared. Very soon thereafter, attention came to be focused on the Statute of the European Central Bank. Lest we forget, when the Conference of Maastricht took place in December 1991, the national central banks of most of the signatory countries were institutions that were more or less dependent on their governments. Bearing that in mind, the decision in favour of the European System of Central Banks (ESCB) and the European Central Bank (ECB) is all the more remarkable.

II. The new institution

Mistrust of the currency is inevitably reflected in corresponding risk premiums in the interest rate, and thus costs a country dearly. The Statute assumes particular significance precisely in the case of a new currency and a new central bank - it is an important signal of what monetary policy and what money the public can expect. "*Institutions reduce uncertainty by constraining human action. Thereby, they enable economic actors to form expectations about the actions of others.*" (Streit et al., 1997, p. 688.)

Will the Statute of the European Central Bank meet these requirements? Is it suited to creating credibility for the institution even before its start?

Credibility

Credibility and reputation have been developed out of a neo-classical concept of monetary policy-making, based on the natural rate of unemployment and rational expectations (Spahn, 1997, p. 235). Barro and Gordon (1983) argued that central banks are likely to suffer from a credibility problem. This credibility problem stems from the assumed goal of increasing employment above its natural rate by means of inflationary surprises. Rational private agents anticipate this outcome and react by increasing the expected rate of inflation. The result is an inflationary bias without any effect on employment.

However, in a multi-period setting, precommitment of monetary policy to adhere to price stability may be possible. If the public is decidedly averse to inflation, it would be difficult to break inflationary expectations after a surprise inflation had been triggered deliberately. This would make the subsequent process of disinflation more costly and thereby effectively discourage monetary policy-makers from using the means of “surprise inflation” in the first place.

Inspired by Rogoff (1985), some have suggested that credibility problems of optimal monetary policy could be mitigated by delegating monetary policy to an independent central bank. The role of the government is then to determine the institutional framework of monetary policy-making with the central bank actually implementing the policy. However, Jensen (1997) has raised the question of why delegating monetary policy should be more credible than implementing optimal monetary policy itself. He has shown that delegation improves sub-optimal outcomes, but only to the extent that there are important costs of “reappointment”. With reappointment costs of delegation the inflation bias is reduced, but not completely eliminated.

The central bank gains credibility if an announced action coincides with the expectation of market agents about this action, i.e. if the targeted money growth rate equals the expected growth rate. Reputation is more similar to a capital good, growing slowly by means of a series of credible actions and eroding quickly if the central bank attempts to deceive the public (Cukierman, 1992, p. 205 ff.).

As a general principle, credibility facilitates interpersonal relationships. Credibility is capable of substantially reducing transaction costs. Experience shows that those central banks which have a successful track record of stability are most likely to enjoy credibility. Very broadly, such a successful track record is characterised over the long term by low inflation with very little fluctuation. Positions supported by the Bundesbank for a long time are now widely accepted among policy makers and in the literature: *“... deliberate attempts to exploit any short-run trade-offs between output and prices are likely to result in a permanently higher and more variable rate of inflation, with significant adverse consequences for resource allocation, long-run output and productivity growth.”* (Lamfalussy, 1997, p. 12.)

When prices rise, the crucial factor is the underlying cause. A fundamental consideration in building up and defending an anti-inflationary track record is that the central bank should never resort to the instrument of unanticipated inflation. If the public feels duped by the central bank, that central bank forfeits its credibility for many years to come. If, on the other hand, prices rise for exogenous reasons, the subsequent anti-inflationary policy course can actually enhance the central bank’s reputation. The phase following German reunification is a case in point.

Obviously, the new ECB will have no established track record to inspire confidence. To what extent the accumulated credibility of national central banks which will make up the European System of Central Banks from the beginning of Stage Three can be transferred to the new institution is an open question. *"Reputation has its roots in decisive and goal-oriented action; it is bound to an institution and cannot be simply bequeathed."* (SVR, 1997, p. 353, translation.) One must therefore resort to theoretical insights and empirical lessons in seeking to predict the level of credibility that will be enjoyed by the ECB. The main criteria for making this prediction are the ECB's Statute, leading personalities and strategy.

<u>The Statute</u>

Article 105 of the Maastricht Treaty gives the European System of Central Banks a clear mandate: "The primary objective of the ESCB shall be to maintain price stability." Its support for the general economic policies in the Community must be without prejudice to the objective of price stability. Article 107 guarantees the decision-making bodies independence in making their decisions. The members of the Executive Board are to be appointed for eight years, and that term of office shall not be renewable (Article 109a). By contrast, the governors of the national central banks, who are to be appointed for at least five years, may be reappointed (Article 14, Protocol on the Statute of the ESCB and the ECB).

Relatively long terms of office and the fact that the term of office is not renewable are integral parts of a central bank statute based on the independence of the persons appointed. Academic study and research have dealt extensively with this issue and emphasised the significance of the independence of the appointees. Seen from that viewpoint, the eight-year term of office for the Members of the Directorate would tend to be at the lower end of the scale. For the same reason, the member states should make use of the possibility of making appointments for longer than five years. (For an analysis of the length of terms of office, see Waller and Walsh, 1996.)

I think it goes without saying that an independent central bank is not free to choose its own objectives. But the mandate of price stability has to be defined more precisely; an initial consensus has already been reached. *"While theory does not provide a precise definition of price stability and while measurement problems exist, there has been a broad consensus among central banks for several years that a range of 0%-2% inflation per annum would be appropriate."* (EMI, 1997, p. 12.)

To this extent, therefore, the theoretical insights and empirical lessons are adequately reflected in the Statute. Does that mean that the credibility problem has automatically been solved? Many politicians - but also quite a few economists - think so. In Germany, for instance, commentators incessantly point out that the ECB Statute, especially as regards its constitutional status, is even more rigorous than the Bundesbank Act. They conclude that the euro will be as stable - a frequently heard phrase is "at least as stable" - as the Deutsche Mark.

Nevertheless, hardly anyone will expect that the ECB will be able or even want to keep the inflation rate below 2% perpetually and under all circumstances. Additional efforts will therefore be needed to establish credibility convincingly from the outset. This is all the more necessary as, given the high unemployment in most European countries, pressure will be exerted on the ECB right from the start to tone down the priority of price stability in favour of boosting employment. This is the tenor of demands for making a relevant amendment to the Statute.

Incidentally, the provision giving the power to make exchange rate arrangements is likewise a potential source of vulnerability. Pursuant to Article 109, the EC Council may, subject to certain preconditions, conclude formal agreements on an exchange rate system in relation to non-Community currencies. Subject to similar conditions, the Council may formulate 'general orientations' for exchange rate policy in relation to non-Community currencies.

This certainly opens up the risk that the ECB might have to take measures which could endanger its own objectives. However, action by the Council to enter into formal agreements would require unanimity and would have to be based on a recommendation of the ECB or the Commission, in the latter case after consultation with the ECB “in an endeavour to reach a consensus consistent with the objective of price stability.” Moreover, the ECB will not be obliged to follow any ‘general orientations’ which it judges inconsistent with achieving price stability.

A formal exchange rate agreement already agreed upon within the European Union is “ERM II”. Most EU countries outside the euro area participating in the new exchange rate mechanism (ERM) will have central rates for their currencies expressed in euro with 15% fluctuation margins on either side. The ECB will be able to suspend its intervention and financing obligations if it believes that this runs counter to its monetary policy. Moreover, the ECB will have the right to initiate proceedings regarding currency realignments.

Personalities

The ECB Statute does not seek to establish a currency standard excluding all and any scope for discretionary action. Consequently, the personalities responsible for formulating and implementing monetary policy will play a role. That applies especially to an institution which is completely new.

In his survey of the history of the Bank of England, the US Federal Reserve System and the Reserve Bank of New Zealand, F. Capie (1997, p. 47) recently concluded *“ ... that whatever was on the statute book personalities almost always had a powerful part to play in practice.”*

Up to now, academic study and research have failed to come up with a convincing proposal for a “foolproof” institutional arrangement. All standards used in practice so far (e.g. the gold standard) have run up against criticism, as have approaches which have not left the drawing board (for example, an index currency, or a commodity-reserve-currency). Therefore, for good reasons, this path was not embarked on for EMU.

If no standard is established which precludes all scope for action, then the persons who act also matter. An effective institutional arrangement and appointing the right persons are thus complementary pillars of a functional monetary system. “*It is not just the case that the design of institutions necessitates major personnel decisions: the functioning of even the best institutions ... always depends to a considerable degree on the persons working within the framework of those institutions. Institutions are like fortresses; they must be well-planned and well-manned.”* (Popper, 1957, p. 177; translation.)

Public controversies about the filling of top posts damage credibility. For the forseeable future, there will be no political union in Europe to bolster monetary union. The leading personalities will therefore be associated almost inevitably with their respective nation-states, yet in the end they have to carry out a common policy, namely a single European monetary policy, and to stand up to political pressure. The same applies, incidentally, to the Governors of the national central banks. Misgivings are therefore called for if, for example, there are intentions to introduce accountability to national parliaments.

Strategy

For the ECB, as a new institution, it is imperative to enter into a precommitment to the general public, to which its policy is bound and which makes it accountable. The preparatory work undertaken by the EMI has reduced the number of possible options to just two strategies: monetary targeting and inflation targeting. The EMI has thus, for convincing reasons, ruled out exchange rate targeting as a nominal anchor for monetary policy in the euro area.

A monetary target emphasises the central bank's responsibility for monetary conditions and demarcates its responsibility vis-à-vis other policy areas and exogenous shocks. Monetary targeting informs the public about the central bank's fundamental orientation and can thus help to stabilise inflation expectations. By adopting such a precommitment, the ECB would expose itself to strict discipline; it will have to justify any deviations from the target path to the public. "*A monetary target would also provide the ECB with the advantage of continuity with the framework used by the dominant central bank of the ERM, the Bundesbank, and it might thereby facilitate the transfer of credibility.*" (IMF, 1997, p. 54.)

Empirical studies so far indicate that the money demand in the euro area should be sufficiently stable for a strategy of monetary targeting (and more stable than in the individual countries). There is thus a good chance that, from a "technical point of view", monetary targeting might fulfil the prerequisites. "*Until the opposite is proved, the European Central Bank should assume that there are sufficiently stable underlying monetary relationships in the single currency economic area and that unexpected instabilities can be brought under control.*" (SVR, 1997, p. 356; translation.)

On the other hand, we should remember that the initial phase of monetary union, in particular, will be burdened by a number of imponderables. These could clearly have an impact on the growth of the money stock. It is thus advisable to supplement the strategy of monetary targeting pragmatically (but not arbitrarily) by including some elements of direct inflation targeting. The multitude of additional information could be compressed in this sense into a formal inflation forecast.

Another issue regarding the prospects for successful operation of a common monetary policy in EMU is the extent to which there will be differences among countries in the transmission mechanism. For example, there are differences in the use of floating-interest-rate instruments versus fixed-rate debt instruments, in the importance of bank lending relative to other form of financing, and in the households' financing of housing investments. Such differences are likely to add to the challenges facing the ECB in its early years.

Accountability

Greater central bank independence in many countries has also led to heightened interest in the accountability of a central bank. In a democracy, the independence of an executive organ cannot be viewed in isolation from its mandate. The independence of a central bank is not an end in itself but only a means of achieving an objective set by the legislature. The associated purpose-oriented transfer of responsibility implies that the central bank is to be held accountable for its decisions. In particular, it has to disclose and justify the progress it has made in attaining its final goal, its monetary policy strategy, and its ongoing monetary policy measures. This is designed to ensure that the central bank carries out its prescribed tasks as well as possible and does not, for instance, pursue its own agenda.

For the ECB, as a new institution, a suitably designed commitment to hold itself accountable is crucial in order to quickly establish credibility. It is in the situation of having to acquire credibility before being able to establish a track record of policy results over a period of some years. It is therefore in the ECB's own best interests to convey, in a clear and convincing manner, the intentions behind the monetary policy being pursued.

Hence, there is no disputing the need for a commitment to accountability. But to whom should the ECB be accountable? The Bundesbank, which has always attached great importance to accountability despite the absence of formal requirements, has practised continous accountability particularly to the general public in Germany. The associated public debate on its monetary policy strategy and its measures has proved to be fruitful: the social consensus backing a stability-oriented monetary policy has been strengthened, and the Bundesbank's credibility has been enhanced. In principle, this might be also an advisable course for the ECB to follow. However, it is difficult to identify a "European public"- at least for now.

Therefore, accountability at the supranational parliamentary level - which is explicitly enshrined in the Maastricht Treaty - will be all the more important right from the outset. The Governor of the ECB will present an annual report to the European Parliament, on the basis of which the European Parliament can hold a general debate. Furthermore, the members of the ECB Executive Board can be called to speak before the responsible committees of the European Parliament. This ensures that accountability is broadly and institutionally enshrined at the European level. By contrast, accountability at the national level, i.e. of the central bank governors to their respective national parliaments, would run counter to the exclusively European mandate of the European System of Central Banks. This European mandate applies not just to the members of the Executive Board, but to all members of the Central Bank Council. This European orientation, the responsibility for a single monetary policy, determines the institution's self-identity.

Besides defining obligations to provide information and explanations, the monetary policy strategy also has implications for the accountability of the central bank. In the academic debate on this topic, the impression is often given that inflation targeting is clearly superior to monetary targeting in those terms (see Tabellini, 1998 and Dornbusch et al., 1998). According to the proponents of inflation targeting the difference between the two strategies is that one sets a target for inflation, the other a target for monetary growth. It is mostly argued that the "man on the street" can make more sense of inflation, and thus of an inflation target, than he can of monetary aggregates. This line of argument is misleading, though, as it confuses two different levels of monetary policy - that of the final objective and that of the strategy. What is more to the point is making a clean distinction between these two concepts.

The accountability of a central bank ultimately hinges on the degree to which it has achieved the final objective it has specified - in the case of the ECB, this means the objective of price stability. The strictness of accountability thus hinges on the clarity of the target which has been set and the degree of the central bank's responsibility for the actual trend in the target variables. The EMI's aforementioned proposal to set a narrow margin is a good idea. However, contrary to the first impression, such an inflation target is independent of the central bank's monetary policy strategy. Admittedly, it is an explicit part of inflation targeting. However, in principle, it can be combined with any other strategy - it is implicitly contained in a monetary targeting strategy (King, 1997b, p. 435.)

Owing to the long time lag between the deployment of monetary policy instruments and the achievement of the inflation rate, however, the central bank's accountability for ongoing monetary policy cannot focus on the current inflation rate. Rather, what is needed - on the part of both the central bank and the general public - is to observe variables which contain information on the future outlook for inflation. In monetary targeting, the monetary aggregate, which is used as an intermediate target, serves as a reference point. The inflation forecast performs this function in inflation targeting.

If one considers that the inflation forecast - and not the current inflation rate - is the essential focus of accountability in inflation targeting, then the viability of this strategy's suitability for the general public's assessment of monetary policy becomes a much more complex issue. The inflation forecasts published by each central bank are an amalgam of complex econometric models, individual indicators and a healthy portion of subjective assessments.

Therefore - despite careful inflation reports - the inflation forecasts are virtually impossible for the general public to comprehend. It is not easy to say with any certainty how good the quality of the forecast provided by the central bank is, nor is it possible to tell to what extent the central bank should actually publicly reveal the problems it encounters when preparing the forecast.

A solution often given by proponents of inflation targeting is that a "forecast competition" exists between the central bank and outsiders, which forces the central bank to formulate the best inflation forecasts it can and to publish them together with a description of their forecasting method. This would enable the public to examine *ex ante* - i.e. before the inflation rate has been achieved - the method and assumptions on which the inflation forecast is based. Furthermore, there would be inflation forecasts by third parties which the public would take into account when judging the central bank's inflation forecast. However, it is rather difficult to imagine the public understanding such an *ex ante* judgement of the central bank's inflation forecast, as it lacks expert knowledge of possible forecasting methods and can neither judge nor compare the quality of the central bank's or other agencies' forecasts.

In addition to such an *ex ante* comparison of the central bank's inflation forecast with that of alternative forecasts or forecasting methods, it is also possible to make an *ex post* comparison of the achieved inflation rate with that previously forecast. However, a comparison of this kind is, by its nature, only possible after some time has elapsed. Another factor is that it involves a number of difficulties: Basically, there are two ways the central bank can make its inflation forecast: it can either take its future actions into account or not do so. In the first case, if the inflation forecast derived in this way differs from the inflation target, the central bank will take relevant measures in line with its inflation targeting strategy. But this means its forecast will automatically turn out to be wrong. In the latter scenario - if the central bank adheres strictly to a strategy of inflation targeting - no difference can arise between the inflation forecast and the inflation target.

As opposed to the inflation forecast, the money stock is a clearly observable statistical variable. In the case of monetary targeting, the statement that the monetary target has been either achieved or missed thus has unequivocal credibility. For that reason, the monetary targeting strategy is transparent and is suitable for communication with the public. It therefore forms a good focus of central bank accountability.

However - as previously mentioned - it is precisely at the start of monetary union that instabilities in the demand for money, and possibly even turbulence, cannot be ruled out. If that is the case, a comparison of monetary growth and the target value cannot be used directly to derive the price movements to be expected nor the necessary extent of monetary policy action. The public must additionally base its assessment on the interpretation given by the central bank of monetary growth, of other indicators considered to be relevant, and possibly even a model-based inflation forecast. In this case the problems relating to the quality of the central bank analysis and the credibility of the central bank's statements with the resulting implications mentioned in the preceding comments on inflation targeting also impact upon monetary targeting. Nevertheless, the advantage of the monetary targeting strategy may lie in the fact that these problems only appear in the event of instabilities in the demand for money, whereas they are, in a sense, inherent to the system in an inflation targeting strategy.

The stability policy system

The step towards a common currency in Europe is viewed with scepticism on the other side of the Atlantic: *"The shift to a single currency for all of Europe would be an unprecedented event. There is no sizable country anywhere that does not have its own currency. A national currency is both a symbol of sovereignty and the key to the pursuit of an independent economic and budget policy."* (Feldstein, 1997, p. 3.)

A special feature of European monetary union will, in fact, be that it will not have a complementary political union - at least in the foreseeable future. The principle of "one country, one currency" runs like a thread throughout monetary history. In EMU, this link is being broken for the first time and replaced by the principle of "one market, one money". (King, 1997a, p. 237.)

From a constitutional perspective, this is certainly an unusual and historically unique event. What is more: the Bundesbank's independence was based on a simple Act - one which theoretically could have been amended any time by a simple one-vote majority. To that extent, the right of policy makers to intervene could be invoked at all times. The legal securing of the ECB's independence even goes beyond being enshrined in the national constitutions - the EU Treaty can only be amended unanimously by all member states (see Böckenförde, 1997, p. 33 ff.). The same applies to the objective of giving priority to monetary stability. Hence, the reappointment costs, i.e. the costs of changing the conditions under which monetary policy operates (Jensen, 1997), seem likely to be very high in EMU.

That gives the supranational institution ECB a special standing. It is not for nothing that there are repeated calls for a political "counterweight". Yet the necessary coordination of economic policy within the EU should not be allowed to become an instrument which undermines the European Central Bank's independence.

Objections to this final and irrevocable "abdication by policy makers" are surfacing throughout Europe. There is already talk of a future "dictatorship" of the ECB; there are also warnings of "centralbankisation", i.e. that Europe will be shaped in the image of the central bank.

However, the priority accorded to stable money is precisely what was agreed in the Maastricht Treaty, and an independent central bank has been given the mandate to keep this promise. Only now do some seem to be getting the picture that this monetary arrangement has implications for many other policy areas, too. Now it will inevitably be revealed to what extent all the other areas comply with the conditions set by the objective of "stable money".

The euro will have to demonstrate a large measure of stability if it is to contribute successfully towards integrating Europe and not towards dividing it. In the past, various individuals have vowed emphatically that this will indeed be the case. However, public statements in favour of a stable euro hardly constitute a copper-bottomed guarantee on their own.

A broad base of public support for the ECB's clear, stability-oriented policy stance will be a crucial factor. Unlike the Statute, the "stability culture" (Richter, 1994) of which so many speak cannot be established by fiat. That does not mean that both phenomena are mutually independent (also noted by Neumann, 1997, p. 27). Permanent confidence in the stability of the currency can be instilled only within the context of a well-conceived status and its implications for monetary policy; this is confidence which, in turn, underpins monetary policy measures geared to stability.

Uncertainties

The Maastricht Treaty has largely laid the foundations for a stability-oriented monetary policy as far as the institutional arrangements are concerned. As I have pointed out, those foundations need to be complemented by an appropriate strategy and a convincing decision regarding the choice of the leading personalities.

The launching of a new central bank and a new currency is accompanied by uncertainty. The associated risk premium in the interest rate can be kept down by choosing an appropriate strategy and by appointing suitable top executives. The financial markets will keep a critical eye on the ECB right from the start. The initial monetary policy course thus takes on crucial importance. Some people are therefore already advising the ECB to pursue a particularly restrictive course right from the outset so as to nip any mistrust in the bud, as it were.

Such an uncompromising approach would inevitably give rise to tensions within the Council. It is also hard to imagine that the ECB would meet with general approval for such a course among the people of Europe, given the high level of unemployment. At the moment we do not even know whether there is a stable European consensus on the acceptable or optimal rate of inflation. The trend towards the convergence of inflation rates at a low level is a good omen. In a monetary union without a flanking political union, we shall simply have to wait and see whether this convergence of preferences will prove to be a lasting phenomenon.

The consensus regarding the preference for stable money - the common "stability culture" - is all the more important as monetary union will have to survive for the foreseeable future without the additional support of a political union. For this reason, the right choice of participants based on the convergence criteria assumes overriding importance. The public finance situation plays a particular role in this assessment. The fiscal criteria have to be met on a sustainable basis, in other words, not just at the beginning of Stage Three. Finally, the member states must implement the labour market reform which is urgently needed and, in general, significantly cut back the dense jungle of overregulation. Without a far higher degree of flexibility at the microeconomic level, it will not be possible for monetary union to yield the desired benefits, nor will the ECB encounter broad and lasting acceptance for a monetary policy geared to ensuring price stability in accordance with the Maastricht Treaty.

In an overall favourable assessment of the EMU Project, the IMF critically remarks that *"... the failure to recognize explicitly the importance of flexible labor markets was an important omission from the Maastricht framework."* (IMF, 1997, p. 64) The decision on what countries are eligible to enter Stage Three will not focus on whether countries have developed sufficiently flexible labour and product markets to make up for the loss of the exchange rate instrument. However, "*a failure to address labor market problems would prevent Europe from realizing its full growth potential, and could also weaken the credibility of the euro if financial markets perceive that persistent unemployment is eroding support for prudent macroeconomic policies."* (IMF, 1997, p. 68.)

In a simulation using its multi-country econometric model (MULTIMOD), the IMF, in one scenario, illustrates the implications of lagging structural reforms. In this scenario real wage flexibility remains low, the natural rate of unemployment gradually increases to the level of actual unemployment in the EU and national governments attempt to offset the effects of deteriorating labour market conditions on output and employment by additional government spending. With inflexible labour markets and rising structural unemployment, the price level is estimated to increase by 2.3% over the medium term, and the level of real GDP declines by 2.5% relative to the baseline.

The government debt-to-GDP ratio rises by more than 10 percentage points. This worsening of economic performance raises the risk premium on euro-denominated assets by 40 basis points in the simulation.

The meaningfulness of such approaches is debatable; however, at any rate this simulation does make clear the magnitude of negative trends which are to be expected if the necessary reforms are not implemented. It is not possible to identify the psychological damage and the political repercussions in this manner, anyway.

III. Conclusion

The Maastricht Treaty has provided the blueprint for a strong ECB, able to act independently as a credible guardian of a stable euro. The euro will mean price transparency across the board and across borders.

However, the importance of legal independence may have been overstated. Not even an independent central bank can lastingly defend monetary stability against a ‘society of excessive demands’ - in other words, every society ultimately gets the rate of inflation it deserves and basically wants. Of course, this statement does not mean that institutions are irrelevant or that central bank independence is unimportant. Precisely the contrary holds true: in principle, resistance to making the central bank an independent institution with the single goal of price stability always reflects the intention of reserving access to influencing monetary policy whenever a currency loses value. Governments seeking re-election often have an incentive to achieve short-term benefits through inflation without considering its long-term costs. In view of the temptations inherent in the political process, a society can signal its determination to safeguard the stability of its money only by choosing the appropriate institutional arrangement. In this context, the independence of the central bank is a necessary, but not sufficient, condition.

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