

## Rogoff's central banker CUM Stability and Growth Pact: Mutually reinforcing institutions or a cursed overdose?

### Abstract

Two different institutions, meant to provide each other's support, underpin economic policymaking in Euroland. First, a shared central bank whose objectives and operational procedures imply inflation stabilization weighting more heavily (relative to employment stabilization) than that the social loss functions of selected individual countries would yield. Rogoff's icon, for all practical purposes, would be in monetary control for the whole area.

Second, the Stability and Growth Pact, aimed at ensuring national budgetary policies supporting such inflation stabilization-oriented monetary policies. This objective calls for national fiscal deficits being kept below 3 percent of the GDP reference value. This narrow margin may not permit to offset the most damaging effects that would inflict a Rogoff's like central banker to the most vulnerable countries.

While this paper is not particularly aimed at reviewing the various opinions and objections that either institutional pillar have raised, it focuses on the slippery recession path that the combination of the two institutional arrangements may entail with resulting political and social turbulences. The underlying question is whether less dogmatic, time-consistent coordination between monetary and fiscal policymaking, between Frankfurt and Brussels, is the iniquity that conventional economic analysis purports to be.

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**A - The Rogoff's icon**

I would call "Rogoff's icon" the culmination of a political process predicated on a conviction that the mandate the society gave to central banks (the safeguard of price stability) was incompatible with their being controlled by or otherwise submitted to a democratic elected administration or government. Policymakers may be lured by the effects that small positive inflation surprises (e.g. an excess of realized inflation over that which had been anticipated when wages were set) may have on output and unemployment. They may also face similar incentives to inflate in order to reduce the burden of government debt. However, as private agents are shrewd enough to anticipate these surprises and the policymakers' strategies, they set higher wages in advance of their decisions.

Mainstream analysts suggest that inflation has been lower in countries with independent central banks than in those where the government interferes in monetary policymaking. There is no unanimity on this, however: Adam Posen (1993), among others, argued that the empirical studies supporting those conclusions confused cause and consequence and that they simply overlook central bank dealings with the financial sector as a determinant of institutional autonomy. (Ripoll, 2002). (See note <sup>(1)</sup> on the influence of New York banking lobby over the genesis of the Federal Reserve System).

Submission to elected policymakers would drive the bank to adopt an "inflationary bias" (of the type that manifested itself in the high inflationary period of the 1970s), (Fuhrer, 1997, Kydland and Prescott, 1977) with a resulting lack of credibility in its further announcements. Distrust on the bank's announced targets and on its incentives allowing more inflation in the economy than is optimal would generate monetary destabilization. Currency dealers would easily be driven by speculation over the erosion of the value of the currency; firms would set prices disregarding an announcement of the bank's intention to disinflate, etc. This leads to an equilibrium at an excessive rate of inflation.

Independence eliminates the uncertainty created by a polarized political system, and thus provides a necessary credibility to policymaking - a chief component of the success of a sound macroeconomic policy. Credibility stemming from independence was considered indispensable for a proper workings of financial system and its market mechanisms and as a route to price stability. By implication, or explicitly, as Forder (1998) pointed out, the democratic process was being blamed for inflation.

A major driving force behind the central bank independence concept are the financial industry's highly politicized efforts to oppose inflation. The commercial banking sector, indeed, traditionally maintains strong organic linkages with central banks and wield sensible power over them. Power and influence stem in the first place from common interests and ideology which central banks share with financial institutions. (Bowles and White (1994). See

also John T. Woolley (1984)). The banking system is the necessary channel through which monetary measures trickled down to business and families. Necessary reliance on the financial system and its operational mechanisms establishes some interconnections between the central bank and the financial community - from which some dependence develops.

A common outlook on monetary matters make indeed the central bank more mindful of the arguments and preferences of the financial community than those expressed by other economic agents, as for instance the industrial periphery. (This assumption needs some qualifications on account of specific structural linkages between banking and industry across countries. References to an agency situation are included in note (2)). At the same time, as Posen (1995) maintains, "Since central bankers know that exercise of their independence can be curtailed, they will only pursue counter inflationary policies consistently when there exists an interest group that can protect them politically from the costs of doing so...".

The option of central bank independence has gradually been adopted as the model for an institution which has traditionally been boasted as "it can do no wrong". It started with a the glamour of the Bundesbank, it has continued with ECB, "the most independent central bank in the world", apparently. Independent policymaking has been high in the agenda of conservative circles (already in 1993, a newly elected right-wing French government lured by this idea, dubbed the "Bubette" a mini-version of its august German counterpart) and shaped a specific central banking culture - not necessarily in terms of the personal features of its head officer, but of the governing body as a whole (which in ECB is made up of central bankers). This culture connects very nicely with the objectives as those of the ECB's chart, which would take "general economic policies in the Community ... only as a secondary goal". [Treaty on European Union (1992), Title II, Article 2]. Its commitment to price stability comes as its primary objective. An ECB attempting to stabilize both employment and inflation with the single monetary instrument available to it would not be credible in its commitment to stabilize inflation.

A syllogism of sorts has permeated the public opinion: to the extent that central bank independence permits to keep inflation at bay (Kydland and Prescott (1977)), and that low inflation has a welfare-enhancing role for the whole society; then, central bank independence has a positive influence for the society as a whole. In fact, linkages between finance industry, academia, and the central bank's structures and their interactions have been important in promoting a new mindset that viewed political interference on monetary matters a means of electoral self-promotion but a negative factor for national social and economic development. (A note on the central bank culture is included in note (3)).

Based on this analysis, Rogoff (1985) contended that central bank independence was not enough to eliminate inflation biases and ensure

credibility - monetary authorities had in addition to be headed by an agent who has a markedly greater distaste for inflation than the public and make price stability a fully credible assumption for the society as a whole. "Society can make itself better off by selecting an agent to head the independent central bank who is known to place a greater weight on inflation stabilization (relative to unemployment stabilization) than is embodied in the social loss function." Appointment of a conservative personality (or a governing body made up of conservative central bankers, as with the ECB) was fostered by the conviction that inflation was ineffective to deliver output stabilization, so that efforts to maintain price stability by means of tight monetary policies would not impair employment or output. The objectives mandated to the central bank did not encompass a particular concern as regards output; unlike the U.S. system, protection against inflation was the only target. For that purpose, the central bank was given a single operating mechanism (short term interest rate), with the understanding that a single operating mechanism could not accommodate two targets at the same time: output and inflation stabilization. This conviction could only be credible enough if a strong inflation-averse personality was in control.

The concept of a Rogoff central banker applies to ECB with particular relevance. Not only by its very mandate on price stability as its primary objective, but also the bank's professional and social environment may be an integral part of its inflation aversion philosophy. Its Governing Council (the highest decision making authority in the ECB system) includes the governors of the twelve national central banks (NCBs). More than half of its staff have been recruited from the NCBs. To paraphrase Simone de Beauvoir, "one is not born a Rogoff, one becomes one" (Duisenberg?). ECB has chosen an inflation rate of less than 2 percent, a toughness that is largely a legacy from the Bundesbank, according to *The Economist* (which however also suggested that "whatever Maastricht treaty says, it has acted roughly in the same way as other leading central banks: i.e., as if it were responding to changes in both inflation and economic activity). As Forder (1998) brought to mind: "Rogoff himself remarked on the apparent prevalence of conservative central bankers around the world and to many ears the adjectival qualification is almost redundant".

The central question in the debate is whether the adoption of Rogoff-like central banker and the increased monetary credibility it promotes has a cost in terms of loss of output and higher unemployment. Probably not in a long term - perhaps the other way round. But short term is important. To be able to reap the benefits of the "sound monetary policy" that underpins the central bank's independence agenda, an unemployed person or a firm in a slump situation have first to ensure their survival until those benefits show up. Survival may command a preference for a type of specific monetary policy diverging from "sound" monetarist orthodoxy, even if this entails sacrificing part of the expected final benefits. This kind of sacrifices, however, would not impress a monetarist opinion.

On the contrary, higher unemployment would be a necessary test of the efficacy of the adopted monetary policy in terms of inflation goals. (For some further developments see note ( 4 ).

### ***B - The Security and Growth Pact.***

Fiscal discipline, as an instrument for macroeconomic stability, was essential to support and provide anti-inflationary credibility to the ECB (Buti et al, 2002). The conventional wisdom is that fiscal policymakers in individual member countries could be lured by the short term effects of larger debt than what the society would need on a longer term perspective. Fiscal deficits crowd out private investments, push up interest rates, and hence have an impact on economic activity. They are therefore an incentive to the central bank to constrain monetary policy, the outcome of which would spread to the whole monetary area. As a result, constrained fiscal policy, as that laid down in Maastricht, was assumed to be an essential complement to the macroeconomic stability that the independence of the central bank was also meant to provide.

And not only it was also accepted that fiscal discipline was necessary for providing support to the monetary authorities and to the overall system of macroeconomic stability, but also that it would not harm output stimulation. Excessive budget spending, it is argued, is responded by economic agents with anticipations of future increase in taxes to pay back the public debt resulting from those deficits; they would then cut back consumption accordingly (the Ricardian equivalence). Keeping deficits at bay would therefore not harm consumption - the fiscal roots of high inflation were said to lie in persistent budgetary imbalances. (Sargent and Wallace (1981), cited in Buti et.al (2002).

That approach underpins the convergence criteria embodied in the Excessive Deficit Procedure of the Maastricht Treaty. Budget deficits as a share of GDP are not to exceed 3 percent of GDP and the public debt should be on a decreasing path as long as it exceeds 60 percent of GDP. These provisions were later taken up in the Stability and Growth Pact (SGP), which for some "must rank as one of the most remarkable pieces of policy coordination in world history" and made it "comparable to the founding of the Bretton Woods system" (cited in Buti et.al (2003)). Automatic stabilizers (generally, transfer payments, unemployment compensation and income supplements and government purchases which rise when income drops) were assumed to provide sufficient room to respond to ordinary recessions without exceeding a reference value of 3 percent, above which questions of budgetary sustainability and financial stability arise. The Pact also established a monitoring system at the EU level to prevent or sanction 'excessive deficits'. To be sure, the Pact also acknowledges the possibility of contingent exceptional circumstances such as severe recessions, under which the deficit ceiling can be temporarily exceeded.

Criticisms have not spared SGP. It is frequently claimed that the Pact is too rigid and consequently prevents fiscal policies from fully playing their stabilization role (Pisani (...)). The absence of a serious academic or scientific debate when it was prepared and negotiated has increased the misgivings over its relevance and effectiveness. Some analysts contend that constraints on fiscal deficits as those embodied in the SGP were only justified because it permitted to sell the EMU to the German public, which was reluctant to join until threats of increase of inflation were in this way totally dispelled (Hefeker, 2003). While there is not much disagreement on the need for fiscal discipline in a monetary union, and that the Pact has triggered reductions in the deficits within the Euro-zone, the Pact's strict rules may not be the right solution for all countries at all times. Discussions on its design and implementation do not abate. Positions of France and Germany at the time of writing, which are more or less ready to ignore the Commission's warnings, add to its lack of credibility. (Hefeker, 2003, p.17>.

Against the strong points of the Pact, (i.e. simplicity, ex post obligation of results and high costs of overriding and amendment (Buti et.al. (2003))), its detractors point to basic flaws which include reduction of budgetary flexibility, asymmetric workings, absence of sanction to politically-motivated fiscal policies, discouragement of public investment, disregard for the aggregate fiscal stance and, by focusing on short term commitments, disregards for the long term sustainability. As Barry Eichengreen (2003) has pointed out,

"The problem that the SGP is designed to address is not simply deficits larger than 3 percent of GDP, for sometimes deficits in excess of 3 percent are part of the solution rather than part of the problem, for example when the economy running them is in an exceptional recession. More fundamentally, the 3 percent reference value is arbitrary. It has no basis in economic logic. It bears no obvious relationship to the sustainability of public debts, which is presumably the underlying concern that the pact is designed to address." And neither is the 60 percent reference value for public debt firmly related to this fundamental concern, adds Eichengreen. (see a quotation from Hefeker in note ( <sup>5</sup>)).

For some, some internal adjustments, rather than a total reshuffle of the SGP's entire framework, are called for. In this line of thinking, Buti et.al (2003) have expressed skepticism over re-opening the debate on the Pact. On the other hand, other less complacent opinions, so far unheeded, claim that more basic reform is needed. Wyplosz (2002), for one, cited in Buti et.al (2003), suggests that a Fiscal Policy Committee at the national level be established to be given the responsibility for setting the budget balance on the basis of debt sustainability constraint defined over a number of years. Casella (2001), also cited in Buti et.al. (2003), suggests a system of tradable budget deficit permits as a mechanism

for implementing fiscal constraints in EMU. Having chose an aggregate target for the Union and an initial distribution of deficit permits, EMU countries could be allowed to trade rights to deficit creation.

The SPG's rationale was that fiscal deficits are caused by lax fiscal policies and necessarily result in high national inflation rates, with the risk of spilling over to the whole Euro-zone. This conforms to a well established macroeconomic theory that Governments running persistent budget deficits must sooner or later finance those deficits through money creation, thus producing inflation. This is basically correct. However, recent analysis do not bear these assumptions out in all circumstances - in a number of countries there has not been a systematic correlation between fiscal deficits and national inflation rates. Empirical work has had little success in proving this (IMF's Catao and Terrones (2003)). The opinion of Peter Bofinger (2003) goes along this line of thinking: "...there is absolutely no evidence of a systematic correlation between the size of fiscal deficits and national inflation rates ... Fiscal rectitude does not necessarily pay off". By the same token, it is not necessarily true that low growth performance is a consequence of high fiscal deficits and thus a too strong government interference with market processes (as the examples of Germany and Finland bear out). Bofinger brings into the picture the real interest rates across Europe being largely determined by national rates of inflation. Countries with strong growth resulting in wage increases experience inflation above Euro-zone averages, and hence real interest rates decline, whose effects further stimulate the national economies. Countries with weak performance conversely experience high real interest rates and consequently restricted growth and a deterioration of fiscal positions.

In Bofinger's view, fiscal policy should compensate overly restrictive monetary conditions instead of aggravate existing imbalances by further reducing national inflation rates. I quote: "...an adequate macroeconomic policy mix at the national level requires that national fiscal policy is flexible enough to provide the necessary compensation for overly restrictive or expansionary monetary policy conditions. Unfortunately, the founding fathers of the SGP were so occupied by the deficit-inflation nexus that they did not pay attention to this additional need for flexibility. Above all, they set the deficit threshold and the SGP escape clauses in too narrow a way, since they were derived from observations for the pre-EMU period, in which countries still had national monetary policy instruments (interest and exchange rate) at their disposal...". (See note <sup>(6)</sup> on the criteria for joining EMU that had not been met by a number of its founding members).

The above suggests that uniform fiscal constraints will deliver different outcomes according to country-specific economic and social structures. Structures are just not homogeneous enough to make one uniform rule adapted to each of the countries concerned. "One size does not fit all", in other words. Economic and social patterns bring about in particular a distinct vulnerability to shocks; the

same applies to the weight of financial and capital markets in national economies and their international spread. Openness to foreign trade, labor markets rigidities, the level of distortionary types of taxes, and other factors result in existing asymmetries which do not seem to fade away. Some relevant opinions contend that asymmetries call for specific, ad-hoc, fiscal policies, which the Pact is incapable to deliver. (See a reference on Arestis and Mouratidis (2003) investigation on a trade-off ratio between output-gap variability and inflation variability in note (7)).

A convergence towards mean values among the now twelve member countries (probably ten more in a few years time) does not seem to be in sight. Conventional international trade theories postulate indeed that interconnected economies and trade and monetary integration contribute to convergence and mitigate the effects of domestic specialization patterns, defuse country-specific shocks, and hence decreases the interest for differentiated fiscal (an monetary) policy patterns. On the other hand, new growth theories hold that integration is more likely to promote divergence rather than convergence and hence, larger fluctuations in the relative prices and real exchange rates - adding up to increased vulnerability to asymmetric shocks. (Recent empirical data and analysis in the U.S. borne this out; the subject merits no doubt further investigation in the Euro-zone). Chamie, DeSerres, Lalonde (1994) already demonstrated that symmetries in 13 EU countries are larger than in 9 U.S. states. Analysis carried out by Clark and Wincoop document that business cycles of U.S. Census regions are substantially more synchronized than those of European Union countries, both over the past four decades and the past two decades. More than that, data from regions within the four largest European countries confirm the presence of a European border effect - within-country correlations being substantially larger than cross-country correlations (Todd E. Clark and Eric van Wincoop, 1999). Bayoumi and Eichengreen (1992) contended that supply shocks are larger in magnitude and less correlated across regions in Europe than in the U.S. A number of other recent and less recent contributions have reached similar conclusions.

Convergence is also made difficult by distinct time lags that take monetary measures to trickle down to the real economies. The legal system in a country forms the basis for the structure of financial intermediation and, hence, for the impact of monetary policy on output. National asymmetries in the monetary policy transmission mechanism are also to be expected as legal systems show a fair amount of diversity across the Euro-zone. The two factors are interrelated in Cecchetti's (1999) views: "Unless the laws governing shareholder and creditor rights and the enforcement of those laws are harmonized across the members of the European Monetary Union, monetary policy will continue to have a differential impact". Harmonization in that sense does not seem to be a priority in the European agenda.

Differences in wage/price mechanisms across European economies and the qualitative cyclical differences in the response to common

monetary policy result also in asymmetries in the monetary transmission process (Clausen (2001)). Countries more affected by fiscal burdens related to health care and pensions due to aging populations, those with particular structural unemployment problems, may also fall into that category of countries. Similar considerations apply to economies affected by the so-called Balassa-Samuelson effects (see note ( 8)).

Confirmation of this thesis would result in divergent well-being degrees among member countries, as a result of the uniform rule embodied in the SGP, with resulting political effects (Hughes-Hallett and Viegi, p.273 (2003), as well as disruptive effects for the Euro-zone as a whole.

Heterogeneous cultural and political features across the euro-zone may exacerbate the effects of lack of convergence. Tolerance for inflation rates and unemployment conditions, are not necessarily similar in all countries concerned, and differentiated preferences do exist. The importance of these features is particularly relevant where historical backgrounds manifest themselves in differentiated languages. All those asymmetries among member states imply different weights in the trade off between unemployment and inflation that the Pact is meant to regulate. The question is whether these specific differences are going to be seen with similar (political, social) eyes in all the countries concerned.

Taste differences and anti-inflationary attitudes, stemming from cultural and historical profiles, may indeed be additional sources of conflict between individual countries and an Eurosystem that imposes uniform fiscal restrictions. Differences across European nations in these aspects are also notorious: Cultural backgrounds were found responsible for differences in inflation and unemployment experiences after the 1973 oil shock. The United States and West Germany reacted with low inflation and high unemployment rates, while France, Britain and Italy all experienced high inflation and relatively little change in unemployment (Tootell, 1990). Using survey data from European Community members over the period 1976--1993, Bernd Hayo (1998) finds also supportive evidence of the existence of a stability culture in low-inflation countries. His conclusion is that, in their assessment of the importance of price stability, people living in countries with a low inflation record appear to be more sensitive to an increase in the actual inflation rate than people in countries where higher inflation is traditionally embedded in the social and political system. Public attitudes on this kind would interconnect with central bank independence via a historical feedback process. Different market and institutional frameworks may also influence social stress with a resulting disagreement over the optimality of monetary measures and preferences.

Local traditions in respect of saving and investment patterns and styles; attitudes towards entrepreneurship; and other social and political circumstances, may also differ across the area and dictate nation-specific monetary inclinations and preferences. Even

differential crime rates may affect economic convergence and thus bear upon monetary preferences (Tullio and Quarella (1999)). Differences between the scope of social welfare institutions and their unemployment insurance schemes, in Northern and in Southern Europe, the extended family networks in Southern Europe, are also factors that may bear upon weights given to unemployment and inflation and their implications on monetary policy stances (Bentolila and Ichino, 2000). In an analysis on the relationship between unemployment and consumption in five countries (Spain, Italy, Germany, Britain, and the U.S.) Bentolila and Ichino (2000) indicate that extended family networks, which appear to be stronger near the Mediterranean, provide a fundamental source of insurance against unemployment in Southern Europe. A derived conclusion may be that accommodative monetary action would be given less importance there than in countries where the family factor is less relied upon as a source of income and consumption.

Nominal wage rigidities may also be subjected to regional variations: Wage rigidity tends to be associated with output variability and, therefore, countries with different rigidities may differ also on their preferences for output stabilization as against their concern for inflation reduction and "sound monetary policies" (Waller, 1991).

### ***C - Policy interactions.***

As interaction of policy instruments plays an essential part of macroeconomic stability, the question arises as to whether and to what extent interaction between Frankfurt and twelve distinct fiscal authorities is possible. Interest rates bear upon inflation rates, but also upon the rate of growth of the national debt through their influence on demand and on the cost of debt finance. The tax rate bears upon output and unemployment but also upon the inflation rate (Blake and Weale (1998)).

Against the framework of the combined effects of fiscal deficits and inflation rates, two authorities pursue separate goals independently and hold divergent preferences on price stability and output stability; unless close coordination between them exists a conflict is apt to arise (Blake and Weale (1998)). But coordination would imply a Trojan horse of sorts in the stronghold of the central bank independence. Otmar Issing (in Buti (2002) p.264), for one, does not consider coordination an acceptable policy, in particular if shocks are highly correlated across countries. "'Ex ante' coordination would run the risk of confusing the specific roles, mandates and responsibilities of the policies in question". If the so-called Fiscal Theory of the Price Level can be relied upon, it is for the government to adapt its fiscal policy to the monetary moves of the central bank, not the other way round. A rise of interest rates on account of inflationary pressures should determine an increase of the primary surplus. But other opinions differ. Dixit

and Lambertini (2003) brush aside the question of coordination as irrelevant, but only as long as fiscal and monetary authorities agree about the ideal levels of output and inflation - a basic condition which does not seem to be met easily. (See note ( <sup>9</sup> ).

More generally, the dynamics of the system make monetary and fiscal policies becoming either competing forces aimed at offsetting each other's effects - or strategic substitutes. At a national level, fiscal and monetary policies have often tended to move in opposite directions in the past. Wyplosz (1999) is less categorical but basically shares similar views: the central bank raises the interest rate when the deficit increases. Mélitz (2003), in an analysis of the interaction of these policy instruments in 19 OECD countries, indicates that fiscal expansions led to tighter monetary policy, while monetary contractions promoted more expansionary fiscal policies. (The author warns however that this contractionary response can be questioned if Germany is removed from the EU sample). This is understood as monetary authorities responding to the inflationary effects of spendthrift governments, - and governments, being concerned by unemployment and output effects of tight money, becoming more relaxed on budget deficits. "Central bank independence should therefore be expected to induce a more active use of fiscal policy...", as in Hughes-Hallett and Viegli, p.273 (2003) - and stricter monetary policy being expected from lax fiscal policy.

Lower inflation being found in countries where independence of the central bank does not entail any loss in output stability, is simply attributed to "the fact that a more active fiscal policy has been able to contain the rise in output variability". (The point is elaborated in Hughes-Hallett and Viegli (2003)). Central bank independence induces the fiscal administration to adopt higher activism in the conduct of fiscal policy, particularly in response to the lower propensity for monetary policy to counteract exogenous shocks. In the delegation model Hughes-Hallett and other have developed, central bank independence would theoretically result in output variability higher than otherwise; as the empirical literature does not bear this out, it can be concluded that fiscal policy must have been used more vigorously than the optimizing model implies it should have been (see also note ( <sup>10</sup> ) on distinct reaction functions).

The behavior of either authority has been illustrated in Blake and Weale (1998) model as a dynamic Nash game, where policy is set taking the behavior of the counterpart as given. As pointed out above, the bank's inflation target can be met not only with interest rate movements but also with appropriate tax rates. Failure of communication makes each authority setting its instrument on the assumption that the other authority is going to keep the setting of its instrument unchanged. In this way, an *implicit* coordination between fiscal and monetary authorities would already exist (or rather a continuous succession of strategic moves) whether or not as a response to the cycle resulting from discretionary decision-making or as an automatic and independent feature (Mélitz, 2003). That kind

of dialectic process was however held responsible for the bumpy monetary episodes between 1945 and 1973, so that better co-operation mechanisms and the desire to restore discipline and credibility to economic decision-making, after the indulgence of the "Keynesian fever", between the two strands of national macroeconomic policies, was called for.

On the other hand, deliberated co-operation between fiscal and monetary authorities has also existed in a variety of instruments, and not only in authoritarian, compulsory, formal means of constraints to central banks, whose independence shield them from coercion. The professional press, the academia, unions, interest groups, and other institutions have stimulated coordinated measures that neither the government nor the central bank could totally ignore. In one case or another, fiscal authorities respond in a stabilizing manner to debt-output ratios and inflationary threats - as demonstrated in pooled data for the largest possible number of OECD countries, 19 in all, compiled by Jacques Mélitz (2003 p.215). (This opinion is not supported by other analysts. Fitoussi, for one, claims that, at best, Europe as a whole features a structural absence of reaction in its economic policies and, at worst, reactions are pro-cyclical, namely restrictive in a recession period and expansionary in a growth period. ('Le Monde' 31 December 2002). (See note <sup>(11)</sup> on communication and coordination).

Where co-operation has been less obvious, or central bank independence has found its most rigid expression, the country's economic performance has been affected as a result. At least, this was the example in Germany before the EMU, whose economy was outstandingly poor. Is there any causality between the two observable facts? (see note <sup>(12)</sup>). An analysis of Hayo and Uhlenbrock, 1999, on the German manufacturing and mining sectors, found that half of the industries show an output reaction significantly different from that of the aggregate sectors. In more than half of the cases significant price reactions were observed. Five industries out of 28 exhibit significantly negative relative production movements in response to a contractionary monetary policy shock. German Länder were also affected asymmetrically by monetary shocks since there are large differences in the respective "regional industry portfolios". An analysis by Bibow (2002) brings out some data that would reflect the negative effects of independence of the Deutsche Bundesbank - "the very ideal on which the European Central Bank was modeled and the policies of which it aspires to emulate" - on economic performance

Institutional structures in other countries before they joined EMU have had contrasting differences. Even where national central banks were stirred by a mindset that did not coincide with the government's fiscal policies, they were nonetheless committed to an inter-related system of agencies and institutions that are bound by a uniform geographic perspective, political allegiances and interest groups.

## **D - The Overdose.**

A combination of a conservative central banker and orthodox constraints on fiscal deficits, while designed for the common goal of monetary and output stability for the whole region, is not expected to deliver a uniform outcome for all and every member country, at least short term. (The issue is surely amenable to an analytical framework in the standard principal/agent or a common agency formulation (Drazen (2000), Fatum (2002), Ripoll (2002)). At a single country level, an agency (the Rogoff's central banker) confronts two principals and their respective constituencies: First of them is an institutional rule, that was mainly stirred by the mighty precedent of the German Bundesbank and by a financial, academic monetarist community and the twelve national central bankers of the Governing Council rigidly adhered to the inflation-aversion stance. The second principal is an elected administration, largely open to a variety of influences and national interests, often contradictory. With a central bank common to twelve countries, the conflict subsists but with much more severity, as it involves larger asymmetries in terms of population, sector concentration, political clout, financial markets, international trade, party ideologies. The national, common terrain for compromises and coordination that prevailed at a national level is largely lost.

There is first the question of variance of monetary parameters and overall values that the monetary authority takes as main criteria for its policy decisions. Second, this variance compounds with the absence of self-regulatory and implicit or explicit coordination and co-operation channels between policymakers, in the fiscal and monetary side, of the type of those which were in place at national levels when currencies were local. A third, related, issue concerns the response of the population (including unions, selected sectors, social organizations, opposition political parties) to what they may perceive, rightly or wrongly, as discriminatory policy against their own preferences and interests. That response broadens the discussion over political developments that could affect the European cohesion and the sense of a common goal and solidarity to which all countries are meant to be committed.

The ECB's monetary strategy is said to build upon two pillars: the rate of growth of the broad-money supply (M3) and a bunch of parameters that might affect inflation in the medium or long term: aggregate demand, capacity utilization, wage growth. Amalgamation of national parameters and their average values and expectations of the euro-zone underlie the policy decisions to target a medium term goal of 2 percent inflation or less. However, none of the countries concerned is expected to conform to these mean values [tables]. (In other times, along orthodox academic wisdom, I would have said that the NAIRU factor shows significant differences throughout the area). Large asymmetries do exist (see above). As a first approximation, the larger the national parameters differ from the average, the less the policy fits the individual, short term, national preferences -

the more countries will have reasons to blame European policymakers for being discriminated.

The above may however be misleading, as nobody claims that the two strategic "pillars" do provide a ready-made, robot-like guidance to policymaking. Policy decisions are the responsibility of the ECB's Council, and voting procedures are a convoluted process of difficult analysis and improbable guessing. (Monticelli (1999) has excellent points on the matter). It is expected that political constraints and influences interfere in the decisions, that Council members are subject to a principal/agent issue (as in Ripoll (2002)), that national governments are not absent from the debate and assert their muscle. "When an issue of difference arises, a French appointee would vote in the style of France, and a German, as predictably, in the way of the Bundesbank." (Dornbusch, Favero, Giavazzi (1998). This is not an empty gossip but an opinion borne out by empirical analysis. Meade and Sheets (2002) find that "the majority of ECB Council members typically voted on monetary policy changes in a manner that can be justified by the differential between their national inflation rate and the EMU average".

Reciprocity gambling or vote trading among ECB's Council members - their commitment to giving support of other countries' preferences in the future in exchange for support they receive from them today - are also a factor that may thwart the pure technicalities arising from the monetary "pillars"<sup>1</sup>.

All the same, Council members are committed to targets involving manipulation of monetary instruments and the scrutiny of parameters (on money supply and other signals of monetary instability) which necessarily weight in policy decisions. That these parameters are integrated in the ECB's strategies aimed at its medium term inflation goal does not seem to be in doubt. The question is whether these integration involve average values, disregarding population magnitudes or some other national size factors, or whether weights are applied. (Inflation rates in Germany being then given more weight than Luxemburg's, etc.).

No available information supports those assumptions. Neither is there a hint whether existing or expected interdependence of national economies all across the area is part of the strategies. As Carlino & deFina (1998) point out, "Country A's monetary policy shocks directly affect country A, and because of product and factor flows between country A and country B, country A's monetary policy indirectly affects country B". The argument provides a rationale for the bank focusing on policy recipes that fit major countries, whose economies spill over to their less important neighbors. The incidence and magnitude of these spills and externalities are expected to keep a proportion with some measure of the national

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<sup>1</sup> Vote trading suggests a repeated game model with reputational considerations. For an analysis based on cooperative game theory see Buchanan and Tullock, 1962, *The Calculus of Consent, Logical Foundations of Constitutional Democracy*, Ann Arbor, MI: University of Michigan Press.

magnitudes, particularly if countries A and B show significant asymmetries and differences. The central bank may be driven in this way, for the very sake of long term area-wide interests, to consider issues that specifically involve selected major countries of the area - with some disregard for average, global values.

The combination of technical and political factors that dictate the monetary policy decisions are expected therefore to make some countries feeling discriminated on some criteria based on size or financial weight or political clout. One or more countries will experience inflation episodes, while some others will experience recession episodes and subsequent business apathy or worse and unemployment rates higher than the EU average. While social hostility would rise in either group against policy measures, unpopular unemployment rates in the latter group will generate particular turbulences and thus be more vocal in the expression of dissents than in the former - population being less tolerant with unemployment and economic slumps than with inflationary episodes. (Some references on social preferences over monetary rigor are included in note ( <sup>13</sup> ). The list of more neglected and affected countries would include poorer and depressed countries, where debt load is generally greater than the average, in relative or absolute terms, and the increased debt service that tight monetary policy brings about puts an additional burden to local economies.

I insist that a main issue in this debate is not only inadequacy of a convergence process that would permit EMU countries to make up an "optimum currency area", but also the absence of coordination structures between policymakers in the monetary and fiscal side. Coordination cannot be expected to deliver its effects when the new game confronts a single central banker with twelve national administrations facing fiscal limitations of the type imposed by the SGP and also submitted to political and electoral constraints. The system supposes that every country has an equilibrium at some level of output and unemployment where there has to be some two-percent inflation equilibrium. Regardless of their history, geography or culture, countries are reduced to conform to a uniform model, made up of two or three monetary-style equations, or to an old German central-banking fad.

Is that going to be fully understood and accepted by the population, the unions, the manufacturing sectors, political opposition parties, of the most affected countries and those countries where welfare protection is low and unemployment insurance is inadequate? A political aspect stems from the distributional effects if uncoordinated disinflationary measures from both fiscal and monetary policymaking and monetary tightening were called for. What is known from tight disinflation episodes in the U.S. is that they have hurt minorities and blue-collar workers with particular intensity - and this should be a warning signal for European developments as well. Thorbecke <WP 264> has found not only that these categories of population were harmed more than other workers in terms of lost income, but that urban households were hurt in general much more than rural households. Analogies with what is

expected in the European framework may easily be established. (A quotation from Thorbecke is in note ( <sup>14</sup> )

Political implications can be expected in the home turf (the point is well taken in Hugues-Hallet and Viegi (2003), see note ( <sup>15</sup> )). There is now the perception of a far-off central bank with which the national median voter has less ostensible connections than those that existed with the former national monetary institution. People is aware of the bank's responsibilities over monetary matters with far-reaching outcome for the national well-being. An increase of the demand for a more active national fiscal policy to offset the bank's measures and to boost in this way output and employment can be expected. The bank cannot respond to differentiated national conditions and preferences <sup>2</sup>, while the government may shy away from a monetary responsibility that falls into the hands of a remote Frankfurt institution. The targets to which the bank is committed, on the one hand, and the limitations of fiscal deficits that individual governments are committed too foreshadow recessionary episodes which will strain internal tensions.

The risk of Brussels and Frankfurt being put as a scapegoat for the local misfortune is to be pondered (Jean Arthuis' opinion on this is in note ( <sup>16</sup> )). For the population at large, arguments on the role of rediscount interest rates, M3, intermediate targets, inflation targeting, and the like, sound technological jargon that blurs the responsibility for unemployment and inflation - the elements that really matter and which people understand. The risk of seeing European institutions disparaged will add to the lack of reputation and authority that already afflicts these institutions. It may also be expected that a process of deterioration as suggested above drift political orientations in the affected countries towards more left-wing electoral choices. The American experience, which conforms to the "partisan theory of macroeconomic policy", bears this opinion out. (see note ( <sup>17</sup> )).

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<sup>2</sup> Not only ECB is unable to respond, but it does not seem to mind. "That there are inflation differentials is nothing more than normal", pointed out Mr. Duisenberg following the June 2003 ECB's Council meeting. "Within a monetary union, deflation is not a meaningful concept when applied to individual regions, like New Hampshire or Germany".

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## Notes

<sup>1</sup> For Broz (1999), "Money center bankers drafted the initial reform and funded an expensive public relations campaign aimed at securing mass support and the approval of Congress... The plan this group produced - the Aldrich plan - was based largely on the work of Warburg and served as the blueprint for the Federal Reserve Act." It was felt however that the proposed banking reform was doomed to fail if a large country-wide consensus was not achieved, so that the group had to rally broad popular support. "Great pains were taken to keep New York's role in the lobbying hidden (organized by 'the National Citizen's League for the promotion of Sound Banking'), given prevailing populist prejudice against Wall Street. Warburg recognized that 'it would have been fatal to launch such an enterprise from New York; in order for it to succeed it would have to originate in the West'".

<sup>2</sup> "Common sense indicates to many that bankers probably rank quite high among would-be superiors of the Fed. They control money, organization, information and expertise" (Woolley, *ibid.* (1984). The existence of a financial market's influence therefore put some qualifications to the concept of independence of the system. Epstein's model (1992) puts forward four key factors - the structure of labor markets, the connections between finance and industry, the position of the economy in the world economy, and the position of the central bank in the state apparatus. One implication of the model is that different views of central bank and its agenda will be appropriate in different institutional contexts. For example, where central banks are independent and connections between finance and industry are weak, as they are in the US, the central bank will tend to be a rentier bank. It will thus pursue relatively restrictive policy, as the populist analysis suggests. Where connection between finance and industry are close, and the central bank is independent, as in Germany, the central bank will attempt to make policy in the interests of the capitalist class as a whole, and can be either restrictive or accommodating depending, among other things, on the power of labor. Where connections between industry and finance are strong, labor is cooperative, and the central bank is integrated into the state, central bank policy will be corporatist and more expansionary. Sweden fits this category. Where the economy is small and highly integrated into the international financial markets, central banks will be structurally dependent, having to follow the policies of the internationally dominant central banks. Most of the central banks in the European Monetary System fit this category after those countries dismantled their capital controls by 1992.

<sup>3</sup> The question of a peculiar central banking culture, mystique, and the inertia that are common to groups is also to be reckoned as elements of a central banking environment and assertiveness, which transcend the scope and purposes for which it was devised. A similar opinion arises in respect of the influences of academic circles - I mean, the intellectual and bureaucratic comfort provided by sticking to highly regarded theoretical models implying a set of rules, hence narrowing margins of discretionary powers and stifling national initiatives. (Ripoll, (2002).

<sup>4</sup> The implications of unemployment and loss of output are not the same in or outside the central bank's doors. Backus and Drifill <...>,

cited by Forder <1998>, suggest that "all policymakers present themselves as highly inflation averse. Those who truly are will always tolerate high unemployment if that is the price of low inflation. Those who are pretending may also do so if it may enable them to persuade the private sector that they are also inflation averse, thereby lowering inflation expectations. Either of these, in enduring high unemployment, is said to be 'reputation building'". In the resultant perfect Bayesian equilibrium analyzed by Backus and Driffill, the private sector's assessment of the probability of the policymaker truly being inflation averse increases when unemployment is high.

<sup>5</sup> Hefeker, Forum p.16. While the current deficit should not be above 3 percent, this limit is expected to be attained only in business cycle troughs. In 'normal' times the budget should be 'close to balance'. If the limit is violated, the government will be asked to correct its fiscal position. If the government fails to do so, it has to make a deposit ranging from 0.2 to 0.5 percent of GDP. If the government further fails to bring its deficit down the deposit will be converted into a fine. Some more lenient conditions apply if the GDP of the country concerned has declined by more than 2 percent during that year.

<sup>6</sup> This Bofinger's concern is shared by a number of analysts. The stipulated criteria were far from being met by several key countries when the system was launched and they joined the EMU, thus providing some justified grounds to the criticism. As pointed out by Baldwin, Berglöf, Giavazzi, Widgrén (2000) "Although the Treaty is quite specific on the five sets of numbers (debt, deficit, inflation, interest rates, and exchange rates), many political exceptions have been made ... . In the year they were judged ready for EMU, only 4 of the current EMU members met the debt/GDP threshold of 60%, with Belgium and Italy having more than twice this figure. On the exchange rate criteria, we have already seen that the rules were bent for Italy and Finland. For France and the other wide-band ERM members, the spirit of the Maastricht criteria was violated since 'normal fluctuation' meant one thing to the writers of the Treaty and another thing after the 1992-1994 exchange rate crises."

<sup>7</sup> A paper by Arestis and Mouratidis (2003) has recently investigated the monetary policy performance of EMS member countries, based on a trade-off ratio between output-gap variability and inflation variability for the whole period of the EMS. It has also examined whether the adoption of an implicit inflation targeting by EMS countries after the Maastricht Treaty in 1992 changed the trade-off between output-gap variability and inflation variability. For the whole period of the EMS, empirical findings show that the trade-off ratio varies amongst the countries included in the sample. Evidence for each sub-period shows that there is improvement of the trade-off ratio in some cases and deterioration in others. These findings point to the existence of asymmetries in the euro area, in view of different preferences concerning monetary policy and different economic structures amongst the EMU member countries. Under such circumstances, say the authors, asymmetric shocks can put a strong pressure on the ECB, potentially undermining its credibility.

<sup>8</sup> The so-called Balassa-Samuelson effects predict higher inflation rates in the relatively weak economies that have rapidly tried to

catch up to the average - namely, those showing stronger growth than countries where growth had already reached higher levels. This effect may well be felt in EMU region, where levels of national development are uneven. To be sure, growth patterns result in a strong demand expansion on non-tradable goods and services, while the productivity in those areas grows at slower pace than that of tradable products. This structural inflation difference may be met by ECB's tighter monetary policy, a measure that would conflict with the interests of stronger economies.

<sup>9</sup> In a recent analytical paper, Dixit and Lambertini (2003) assert that "if the two types of policymakers agree about the ideal levels of output and inflation, then this ideal is attained despite disagreements about the weights of the objectives, despite ex post monetary accommodation to fiscal profligacy, without fiscal coordination, without monetary commitment, and for any order of moves". Assumptions of this model include, in addition to an agreement between the central bank and the fiscal authorities on the most desirable level of output in each country and the most desirable level of inflation, irrespective of the welfare implications of distortionary fiscal instruments. These limitations gloss over much of the social and political incidence of the model with heavy political costs and electoral implications.

<sup>10</sup> In the current formal literature both monetary and fiscal authorities show distinct reaction functions depending on whether shocks originate from the demand side or the supply side. Buti et al. <Buti, interactions, p.249> present sensible assumptions on the matter: under negative demand shocks (e.g. on consumption), both authorities move in similar directions: the fiscal ones are supposed to move to larger deficits to eliminate output deterioration while monetary authorities will promote lower interest rate to avoid disinflationary drifts. In the case of supply shocks (such as an oil price rise or technology innovations) monetary and fiscal policies move in the opposite directions: the central bank increases interest rates to prevent inflation and, as a response, the fiscal authorities expand budget deficits to prop out output and stimulate employment. A new equilibrium is reached with higher interest rate and a higher budget deficit. Now, if fiscal policy is constrained - as Maastricht and SGP determine - it is expected that output and employment will be lower in the event of demand shocks (with inflation being stabilized) and lower output stabilization (with higher inflation stabilization) in the event of supply shocks.

<sup>11</sup> Formal or informal discussions between fiscal and monetary organs are already assumed to play a coordinating role on how particular fiscal policy changes are responded by monetary authorities and on how particular changes to the interest rates will be met by fiscal responses. Blake and Weale (1998) report on discussions of this type taking place in the U.K., although "there is neither evidence of any formal co-ordination between monetary and fiscal policy nor any recognition that such co-ordination might in some circumstances be desirable". These authors conclude that "there is a real and significant risk that lack of communication between monetary and fiscal authorities on the implementation of economic policy rules can be a major factor leading to their subsequent failure, and provides the strongest reason for co-ordination of monetary and fiscal policy".

<sup>12</sup> "The striking fact is that Western Germany's economic performance in the 1990s was outstandingly poor: Between 1992 and 1997, real gross domestic product growth averaged a meager 1.5 percent, job losses amounted to roughly 5 percent of the labor force, and the unemployment rate nearly doubled. The key to the overall outcome was the extreme tight-money policy pursued by the Bundesbank from 1990 through 1995. Rather than compensating, the prolonged tight-money policy magnified the effects of the excessively restrictive fiscal stance adopted in 1992. As economic theory would predict, this policy mix had glaring real consequences. Capacity utilization dropped sharply in the 1992-1993 recession and remained at severely depressed levels for most of the 1990s. Employment kept on falling, and unemployment continued to soar until the end of 1997. Depressed domestic demand reflected the severity of the tight monetary and fiscal policies...".

<sup>13</sup> Empirical data illustrate that a preference for monetary rigor, in the presence of an exploitable trade-off between inflation and employment, gradually increases from bottom (population, unions, left-wing parties) to political and social institutions in regions particularly affected by a higher than average unemployment, to national governments - and to the top level of monetary authorities. In particular, the higher the unemployment rate the larger also the tolerance of the public to increase of the inflation rates. A survey carried out in the US on the relative importance of those two evils, action against unemployment was considered a priority in 55 percent of responses, when unemployment reached a 8.1 percent level (April 1976) as against 33 percent of responses which considered inflation (4.8 percent at that time) as the main issue. Four years later, when unemployment was 6.1 percent and inflation was 14.4 percent, priority targets for monetary action were 19 and 73 percent respectively.<sup>13</sup> If fluctuating relative values determine fluctuating preferences or loss functions over time a similar process can plausibly be predicted in similar developments across the national geography. More recently, Frey and Stutzer (2002) with data elaborated by Rafael Di Tella, Robert MacCulloch, and Andrew Oswald (2001), show that in twelve European countries for the period 1975-91 a 1-percentage-point increase in the unemployment rate is marginally compensated for by a 1.7-percentage-point decrease in inflation.

<sup>14</sup> Thorbecke has found that theoretical predictions, econometric results, and the example of the Volcker disinflation of 1979 to 1982 present a consistent picture of the distributional effects of contractionary monetary policy. Unemployment increases, especially among lower-wage workers, with urban workers, workers not covered by union contracts, and minorities faring worst. For example, during the disinflationary period from 1979 to 1982 African American unemployment increased 9.5 percent, Hispanic unemployment increased 7.1 percent, while white unemployment increased 4.5 percent. Research on the effect of disinflationary policies on various industries and businesses indicates that small firms suffer more than large firms and that durable manufacturing and construction industries suffer more than other industries when interest rates rise. As interest rates rise during a contraction, however, returns on bonds increase. Therefore, since most bond market investors are among the wealthiest 10 percent of Americans, it is those households with high-income that

tend to benefit from contractionary policies, while lower-income and minority households tend to pay the costs. This redistribution from poorer to wealthier households contributes to the growing wealth inequality in the United States. The performance of the U.S. economy between 1994 and 1998 was so good that some pundits began to call for the Federal Reserve to increase interest rates to depress economic activity and reduce asset prices. However, slowing the economy to stabilize asset prices would have adverse distributional effects. Impulse-response functions from identified vector autoregression (VAR) indicate that unexpected increases in the federal funds rate increase unemployment among blacks and Hispanics by 50 to 90 percent more than among whites. A narrative approach applied to two disinflationary periods shows that higher interest rates in the 1974 disinflation decimated the housing industry and that two interest-rate-sensitive sectors—construction and durable goods—showed the largest declines in 1980 and 1981 (periods following the 1979 tightening). Using the Romer and Romer examination of the minutes of Federal Open Market Committee meetings to determine dates on which the Fed attempted to create a recession to reduce inflation, anti-inflationary policy shocks can be estimated to increase unemployment among nonwhites more than twice as much as they do among whites. A social accounting matrix (SAM) indicates that in the sectors that were hardest hit by recession following the 1974-1975 and 1979-1982 disinflations (construction and durable goods), blue-collar workers were harmed more than other workers in terms of lost income and urban households were hurt much more than rural households. Minorities bear the brunt of disinflationary policy and do not share proportionately in the benefits of keeping the stock market stable.

<sup>15</sup> "Far from being neutral, the appointment of an independent central bank reduces the importance of inflation as a policy objective among governments and favours those political parties more willing to use the fiscal instrument to achieve other objectives of economic policy. Therefore central bank independence is not the instrument to solve any possible conflict between preferences: any differences over the preferred use of monetary policy are simply transformed into differences over how best to use fiscal policy. The point we make here is that the median voter, assured now about inflation control, would naturally prefer a more active fiscal policy". (Hughes-Hallet and Viegi, (2003).

<sup>16</sup> Jean Arthuis, former France's Minister of the Economy and Finance, in "Le Monde", 26 June, 2003: "Cruel paradoxe, au moment même où les soubresauts de la conjoncture, la difficulté à contenir la dépense publique dans un contexte d'effritement des recettes fiscales et non fiscales ont pour effet de creuser les déficits publics et, en premier lieu, le déficit budgétaire de l'Etat ... la tentation est alors forte de voir dans les règles posées par le pacte de stabilité et de croissance, et donc dans l'euro, la cause de tous nos maux et la source de toutes nos difficultés. Or rien n'est moins vrai."

<sup>17</sup> The two parties in the United States have shown different preferences over inflation and unemployment which reflect those of the constituencies these parties represent. Empirical support of the "partisan theory" of macroeconomic policy (Hibbs (1977) confirms, first, that Democratic administrations are more concerned with an output target than with a money growth/inflation target. Second, that

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the real effects of new policies are stronger at the beginning of new administrations. Democrat Administrations have generally recorded above average and Republican administrations below average economic growth in the first half of their term. Also, the former party has been traditionally associated with more depressed states than has been the Republican Party. Similar developments are found in Germany: Länder exhibiting an unemployment rate higher than the national average have been inclined to elect a more leftist local government (i.e. SPD-controlled) than that elected (i.e. CDU/CSU-controlled) in a more affluent region. For all the ambiguity of partisan ideology and economic strategies, it is quite plausible that a similar argument applies to left-wing and right-wing parties in other countries.