Designing a Central Bank in the Run-Up to Maastricht

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The 1990s saw the emergence of a new philosophy of central banking, in which independence of central banks from the political process became a core component of the culture of monetary stability. Europe played a pivotal role in the formulation of the new philosophy, largely because designing a new central bank outside the framework of the nation-state raised new conceptual issues.[1] In every country, there was a continual and natural tension between governments' wish to control and manipulate monetary policy for the sake of short-term growth and short-term political advantage, and the logical prerequisites for long-term monetary stability. If stable money were to be an international rather than a merely national good, that conflict would take on an additional level of complexity. That was especially the case in the European context, where there were contrasting philosophies of monetary management, with on one side an entrenched German view of the importance of central bank autonomy, and on the other side a French emphasis on traditions of economic management and the primacy of politics.[2]

Unlike the late 1970s, when the principal push for a new European monetary solution came from high politics, and in particular from an initiative of Chancellor Helmut Schmidt and President Valéry Giscard d'Estaing, when the push for monetary union was renewed in the late 1980s, EC Commission President Jacques Delors was keen to ensure that central bankers played a critical part in designing the new institutions and laying out the blueprint for transition. Central bankers composed the dominant majority of the Delors Committee that in 1988-89 sketched out the road to monetary union; and central bankers also played a crucial part in designing the institutional realization – one that not surprisingly (given who was in charge of designing it) accorded a high priority to the realization of central bank independence.

The Delors Report envisaged monetary union as the establishment of "a currency area in which policies are managed jointly with a view to attaining common macroeconomic objectives". It would be achieved in stages: in the first, anticipating a treaty changing the character of the European Communities, the European central bank governors would establish sub-committee dealing with monetary policy, with exchange rate policy and banking supervision. In the second stage, the new European System of Central Banks (henceforth ECSB) would absorb the already existing Committee of Governors of the Member Countries of the European Communities, and would manage the transition from the combination of monetary policies of national central banks to a common monetary policy. In the third stage, exchange rates would

1. This paper draws heavily from H. JAMES, *Making the European Monetary Union: The Role of the Committee of Central Bank Governors and the Origins of the European Central Bank*, Harvard University Press, Harvard, 2012.
2. See N. JABKO, *The Hidden Face of the Euro*, in: *Journal of European Public Policy*, 3(2010), pp. 318–334.

be locked finally and irrevocably. The ESCB would then pool reserves and manage interventions with regard to third currencies.

The Committee of Governors of the Member Countries of the European Communities (henceforth CoG) occupied a central role in this debate. It had originally been created in 1964, in response to a feeling that European monetary matters had been subject to too much discussion and intervention at a global level (in particular with US involvement). It offered a sanctum where central bankers could commune in an environment largely free of immediate political pressure. In the early 1990s, the CoG was chiefly responsible for drawing up the details of a new monetary constitution, and thus for leaving its intellectual imprint on Europe's future monetary institutions. In the aftermath of the Delors Report, the CoG began to transform itself from a committee or forum for the exchange of ideas and information into the skeleton apparatus of a central bank. The translation of the Delors Report into a potential basis for a new central bank depended on the extension of the existing, rather informal, group structure of the CoG. The governors, in their personal capacity, had constituted the core of the Delors Committee. The report provided the big vision, as it were the poetry of monetary reform. The governors now hoped that they would be able to write the "prose version" of the treaty provisions that would govern any new institutional advance. There was an explicit acknowledgment that, far from being marginalized as the governors had feared at the outset of the negotiations about the new monetary order, the CoG was the "prefiguration" of new institutions.[3]

A political science distinction is helpful in considering the function of the central bankers in developing notions from the Delors Report into an institutional reality. The Delors Committee has sometimes been described as an "epistemic community" in that its success depended on its ability to project a shared vision. What distinguishes an epistemic community from a merely bureaucratic body is that whereas the bureaucracies "operate largely to preserve their missions and budgets", the epistemic community applies "consensual knowledge to a policy enterprise subject to their normative objectives".[4] Bureaucratic structures are much more limited, and cannot easily work in a transformative way, because they are protecting interests rather than promoting ideas. By contrast, the process described in this paper is less one of bureaucratic capture than of the promotion of an idea or a vision.

The development of central banking corresponds with a broader international movement to produce a framework for managing globalization through the introduction of new rules but also by unburdening the political process by delegating respon-

3. Interviews. See also HADB [Historisches Archiv der Deutschen Bundesbank, Frankfurt], B330/18436, Betr. Tagung des Gouveneursausschusss am 11. Juli 1989, 05.07.1989; BdF [Archives of the Banque de France], 1489200205/11, A l'intention de M. Lagayette: Commentaires sur la lettre de M. Van Wijk à Gunter Baer, n.d. [1992].

4. A. VERDUN, *The Role of the Delors Committee in the Creation of EMU: An Epistemic Community?*, in: *Journal of European Public Policy*, 6(1999), pp.308–328; P.M. HAAS, *Introduction: Epistemic Communities and International Policy Coordination*, in: *International Organization*, 1(Winter 1992), p.19.

sibilities to transnational experts.[5] The visionaries associated with this process at both the international and the European level were largely French, and came from a French school of thinking of how experts might manage policy: the crucial roles were played not only by Jacques Delors but also by Jacques de Larosière, Governor of the Banque de France in the early 1990s, but a former prominent international civil servant as Managing Director of the International Monetary Fund. Jean-Claude Trichet, director of the French Treasury, and Pascal Lamy, Delors' chef de cabinet, figures who later became central to the business of managing globalization, already played a prominent part in the debates of the early 1990s.

Drawing Up a Statute

The framing of the new European monetary order occurred in several different contexts: the tensions following from German monetary policy, which created problems for French policymakers (and also for US policymakers); the political suspicions following from the sudden German unification process in 1990; but also a longer-term debate about the desirability of central bank independence. A fundamental conflict broke out over the choice of the forum that should realize the proposals of the Delors Committee. The French and German Finance Ministers, Pierre Bérégovoy and Theo Waigel, met on August 24–25, 1989, at Rottach-Egern on the South German Tegernsee, a meeting that proved to be the beginning of a period of very close German-French rapport on monetary arrangements. Both Ministers agreed to push for the Monetary Committee and the CoG to be the central arenas for discussion. The central bank governors, Jacques de Larosière and Karl Otto Pöhl, as well as Jean-Claude Trichet, director of the French treasury, were also prominent participants in the Tegernsee meeting. The financial experts faced some competition: a study group under President François Mitterrand's policy adviser Elisabeth Guigou believed that it was Foreign Ministers who should be responsible for a proposal that would lead to a new EC treaty, and wanted to exclude the technocrats. But the Guigou paper was largely ignored, and the central bankers continued to play the central role in preparing for monetary union. The EC Monetary Committee then prepared a paper that was presented to an informal ECOFIN and CoG meeting in Ashford Castle (March 31–April 1, 1990) in Ireland, which in practice left the elaborations of the detailed draft to the CoG.[6]

When central bankers design a new central bank, they obviously draw lessons from their own experiences. In the 1960s the members of the CoG had emphatically asserted their independence from Community institutions, from the Commission and

5. R. ABDELAL, *Capital Rules: The Construction of Global Finance*, Harvard University Press, Cambridge Mass., 2007.
6. See C. MAZZUCELLI, *France and Germany at Maastricht: Politics and Negotiations to Create the European Union*, Garland, New York, 1997, pp.65–66.

the Council; but in reality the majority were highly dependent on governments and Finance Ministers. The debate of the early years had thus focused heavily on the relations of national governments with European institutions. The general issue of central bank autonomy or independence, which had been a prominent concern in the 1920s, in the era of the fiercely proud Bank of England Governor Montagu Norman, was not very widely discussed in the golden years of post-1945 economic growth. In part, monetary policy was not seen as a centrally important part of general economic policy-making; in part, the international fixed-exchange-rate system provided a simple monetary rule.

In the 1970s high levels of inflation and the end of the par value system ensured that there was more discussion not only of monetary policy (including at the CoG), but also of the circumstances in which an optimal monetary policy could begin to be implemented.

Two large issues emerged as crucial, the first concerning the status of a central bank, the second relating to the policy guidelines to be adopted. The two were clearly closely related in that a wrong institutional framework for central banking might be expected to lead to bad policy decisions. In both cases, there was a wide variety of practices among the national European central banks. Achieving some sort of reconciliation between the different modes of operating appeared to be an intractable issue, but during the 1990s both questions were resolved. The first was resolved by the treaty process. The issue of monetary policy formulation could not be dealt with in this way, and in fact it was eventually handled in the European Monetary Institute through the development of a new institutional mechanism.

Realizing Central Bank Independence

Central bank independence was at the core of the discussions of the Delors Committee and of the recommendations of the Delors Report, as well as of the controversies that it provoked at the political level, especially in Paris. Without inclusion of this principle, the text would have been unacceptable to Germany. The result was reflected in the draft statute evolved by the alternates in 1990, whose first article seemed to echo the terms of the 1957 Bundesbank Law. But the key to independence was actually not to be found in the specific text of an article of the statute, but rather in the mechanism for putting the statute into force.

Three aspects of the new institutional arrangements were vital to German willingness to move to sacrifice the Bundesbank's role in monetary policy. First, a national law, even one such as the Bundesbank law that seems to command a deep national political consensus, could always be altered by legislative process. On the other hand, altering an international treaty that created the European Union would require the unanimity of the signatories. Consequently, Bundesbankers who reflected on why their 1980s scepticism about economic and monetary union (EMU) had turned into later support for the process always gave the answer that what mattered was central bank independence; and that while the Bundesbank was protected by a law, the ECB was backed by an international treaty. This operation seemed to echo one of the most successful operations in German monetary and economic history: the currency reform of 1948 and the new monetary institutions (the Bank Deutscher Länder, the forerunner of the Bundesbank) were not the creation of German law, but originated from an Allied military government. Many Germans quickly realized that in the long run this setting of monetary institutions outside a democratic framework made them better off, as it removed the institution from political controversy and from the temptation to politicians to make legal and institutional changes. The second vital aspect of the new arrangements lay in a mechanism for excluding the European Parliament from any influence on monetary policy-making. The Frankfurt central bankers saw the risk that transferring the business of central banking to a European level would involve a new array of political actors, including the EC Commission and the European Parliament.[7] Third, there was an awareness that law and practice do not always conform. The Bundesbank negotiators were particularly emphatic in their insistence that independence had to be a "lived reality".[8]

The EC Monetary Committee found two aspects of the institutional architecture problematic. What would happen in Stage Two? Germany, supported by a broad grouping of Belgium, Luxembourg, Denmark, Ireland, and the Netherlands, saw no real need for Stage Two institutions at all, besides offering the kind of technical functions that the CoG in fact already provided. A separate stage was therefore redundant, and would only be an unnecessary and unwelcome invitation to increased politicization of central banking. By contrast, France and Italy, while recognizing that ultimate responsibility would remain with national authorities until Stage Three, thought that there would be a need for a "factory" to be established during Stage Two in order to create the basis for immediate policy effectiveness in the next stage.[9]

A further issue was raised by the prospect of the availability of new financial resources. Who should control them, and on the basis of what conditionality? The history of EC conditionality was a saga of softness and failure, and interestingly there was no distance between France and Germany on this issue. Discussing the deteriorating situation in Greece in late 1989, the French treasury director Jean-Claude Trichet wondered whether a new conditionality mechanism should be applied to a new loan, but went on to comment that "the IMF was the better vehicle for conditionality". Hans Tietmeyer, then State Secretary in the German Finance Ministry, agreed, on the grounds that EC discussions tended to be politicized and affected by interest linkage. As he put it, "Country conditionality would be watered down by politics, including by interventions by the Commission and the Foreign Affairs

7. CoG [Committee of Governors archive, European Central Bank Frankfurt], Alternates discussion, 08.01.1990.
8. Interview with Helmut Schlesinger.
9. BoE [Bank of England Archive, London], 8A/225/2, Monetary Committee meeting, 24.04.1990.

Council".[10] The whole history of European integration was one of sharp limits on attempts to impose conditionality on member countries.

In seeking to avoid politically influenced monetary decisions, the Monetary Committee was writing itself out of the future of the European design and making central bankers the decisive part of the process. At the May 1990 meeting of the MC, there was a consensus to recommend guarantees of the institutional, operational, personal, and financial autonomy of the national central banks operating in the new system. In line with the German views, the Monetary Committee report of July 1990 emphasized that the passage to Stage Two and Stage Three might not necessarily be made simultaneously by all member countries, and that measures should be taken to reinforce market discipline over budget deficits. The Monetary Committee's "orientations" for the intergovernmental conference (IGC), needed to prepare an amendment to the Treaty of Rome, provided for a procedure for monitoring and avoiding excessive deficits. It recognized that member states needed to remain "masters of the main aspects of budgetary policy", but at the same time stated that "a stability-oriented monetary policy can in the long run only be successful if supported by sound budgetary policy". That meant a prohibition on the monetary and compulsory financing of public deficits, and a no-bailout rule: "It must be clear that the member states do not stand behind each other's debts". In the MC's view, the consequence of such a rule would be that financial markets would exert discipline by imposing differential interest rates and "ultimately by refusing to lend". A majority of the committee wanted to establish a mechanism for enforcing legally binding positions, perhaps through the European Court of Justice.[11]

The CoG made a similar point. As its chairman Karl Otto Pöhl presented the governors' conclusions to an informal ECOFIN meeting in March 1990, he "stressed the importance of budgetary discipline and its key role in the Economic Union, which must be realized in parallel with the Monetary Union. Sound budgetary policies are indispensable and complementary to stability-oriented monetary policies". Pöhl emphasized that

> "it is essential to avoid in the future the repetition of developments often observed both within and outside the Community, namely that budgetary laxness has been tolerated on the basis that monetary policy would compensate for any shortfall".[12]

The emphasis on central bank autonomy raised questions about the future role of the EC Monetary Committee (henceforth MC). A strengthening of the central bank side of cooperation might logically imply that central banks should no longer be represented in the MC: such a stance was taken by the German government. Many Finance Ministers saw a strengthening of the Monetary Committee as a necessary counterweight to the central banks, and some suggested that as the national central bank governors and then the ECB acquired greater authority and autonomy in the monetary

10. BoE, 8A/225/1, Monetary Committee bureau, 21.10.1989.
11. CoG, Monetary Committee: Economic and Monetary Union beyond Stage 1: Orientations for the preparation of the intergovernmental conference, 26.03.1990.
12. CoG, 31/1–7, Report by Chairman to Informal ECOFIN, 26.03.1990.

policy sphere there should be a clearer separation of powers with regard to monetary and fiscal policy.[13]

Meanwhile the CoG began to run with the ball on institutional design of the new central banking system. In April 1990 Pöhl made a proposal at the CoG for draft statutes on the objectives, organization, functions, instruments, and voting system of a new bank.[14] In May Delors distributed a note from the Commission about the institutional character of EMU. In particular, the Commission was concerned about three issues: voting within the ECB, democratic control, and external monetary policy. The Commission proposed a weighted voting system as in the EC, with the addition that the ECB board should be required to cast its vote as a bloc to avoid divisions. The "reconciling of Eurofed independence with democratic control" was quite problematical. The term preferred by the Commission to describe the future institution, Eurofed, captured some sense of the desirability of political control in its allusion to the American model; the CoG's favourite term, the European System of Central Banks, did not. But both versions saw some attraction in the US example.[15]

The governors were resistant to any hint of political supervision, and believed that any measure of political control would in practice mean pressure to inflate. They also wanted to escape from any obligation to accept quantitative inflation targets – a view that was gaining acceptance among policy-oriented academic economists.[16]

Pöhl believed that "responsibility for monetary policy was indivisible – he had already said so at a conference in Paris – but some might not take that view and might propose other solutions". The preparation of the statute thus set off an intense political clash. The governor of the Bank of England began to worry about a "two-speed Europe" dominated by a "German bloc" with locked exchange rates, but with a looser periphery where exchange rates continued to move.[17]

At its meeting on June 26–27, 1990, the European Council asked the CoG to undertake preparatory work for the forthcoming intergovernmental conference on monetary union, which would run in parallel with an IGC on political union. The CoG took as its guideline two principles: price stability as the primary objective of the central bank; and the indivisibility and centralization of monetary policy. This would not be "in contradiction with the principles of federalism and subsidiarity".[18] The model of the Bundesbank looked powerfully attractive as a guide for central banking practice, and many participants felt that the new institution was in fact de-

13. BoE, 8A/225/3, J.A.A. Arrowsmith, Future Role and Composition of Monetary Committee, 06.02.1991.
14. See also C.A. VAN DEN BERG, *The Making of the Statute of the European System of Central Banks: An Application of Checks and Balances*, Dutch University Press, Amsterdam, 2004, p.6.
15. CoG Meeting 245, Basel, 15.05.1990.
16. B.S. BERNANKE et al, *Inflation Targeting: Lessons from the International Experience*, Princeton University Press, Princeton, 1999.
17. BoE, 4A39/11 EEC, Note, 18.06.1990.
18. CoG, Introductory Report to the Draft Statute of the European System of Central Banks, 18.09.1990. Subsidiarity is the principle that decisions should be made at the lowest level of authority practicable: national rather than European, and provincial/state rather than national.

signed to replicate the structure and philosophy of the Bundesbank. In the draft statute prepared by the CoG, there was a direct echo of the relationship of the German central bank to the government in Article 2, specifying the "objectives" of the system, and stating that the System of Central Banks would "support the general economic policy of the Community". Yet at this point the Community had no mechanism for defining a single economic policy to go alongside the single monetary policy of the new central bank, and the phrase was consequently altered by the government negotiators into the much less intellectually satisfactory obligation to "support the general economic policies in the Community".

As a result of the dialogue between the European Council and the CoG, the alternates were assigned the responsibility of producing a draft statute on the basis of the principles that had been at the core of the governors' discussion in May 1990. The initial debates focused upon the name: should the new institution be called the European Central Bank, or should it have a "lower-profile" name, such as Authority or Agency? Should it be given the task "to support the stability of the financial system"? This phrase was placed in square brackets to indicate that it was controversial. What should the legal status of the institution be in the Community?[19]

A report to the CoG alternates' committee by a group of legal experts in August 1990 set out the quadripartite institutional structure of the EC (Parliament, Council, Commission, Court of Justice) and pointed out that the European Investment Bank and the Centre for Vocational Training were "Community organs". But a central bank was not analogous to these institutions, and the report recommended very strongly that the European System of Central Banks should not be classified as an EC institution.[20]

At the same time, the insistence on the independence of the central bank explicitly echoed the much older debate about the relationship of the Commission to national governments. The wording chosen in Article 7 on autonomy deliberately recalled the language of 1967 describing the role and position of the European Commission:

> "in the performance of their duties, they [Commissioners] shall neither seek nor take instructions from any Government or from any other body.[…] Each Member State undertakes to respect this principle and not to seek to influence the members of the Commission in the performance of their tasks".[21]

In July the CoG agreed on the "one man one vote" principle for the ECB Executive Board, which in case of a conflict would apparently mean that the effective power of the Bundesbank would be greatly reduced. There would be no rotation of voting equivalent to the arrangement that prevails in the Open Market Committee of the Federal Reserve Banks, in which only the New York bank (perhaps to be considered the American equivalent of Frankfurt as the site of the financial powerhouse) has a

19. CoG, Committee of Alternates, July 24, 1990, Draft Statute.
20. CoG, Meetings of Legal Experts on certain aspects relating to the draft Statute of the "System", 31.08.1990.
21. C.A. VAN DEN BERG, op.cit., p.104.

permanent vote.[22] The central bankers thus rejected the original plan of the EC Commission, which would have made the system much more political. The shift later attracted a great deal of criticism in Germany, which looked to be the loser if the institution was viewed in terms of a balance of power, with influence shifting to the numerous softer-currency and Southern countries. But in fact the decision reflected the experience of successful consensus forming in the CoG, and indicated the extent to which the Bundesbank was now prepared to trust the stability-oriented monetary philosophies now emerging in other central banks. In the end the exercise of consensus formation, combined with the avoidance of the formal votes that characterized the Federal Reserve's Open Market Committee, generally would give German interests a greater rather than a lesser voice in the ECB Council. But this design element was also probably predicated on the assumption that the accession criteria to the EMU would be set sufficiently strictly to stop the inclusion of very soft countries; the design would indeed eventually prove to be problematical with the expansion of membership in EMU.

By September 1990 there was substantial agreement on the major design features, including independence and the unitary monetary policy, but some disagreement remained about the division of responsibilities between the Council and the Executive Board of the ECB, and how operations might be decentralized without impairing the implementation of a unitary monetary policy and coherent exchange rate policies and operations. The options ranged from including all national central banks within the system to maintaining central banks with their own balance sheets, with specified contributions to a central institution.[23]

The Bundesbank's response to the remaining uncertainties was to press for all monetary policy-making to be concentrated in the ECB Executive Board.[24] Such an arrangement would be less political, less subject to a confrontation of divergent national interests on monetary policy, and would prevent national central banks from smaller or softer countries from playing an excessive role. But this solution, in which decisions were left to the small board, attracted some opposition, as a board that was not directly linked to the national central banks might develop into a new and dangerous sort of supranational monetary government.

The alternates' discussion occurred at the same time as positions at the political level had become harshly polarized. A dispute had flared up in the aftermath of the October 27 and 28, 1990, meeting of the European Council in Rome. At Rome, the discussions had been carefully channelled by Italian civil servants, notably by Tommaso Padoa-Schioppa. Italian Prime Minister Giulio Andreotti had managed to push through an agreement to start Stage Two on January 1, 1994, largely by securing in advance the agreement of Chancellor Helmut Kohl. In its meeting, the European Council wanted to call the monetary institution created in Stage Two the European Central Bank, but the Dutch government quickly responded with a statement that also

22. CoG, Meeting 247, Basel, 10.07.1990.
23. CoG, Secretariat Note: Draft Statute, 05.09.1990.
24. CoG, Stellungnahme zum Draft Statute, 09.09.1990.

reflected the position of the Bundesbank. According to The Hague, the new institution was something different from an ECB. The main German and Dutch fear was that if there were to be a gradual institutional evolution of the ECB, the door would open to increasing political pressure on policy, as well as in regard to the potential membership of a monetary union.

The EC Rome meeting laid out plans for a market-based EMU, which would promote both price stability and growth. The Monetary Union involved a new independent monetary institution, responsible for single monetary policy based on a single currency, and with a primary goal of maintaining price stability. Stage Two was to begin on January 1, 1994, and, in advance of that date, EC member countries would be under an obligation to participate in the EMS exchange rate mechanism (ERM). In that stage, the monetary institution would reinforce the coordination of monetary policy, prepare a single monetary policy, and supervise the development of EMU. There was a "process" that would "ensure the independence of the new monetary institution at the latest when monetary powers have been transferred".[25]

The UK government fiercely objected to the outcome of Rome, because of the road map it laid down for monetary union, but London was isolated in its stance. Other governments accepted but noted the lack of clarity about whether Stage Two was conditional on fiscal improvement, and whether the monetary institution was the same as in Stage Three, namely the European Central Bank.[26] Tommaso Padoa-Schioppa and the Banca d'Italia believed that the institution created in 1994 would be the ECB. This was implied in the agreement reached at the Council, though not explicitly stated. The October 1990 Rome communiqué had stated: "At the start of the second phase, the new Community institution will be established".

There were thus two parallel fault lines: one in which Britain looked isolated from all the other member countries, and a second running between France and Germany. In November 1990 the EC Monetary Committee was the scene of a bitter clash involving Trichet and the British, when Trichet ridiculed the British proposal for a hard ECU (which in some ways looked similar to de Larosière's proposals in the Delors Committee, and to older French ideas of a parallel currency). Trichet saw this new proposal emanating from London as little more than a delaying tactic.

When the CoG discussed the draft statute in November 1990, the controversies focused on three major elements, and in each case the Bundesbank representatives were insistent on a solution that translated German answers onto the European level.[27]

1. Exchange Rate Intervention. Exchange rates are obviously political, and attempts to fix global exchange rates had been negotiated not by central banks but by

25. European Council in Rome, October 27-28, 1990, Conclusions of the Presidency, available as: http://www.europarl.europa.eu/summits/rome1/default_en.htm, accessed 01.12.2011.
26. A. ITALIENER, *Mastering Maastricht: EMU issues and How They Were Settled*, in: K. GRETSCHMANN (ed.), *Economic and Monetary Union: Implications for National Policy-makers,* M. Nijhoff, Dordrecht, 1993, p.64.
27. CoG, Meeting 249, Basel, 13.11.1990.

governments, either through the IMF or later increasingly in the framework of G-7 Finance Ministers' meetings. Even in Germany, the Bundesbank was not responsible for foreign exchange policy according to the 1957 Bundesbank Law; and one of the most long-standing struggles of the Bundesbank involved the argument that the government should recognize that foreign exchange policy had consequences for monetary policy. In particular, the Bundesbank shied away from the possibility of intervention commitments that would require the use of Deutsche Marks with potentially inflationary consequences in Germany. From the French point of view, however, a great deal of the attraction of new institutional arrangements lay in the improved management of exchange rates. This was particularly a topic for discussion at the Monetary Committee meetings, where the French treasury pressed especially vigorously for the view that government should determine and define the external value of the currency. The Bundesbank's Hans Tietmeyer tried to counter that exchange rate policy was properly the business of the central bank (although, in reality as well as in German law, that responsibility fell to the government). In the CoG discussions, Pöhl was sceptical about the desirability of including references to exchange rate intervention.[28]

The Bundesbank and De Nederlandsche Bank suggested adding to Article 4 the requirement that the Community's exchange rate policy be subject to the consent of the ECB.[29] The result, which appeared as a formulation in the Maastricht Treaty, was seen by the Bundesbank as a European equivalent of the famous Emminger letter, a get-out clause that protected the central bank from really extreme consequences of foreign exchange commitments by governments.

At the March 12, 1991, intergovernmental conference personal representatives (the negotiators immediately below the ministerial level) and the March 18 ministerial-level meeting, German State Secretary Horst Köhler insisted that the principle of unanimity applied to Council decisions on the exchange rate system, so that Germany would in practice hold a veto. Finally, at the IGC ministerial level of December 2–3, 1991, German Finance Minister Theo Waigel achieved what was thought to be a German victory with the formula that "general orientations" rather than "guidelines" would be given by EC governments on exchange rate policy. Article 109.2 of the Maastricht Treaty eventually stipulated: "These general orientations shall be without prejudice to the primary objective of the ESCB [European System of Central Banks] to maintain price stability".

2. <u>Lender of Last Resort Functions</u>. It would be reasonable to assume that the central bank issuing a new currency would take over the functions normally associated with existing national central banks. But assumptions about central banks' operations – and their willingness to state clearly what the objectives were – varied significantly from country to country. In particular, the Germans worried about the moral hazard implications of central bank regulation of the financial sector. Before the First World War, the German Reichsbank had been widely viewed as providing

28. CoG, Meeting 249, Basel, 13.11.1990.
29. CoG, Draft Statute Commentary, 21.11.1990.

the ultimate support of the financial sector. Its origins lay in a response to the severe financial crisis of 1873, and the big German banks saw the central bank as a backstop. But the experience of hyperinflation in the 1920s led to a new approach, and a feeling that unlimited support for the financial system contained a danger to monetary stability; and in consequence, the idea of a central bank as a lender of last resort had much less support in late-twentieth-century Germany than in the Anglo-Saxon world, where Walter Bagehot's treatise of 1867, Lombard Street, was still widely regarded as the basic text for modern central bank behaviour.

There was thus considerable uncertainty about the wording of the statute on financial sector regulation. In the draft produced by the governors' alternates (who played a vital role in the drafting process), the "tasks" of the ECB included "to support the stability of the financial system"; and Article 25 on "Prudential Supervision" included quite extensive tasks for the ECB, which were placed in square brackets to indicate that they were not yet consensual. The Bundesbank wanted to avoid references to an explicit role for the ECB in supervising banks, as "these two Articles could be misinterpreted as a lender of last-resort function".[30] As a consequence, the items in square brackets were in the end excised from the CoG draft.

3. Supervisory Board. The Delors Report had recommended the appointment of a supervisory board for a new European central bank. Such a provision would necessarily have provided a higher element of political involvement and control. The governors now abandoned any such proposition. Again, this step was in line with the preferences of the Bundesbank, which was confident that it provided a good institutional template for a future European monetary order, and that the directorate or bank council should bear sole responsibility for setting monetary policy.

Further Negotiations

When the European Council started the two parallel IGCs, one on political and the other on monetary union, a new round of controversy broke out, along the lines of the old divisions between a German view, which was now termed "fundamental" about the need for gradual policy convergence (that had in the 1970s been called the "economist" perspective), and the Italian and French position, formerly known as "monetarist" but which was now given the sobriquet "telescopic". In the latter view, a quick transition would bring a shock therapy to harness market forces so that nominal convergence in goods markets as well as in financial markets would be accelerated. The German enthusiasm for monetary union seemed to have cooled.[31]

30. CoG, Meeting 249, Basel, 13.11.1990.
31. *Rome Summit*, in: *Financial Times*, 17.12.1990. See also D. GROS, N. THYGESEN, *European Monetary Integration: From the European Monetary System to Economic and Monteary Union*, Longman, Harlow, 1998, pp.407-409.

Italy tried to refocus the discussion on the need for a quick establishment of the ECB. In December 1990 the Banca d'Italia circulated a memorandum in the CoG, "The Functions of the European Central Bank in the Second Phase of Economic and Monetary Union". It tried to distinguish between "qualitative" policy (the structural characteristics of policy instruments), which would be made by the new institution, and "quantitative" policy (interest rates and liquidity), which would remain with the central banks. At the end of the second phase, with a common approach to open market operations and minimum reserves, the ECB would also take over monetary policy. But already in the second phase there would be foreign exchange interventions conducted through the ECB. In addition, the ECU would be strengthened through a specification of conditions for foreign exchange interventions in private ECUs.[32]

The Italian initiative looked as if it corresponded quite precisely to a draft treaty presented on December 10, 1990, by the EC Commission, which referred to a "Eurofed" already instituted in Stage Two, a stage that would not be conditional on any policy convergence.

The discussion prompted by these initiatives polarized the CoG in the subsequent meeting (January 8, 1991). De Larosière echoed the Rome communiqué when he said that he wanted to set up "at the beginning of Stage Two an ECB and an ESCB as defined in the draft Statute". Stage Two would be of only limited duration and simply be concerned with the preparation of Stage Three. By contrast, Pöhl tried to downplay the consequences of the language used at Rome. The communiqué "should not be seen as a legal document but as a statement of political intent". Henning Christopherson, the EC Commissioner for Economic and Financial Affairs, thought that the second stage would include "an embryonic form of the ECB and ECSB".[33]

The clash of the Italian and French approach with that of the Germans and the Dutch was sidestepped as another front opened up in the conflict over institutional design. It concerned the way in which a new money should be established. Three governments (the United Kingdom, Spain, and France) put forward alternative visions to that of the CoG draft, in which the single currency was an evolution of the ERM's basket currency: the United Kingdom, wanting to signal its distance from the project, proposed a radically incompatible alternative based on the idea of a hard ECU.[34] There should be no basket currency, and no reliance on one national currency, but rather a link to the most stable currency at the time. In case of realignments, the hard ECU would thus never be devalued against any participating currency. Spain identified in substance with major elements of the British proposal, and urged a hard basket, in which there would be a change in the basket composition of the ECU at each realignment, to ensure that the ECU would not be devalued against the strongest

32. BdF, 1489200205/90, Banca d'Italia. The Functions of the European Central Bank in the Second Phase of Economic and Monetary Union, 24.12.1990; see also K. DYSON, K. FEATHERSTONE, *The Road to Maastricht. Negotiating Economic and Monetary Union*, Oxford University Press, Oxford, 1999, p.520.
33. CoG, Meeting 251, Basel, 08.01.1991.
34. United Kingdom Treasury, *Economic and Monetary Union beyond Stage One: Possible Treaty Provisions and a Statute for a European Monetary Fund*, 08.01.1991.

EMS currency, in other words the same feature as the British proposal for a stable European currency. But elsewhere there was a suspicion that the "hard ECU" was a wedge that was being deliberately and skilfully inserted by British negotiators in order to drive France and Germany apart.[35]

The most critical alternative proposal came from the French government, which saw in the CoG version too much of the hand of the Bundesbank, and pushed for a greater role for the ECU, as well as more political control of the ECB and a stronger role for the European Council. France also, like Italy, saw the EMS as part of the new treaty and consequently deduced a need for all member states to participate. French ministers advocated an idea of "economic governance" that should function at a political level in parallel to the new monetary institutions; and for a brief time Finance Minister Bérégovoy also took up the "hard ECU" plan. But then, in a dramatic meeting in the Elysée on January 26, 1991, President Mitterrand instructed him to desist; there should be "no reversal of alliances. The ally is Germany! The Brits are aligned with the United States"![36]

Germany's draft treaty proposals looked very different from the French or British schemes. Germany emphasized "ground rules" that were designed to ensure a genuinely competitive market and rapid price adjustment: a commitment to price liberalization, freedom of wage contracts, and a stipulation that price indexation would require the consent of the new central bank. Fiscal policy would be limited by a "golden rule" permitting deficits only to finance investment and not current expenditure. In Stage Two, there would be only a Council of Governors of the member states and no ECSB.

In the first part of 1991, under the Luxembourg presidency of the EC, the controversies in the preparation of the draft statute and a draft treaty focused on financial issues concerned with the operation of the ECB, and on the mechanisms for moving through Stages Two and Three. The Bundesbank worried that the central bank governors' documents were not treated as the basis for negotiations by the IGC of personal representatives, but were merely viewed as one option among many.[37] The personal representatives drew up a nonpaper that gave a decisive role to the political authorities in any decisions by the ECB to increase capital, as well as in the allocations of profits from the ECB operations to a reserve fund.[38] The Luxembourg proposals also provided for sanctions in regard to excessive deficits, and wanted to leave the decision on the start of Stage Three to the European Council.

According to the Luxembourg proposals, the ECB Board of Governors, essentially an enlarged version of the CoG, would take the place of the European Monetary

35. See R.H. HASSE, T. KOCH, *The Hard ECU—A Substitute for the D-Mark or a Trojan Horse?*, in: *Intereconomics*, 4(July/August 1991), pp.159–166.
36. K. DYSON, K. FEATHERSTONE, op.cit., pp.35, 227–228 and 678; J. QUATREMER, T. KLAU, *Ces hommes qui ont fait l'Euro: Querelles et ambitions européennes*, Plon, Paris, 1999, pp.202–203.
37. HADB, ZBR meeting 817, 28.02.1991.
38. CoG, Meeting 256, Basel. Report of Gunter Baer, 10.06.1991.

Cooperation Fund and assume the functions and powers of the CoG as early as Stage One, and its functions would then be transferred to the ESCB in 1996. Thus in effect Stage One would be subdivided into two substages. The ECSB would then take over responsibility for the operation of the clearing system.[39] That timetable was strenuously opposed by the EC Commission, and on June 10 at an ECOFIN meeting Belgian Finance Minister Philippe Maystadt proposed that a new institution, the European Monetary Institute, should be established in January 1994, right at the beginning of Stage Two. In response to the Luxembourg nonpaper, the CoG alternates worked on reconciling the original draft of the statute with amendments proposed by the IGC. Both the Banking Supervisory Subcommittee and the alternates wanted to retain the draft statute's provision on banking regulation. All except one of the alternates wanted to keep the ECB Statute's Article 21.1 on avoiding monetary financing of the public sector.

At this stage, although there was a substantial consensus among the governors about the no-bailout formulation of Article 21.1, prohibiting central bank purchases of government securities on the primary but not on the secondary market (where dealings in government securities constituted an essential tool of monetary policy), the CoG's staff was sceptical about the impact of such a restriction on future national fiscal policies in the monetary union.[40]

The CoG sent a revised statute to the EC presidency on April 26, 1991, with a mechanism for allocating income based on relatively simple population and GDP criteria, adjusted every five years, with the same key being used to determine subscriptions to the new institution, the transfer of foreign reserve assets, and the determination of voting on financial matters. The issue of amending the system's operation was handled by a simplified amendment procedure.

Maastricht

In September 1991 the Dutch central banker André Szász wrote an unusually candid note on what had been achieved in the lead-up to the Maastricht negotiation. He argued that the "tasks which are now vested in this committee [CoG] pursuant to a Council decision of 12 March 1990 but which have thus far remained in large measure a dead letter" should now be taken up once again: the coordination of monetary policy, the formulation of views on "the overall orientation of monetary and exchange rate policy", and finally, the responsibility of expressing

39. CoG, UEM 41/91, 43/91, Drafting of Articles 109d and 109e; The Presidency's Proposals for Stage Two of EMU, 03.05.1991.
40. CoG, 3.4/1–7, Economic Unit. Monetary Financing of Budget Deficits in Stage Three, 19.06.1991.

"opinions to individual governments and the Council of Ministers on policies that might affect the internal and external monetary situation in the Community and, in particular, the functioning of the European Monetary System".[41]

The functioning of the EMS had in fact become a very substantial threat to the negotiations on further European monetary integration.

The meeting of the European Council on December 9–10, 1991 in Maastricht, finalized the draft of a treaty that had substantially been prepared in advance. In particular, the statutes of the European Monetary Institute and the European Central Bank deviated from the governors' draft legislation only with regard to banking supervision and some of the claims for central bank independence. The most controversial aspects that were settled only at a late stage were the discussion of the entry criteria for EMU (with the German and Dutch preference for tough criteria) and the question of a British opt-out, which was the subject of frantic last-moment direct negotiation with the British Prime Minister, John Major. Article 109(e) specified under the transitional arrangements:

"4. In the second stage, Member States shall endeavour to avoid excessive government deficits.

5. During the second stage, each Member State shall, as appropriate, start the process leading to the independence of its central bank, in accordance with Article 108".

Article 109(f)3 laid down the way in which the EMI would prepare the transition: At the latest by 31 December 1996, the EMI shall specify the regulatory, organisational and logistical framework necessary for the ESCB to perform its tasks in the third stage. This framework shall be submitted for decision to the ECB at the date of its establishment. Finally, the crucial Article 109(j) set out the convergence criteria of

- the achievement of a high degree of price stability;
- the sustainability of the government financial position;
- the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other member state;
- the durability of convergence achieved by the member state and of its participation in the exchange rate mechanism of the European Monetary System as reflected in the long-term interest rate levels.

Article 109(j)4 set the timing of the transition to the third stage:

"If by the end of 1997 the date for the beginning of the third stage has not been set, the third stage shall start on 1 January 1999. Before 1 July 1998, the Council, meeting in the composition of Heads of State or of Government, after a repetition of the procedure provided for in paragraphs 1 and 2, with the exception of the second indent of paragraph 2, taking into account the reports referred to in paragraph 1 and the opinion of the European Parliament, shall, acting by a qualified majority and on the basis of the recommendations

41. CoG, Szász note, The position of the central banks during stage two, 20.09.1991.

of the Council referred to in paragraph 2, confirm which Member States fulfil the necessary conditions for the adoption of a single currency".

The treaty was signed in Maastricht on February 7, 1992, though its subsequent ratification was surprisingly rocky and threatened to destroy the EMS. The problem was a political one in that the debate about monetary union became embroiled in a general discussion of the single market and of the competence of national governments in a period of quite severe recession. But there was also a technical problem in that the EMS and its operation was built into the treaty by the convergence provisions of Article 109(j). Any major upset in the EMS would thus destroy the prescribed path to monetary union. An omen of the future difficulty came when the Bundesbank on December 19, 1991, just a few days after the conclusion of the Maastricht European Council meeting, voted to raise its interest rates.

Conclusion

The ECB statute represents the high-water mark of the idea of an independent central bank committed to the unique goal of price stability. The outcome of Maastricht was possible only because of the widespread consensus about central bank independence, which made it seem as if the astonishing act of European monetary integration could occur without any substantial transfer of sovereignty. Tommaso Padoa-Schioppa saw this emphasis on the independence of the central bank as part of a more general acceptance of "minimum government" that made a new stage of European integration possible.[42] As he implied, the discussion of central banking was part of a broader trend that prepared the way for what was later dismissively referred to as "market fundamentalism". But the consensus inevitably shone a new kind of spotlight on the central banks.

Had central bankers taken on too much of the burden of responsibility for providing a stable economic and social order? Had they insisted too much on the separation of central banking from politics? As an aftermath of the Maastricht discussion, European politics braced for a blame game in which central bankers played against politicians. A Euro-sceptic Briton wrote about this phase:

> "Many central bankers are intelligent, courteous and affable: your typical central banker is quite a high class of person, much nicer, one imagines, than your average politician. But politicians have at some point to confront the consequences of their mistakes; their unaccountable central bankers do not".

By contrast, a Europhobic American economist made the exactly opposite claim: "Central bankers are a tough, mean lot, but in the end the kind-hearted politicians will

42. T. PADOA-SCHIOPPA, *The Road to Monetary Union in Europe: The Emperor, the Kings, and the Genies*, Oxford University Press, Oxford, 2000, p.186.

tell them what to do".[43] Had politicians abdicated too much? That was the question that was tested in 1992 and 1993, in the immediate aftermath of the Maastricht Treaty. An astonishing series of violent financial crises destroyed the credibility of governments that had wagered their reputations on the ability to maintain fixed exchange rates. Markets then blew up governments. The outcome left central bankers more powerful and more prestigious than ever before.

43. B. CONNOLLY, *The Rotten Heart of Europe: The Dirty War for Europe's Money*, Faber and Faber, London, 1995, p.277; Martin Feldstein quoted in *From Bundesbank, a Clue to EC's Future Approach*, in: *New York Times*, 16.09.1992.