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The European Central Bank

One central bank, one currency, and one monetary policy for Europe. What will it mean for Europe — and for the United States? The structure and objectives of the new institution are described below and compared with the Federal Reserve. It is too soon to tell whether it will promote price stability or inflation. But its purposes are more political than economic.

On January 1, 1999, eleven member nations of the European Union (EU) began an historic undertaking in monetary cooperation by subordinating their national central banks and monetary policies to a European Central Bank (ECB). The countries involved are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.[1] The ECB, with headquarters in Frankfurt, Germany, and the eleven national central banks together make up the European System of Central Banks (ESCB). The structure and purposes of the new central bank were set forth in a treaty drawn up at Maastricht, the Netherlands, in 1992. This treaty revised and expanded the 1957 Treaty of Rome that established the European Economic Community (EEC), better known as the Common Market. Maastricht changed the community's name to the European Union, and as stated in its Preamble, was another step on the path to "an ever closer union among the peoples of Europe." So we may view the ESCB not only as an international central bank, which it is at present, but as a federal central bank for a single political unit, the EU, which it is intended to be. It is essentially like the German central bank, the Deutsche Bundesbank, which is also located in Frankfurt and was itself patterned after the American Federal Reserve System.

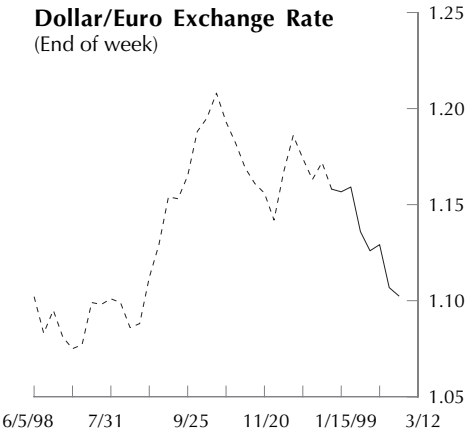
The Structure of the ECB and ESCB[2]

The new maker of monetary policy for Europe, the governing body of the ECB, is the Government Council, which consists of a six-member Executive Board and the eleven Governors of the national central banks. The President, the Vice-President, and the other four members of the Executive Board are appointed "from among persons of recognized standing and professional experience in monetary or banking matters by common accord of the Governments of the member states." The first President is Wim Duisenberg, former head of the Dutch central bank. The terms of the Executive Board are eight years and are not renewable, but political controversy has already been injected into these appointments. During the negotiations leading to his appointment, Duisenberg indicated that he would step down after four years as President to make way for Jean-Claude Trichet, Governor of the Bank of France.[3] Representatives of the EU's government, in particular the European Council and the European Commission, may participate in the ECB Council's meetings, but may not vote. The European Council consists of ministerial representatives of member states and is the primary decision-making body of the EU. The European Commission is the executive branch of the EU with responsibility for implementing the decisions of the European Council. The President of the European Council and a member of the Commission may attend ECB Council meetings and the former may submit "motions for deliberation." In addition, the head of the central bank may be invited to European Council meetings "when the Council is discussing matters relating to the objectives and tasks of the ESCB." So there are formal — and no doubt informal — avenues for the exchange of ideas between the central bank and the government of the European Union.

The Conduct of Monetary Policy and its Objectives

However, these exchanges are not supposed to infringe on the ECB's independence. Its activities must be transparent. The President must present "an annual report on the activities of the ESCB and on the monetary policy of both the previous and current year … to the Council and to the European Parliament, which may hold a general debate on that basis." And he and the other members of the Executive Committee may be summoned to appear before "the competent Committees of the European Parliament," and they may appear before the Committees on their own initiative. But these reports and consultations may not deflect "the primary objective of the ESCB," which "shall be to maintain price stability." The "basic tasks" of the ESCB are to

- define and implement the monetary policy of the Community;
- conduct foreign exchange operations



Note: The dashed portion of the plot represents the implied dollar/euro exchange rate following the peg of the euro currencies in June 1998.

[1] Of the other members of the EU, Denmark, Sweden, and the United Kingdom have chosen not to participate at present, and Greece has not yet met the requirements for monetary union. The main requirement is a small government deficit relative to gross domestic product.

[2] The quotations are from Title VI, "Economic and Monetary Policy," of the Maastricht Treaty. See Neville M. Hunnings and Joe M. Hill, *The Treaty of Rome Consolidated and the Treaty of Maastricht* (European Law Centre, 1992); and Richard Corbett, *The Treaty of Maastricht* (Harlow, Essex, UK: Longman, 1993).

[3] *The Economist*, May 9, 1998, p. 54. For an organization chart of the ECB and curriculum vitae of its decision-makers, see http://www.ecb.int on the internet.

The ECB and the Federal Reserve

	European Central Bank	Federal Reserve System
Membership of governing body	A 6-member Executive Board, with experience in banking and monetary affairs, for 8-year, non-renewable terms, appointed by member governments, and the Governors of the 11 national central banks.	A 7-member Board of Governors with 14-year terms, appointed by the President of the U.S., and the Presidents of the 12 Federal Reserve Banks, appointed by their boards of directors (primarily commercial bankers) subject to the approval of the Board of Governors. The main policy-making body, the Federal Open Market Committee, consists of the Board of Governors and 5 of the Reserve Bank Presidents on a rotating basis.
Objectives	Price stability. Other tasks such as managing exchange rates and the payments system and promoting growth and employment must be "without prejudice to price stability."	The *Federal Reserve Act of 1913* provided for "an elastic currency," the *Employment Act of 1946* obligated the Federal Government "to promote maximum employment, production, and purchasing power," expanded by the *Full Employment and Balanced Growth (Humphrey-Hawkins) Act of 1978* to "full employment, production, and real income, balanced growth, adequate productivity growth, and reasonable price stability."
Transparency/ Accountability	Government representatives may attend meetings and propose "motions for deliberation." The ECB must report on past activities and future plans, and testify to parliamentary committees.	The minutes of meetings must be published and the objectives of monetary policy — particularly ranges of monetary growth — must be transmitted annually to Congress. Federal Reserve officials appear frequently before congressional committees and meet regularly with members of the administration.

and enter into exchange rate agreements with non-Community countries subject to the objective of price stability;

- hold and manage the official foreign reserves of the member-States; and
- promote the smooth operation of payment systems.

The treaty requires the ECB to "support the general economic policies in the Community," which are "sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among member states." But the ECB's support of other goals must be "without prejudice to the objective of price stability." In order to limit pressures to inflate, governments are urged to avoid deficits, which in any case may not be monetized directly by the central bank: "Overdraft facilities or any other type of credit facility with the ECB or with the central banks of the member-states in favor of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of member-States shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments."

Publicly owned credit institutions were excluded from this prohibition. Public and private banks are to be treated alike. But the framers of the treaty were anxious to avoid the moral hazards of the too-liberal use of lender-of-last-resort facilities. "Any measure, not based on prudential considerations, establishing privileged access by Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of member-States to financial institutions shall be prohibited."

Despite the foregoing prohibitions, the euro is a purely fiat currency. The ESCB's gold holdings are not redeemable on demand and the bulk of its assets are debt instruments of the member governments of the EU, just as U.S. Treasury securities are the major holding of the Federal Reserve (despite a similar prohibition against direct purchases of Treasuries by the Fed). However, as far as we are aware, it has not been disclosed how the ESCB will allocate either its open market operations among the debt obligations of the various governments or its profits.

The most obvious manifestation of the European Monetary Union will be its common currency — the euro — that is to begin circulating in 2002. The ECB will have the exclusive right to issue currency in the Community, and it will be legal tender. The euro is already the official currency, but national currencies will continue to circulate on a "no-compulsion, no-prohibition" basis in the interim to give the public an opportunity to become accustomed to the new currency and the authorities time to replace existing currencies. The euro is already used in interbank transactions and is quoted on foreign exchange markets. It was the currency of choice for half of all new international bond issues during its first month of trading, January 1999, surpassing the U.S. dollar, which took forty percent of the total.[4]

Reasons for the ECB and the Euro: Costs and Benefits

Many people, especially in the United States and the United Kingdom, are inclined to judge European monetary union in terms of its direct economic costs and benefits. These are summarized below, but they are strictly secondary. The primary objectives of European Union have always been political. The Schuman Plan under which the European Coal and Steel Community (Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany) was formed in 1950 referred to the ultimate objective of a federal Europe. The EU has several federal characteristics similar to the United States, including a European Court of Justice and a European Parliament. Paul-Henri Spaak of Belgium, whose committee prepared the way for the EEC in 1957, said: "Those who drew up the Rome Treaty…did not think of it as essentially economic; they thought of it as a stage on the way to political union."[5] Walter Hallstein, first President of the EEC, said: "We are not integrating economies, we are integrating politics. We are not just sharing our furniture, we are jointly building a new and bigger house."

Turning from politics to economics, it is tempting to attribute some of the support for a unified monetary policy to the decline of Keynesianism. It is now generally accepted after the fiscal and monetary failures of the 1960s and 1970s that nationally independent monetary policies, far from being essential to domestic prosperity as Keynes argued, promote inflation that is inimical to economic well-being. But Continental Europeans, while sometimes big spenders for social purposes, never took the Keynesian counter-cyclical promises seriously. As a matter of fact,

[4] *Financial Times*, Feb. 2, 1999, pp. 1, 19, 28.
[5] To the Consultative Assembly of the Council of Europe, 1964. For this and the next quotation see, Derek Unwin, *The Community of Europe*, 2nd ed. (London: Longman, 1995), p. 76.

CONSUMER PRICE CHANGES IN 1998

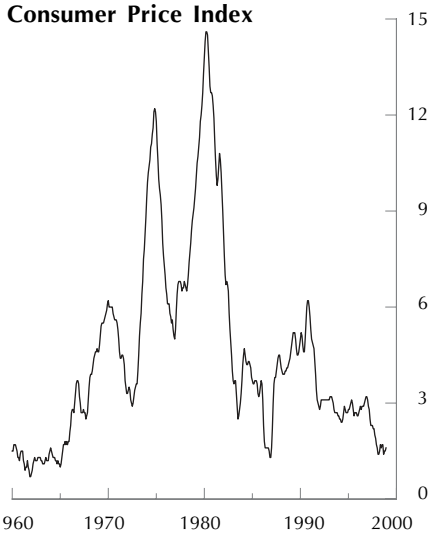
The Consumer Price Index increased just 1.6 percent last year, the lowest rate of price inflation in over a decade.

Taking into account measurement errors, the increase in the general price level was probably even less than indicated by the CPI. As can be seen in the accompanying chart, price inflation has not been this low since 1986. Since 1992, price inflation has averaged less than 3 percent a year, the best record since the 1960s.

The prices of many consumer goods and services fell last year, led by high-tech items like personal computers (down 36 percent), gasoline and fuel oil (down 15 percent), coffee, and pork. The price of butter, in contrast, soared 32 percent, and the price of tobacco products increased 32 percent, mainly due to higher cigarette taxes.

If you do not eat butter or smoke, these price hikes did not affect your cost of living. Likewise, lower computer prices benefit you directly only if you buy one. If you spent more than the average household last year on items for which prices increased relatively more, your cost of living probably increased more than the 1.6 percent increase implied by the CPI. Oppositely, if you bought relatively more of the items for which prices dropped, your cost of living may actually have decreased last year.

Annual Percentage Change in the Consumer Price Index



Percent Changes in Selected Consumer Price Indexes
December 1997 – December 1998

Expenditure Category	*Percent Change*
All Items	1.6
Food and beverages (16% of expenditures)	2.3
Food	2.3
Food at Home	2.1
Breakfast Cereal	2.0
Bread	2.5
Cookies	2.1
Meats	-2.2
Beef and Veal	0.1
Pork	-5.8
Bacon, breakfast sausage, and related products	-3.2
Pork Chops	-7.1
Poultry	2.6
Fish and Seafood	3.7
Eggs	-5.4
Milk	6.1
Cheese and related products	7.2
Ice cream and related products	7.2
Fresh fruits and vegetables	5.8
Apples	-1.1
Bananas	9.3
Potatoes	1.7
Citrus fruits	18.0
Lettuce	-8.8
Tomatoes	11.2
Canned fruits and vegetables	2.3
Frozen vegetables	1.7
Candy and chewing gum	1.1
Butter	31.7
Salad dressing	3.4
Peanut butter	2.2
Nonalcoholic beverages	-1.1
Juices and carbonated drinks	-0.1
Coffee	-8.8
Soup	1.4
Food away from home	2.5
Full service meals and snacks	2.8
Limited service meals and snacks	2.2
Alcoholic beverages at home	1.4
Beer and ale	1.6
Wine	1.4
Distilled spirits	0.7
Housing (40% of expenditures)	2.3
Shelter	3.3
Rent of primary residence	3.4
Owners' equivalent rent of primary residence	3.2
Hotels and motels	3.7
Fuels and utilities	-2.6
Fuel oil	-15.2
Electricity	-3.2
Utility (piped) gas	-3.5
Water and sewerage maintenance	2.7
Garbage and trash collection	2.8
Household furnishings and operations	1.2
Floor coverings	2.3
Window coverings	0.1
Bedroom furniture	-0.6
Living room, kitchen, and dining room furniture	1.6
Major appliances	-1.5
Clocks, lamps, and decor items	-1.2
Dishes and flatware	-0.6
Tools, hardware and supplies	-2.6
Outdoor equipment and supplies	0.5
Housekeeping supplies	2.0
Household operations	3.0
Gardening and lawncare services	1.5
Repair of household items	5.6
Apparel (5% of expenditures)	-0.7
Men's apparel	-0.4
Suits, coats, and jackets	-1.9
Shirts and sweaters	0.6
Pants and shorts	-0.1
Boys' apparel	-1.6
Women's apparel	-0.6
Outerwear	-3.6
Dresses	4.4
Suits and separates	-1.8
Girls' apparel	-3.4
Infants' and toddlers' apparel	3.0
Watches	-1.4
Jewelry	-2.2
Footwear	-0.5
Transportation (18% of expenditures)	-1.7
New cars	-0.1
New trucks	0.5
New motorcycles	0.4
Used cars and trucks	3.5
Car and truck rental	1.5
Motor fuel	-15.4
Motor vehicle maintenance and repair	3.0
Tires	-0.4
Motor vehicle insurance	-0.3
Motor vehicle fees	3.1
Public transportation	2.2
Airline fares	4.1
Ship fare	4.6
Public transportation within city	-2.7
Medical care (6% of expenditures)	3.4
Medical care commodities	4.1
Prescription drugs and medical supplies	4.9
Over-the-counter drugs	2.5
Medical care services	3.2
Physicians' services	3.3
Dental services	4.4
Eye glasses and eye care	0.6
Hospital and related services	3.2
Hospital services	3.1
Nursing homes and adult daycare	4.3
Recreation (6% of expenditures)	1.2
Video and audio	0.7
Televisions	-4.8
Cable television	6.9
Video cassettes, discs, and other media incl. rental	-6.1
Audio equipment	-7.4
Pet food	1.4
Veterinarian services	4.6
Sporting goods	-0.6
Photography	-0.7
Toys	-6.1
Sewing machines, fabric and supplies	-1.9
Music instruments and accessories	-0.4
Recreation services	3.7
Club membership dues and fees	5.0
Admissions	2.7
Fees for lessons or instructions	2.8
Newpapers and magazines	3.4
Recreational books	2.5
Education and communication (6% of expenditures)	0.7
Education	4.7
Educational books and supplies	6.0
College tuition and fees	3.9
Elementary and high school tuition and fees	6.0
Child care and nursery school	4.8
Communication	-2.9
Postage and delivery services	0.1
Telephone services, local charges	1.3
Telephone services, long distance charges	-1.0
Personal computers and peripheral equipment	-35.8
Computer software and accessories	-10.0
Other goods and services (4% of expenditures)	8.8
Tobacco and smoking products	31.8
Personal care	2.8
Cosmetics and related products	4.5
Haircuts and other personal care services	2.7
Legal services	4.2
Financial services	3.5
Funeral expenses	3.9
Laundry and dry cleaning services	2.3

the Werner Report proposed monetary union in 1970, and the member countries had embarked on the "snake in the tunnel" mechanism of exchange rates in 1972 that was derailed by the global monetary crises of the 1970s.[6] The snake was reinstituted in 1979 as the Exchange Rate Mechanism, and its success — made possible by growing fiscal conservatism and falling inflation — led to agreement on full monetary union at Maastricht in 1992.

The ECB's dominant goal of price stability could also have been — as it in fact was in the United States and the United Kingdom — an effect of the end of Keynesian economics. But the twin conditions of political independence for the central bank and price stability were understood from the beginning. "The Germans would simply not even consider a European Central Bank with less stringent rules than those of the Bundesbank."[7]

On the other end of the spectrum from the complaints of vestigial Keynesians about the loss of national macro-policy independence and the ability to produce inflations, advocates of competitive private money fear that monetary union will encourage inflation. Although Europe's link to German monetary policy — which is how the ECB can be interpreted — might be a step toward monetary stability, it reduces the number of safe havens available to money holders and might therefore have the opposite effect. In the course of his argument for unregulated money, Nobel laureate F.A. Hayek wrote that "the utopian scheme of introducing a new European currency … would ultimately only have the effect of more deeply entrenching the source and root of all monetary evil, the government monopoly of the issue and control of money."[8]

The ECB vs. the Federal Reserve

The features of the ECB and the Federal Reserve System that bear most directly on monetary policy are compared in the table. The transparency required of the two bodies is similar. Their actions are public knowledge, but the rationale of those actions as well as their intentions are also supposed to be made clear. The clearest distinction is between their explicit objectives, but differences between the kinds of people charged with the responsibility for those objectives may also be important. As already indicated, the ECB is patterned after the Bundesbank, which was modeled on the Federal Reserve System — with two major exceptions. First, price stability, which was written into the Bundesbank Act of 1957 and the Maastricht Treaty of 1992 as the paramount goal of macroeconomic policy, enters more-or-less equally with several other goals in American law. Second, the main governing body of the Federal Reserve System, the Board of Governors, was inserted at President Woodrow Wilson's insistence as a political "capstone," located in the political capital, to act in the "public interest." These differences make the Federal Reserve less independent of political and other pressures than the Bundesbank and the ECB, although it has more freedom of action than most of the world's central banks, which are little more than appendages of finance ministries.

Whatever the structures, personnel, and explicit goals of central banks, it must be recognized that their actions ultimately depend on the will of the electorate. Since its introduction in January, the new currency has not, as widely forecast in the financial press, fared particularly well against the dollar (see chart on first page). It remains to be seen, however, whether the ECB in the long run will be governed by the same antipathy toward inflation that has characterized the German political scene since the hyper-inflation of 1921-23, and seems to have gained a hold over the industrial world since the 1970s, or become an instrument of general European inflation. ❑

[6] Pierre Werner, premier of Luxembourg, headed a committee to plan a timetable for monetary union.
[7] Corbett, *op.cit.,* p. 4.
[8] *Denationalisation of Money*, 3rd ed. (London, Institute of Economic Affairs, 1990), p. 23.

Helen Longfellow Fowle Harwood, 1905 - 1999

With sadness at her passing, but with deep gratitude for a life well-lived, we report the death on February 15th of Helen Longfellow Fowle Harwood, 93, of Casa Dorinda, Montecito, California, of pneumonia following a 1995 stroke. Born in West Lebanon, New Hampshire, she was one of the first women sports reporters for the Boston Globe from 1928-1930, Registrar for the Engineering Economics Foundation, Boston, from 1930-1932, and Secretary of the Corporation to the American Institute for Economic Research from 1934-1964. She also was an AIER Incorporator and life-time Voting Member of the Corporation.

She married Col. Edward C. Harwood, founder and former Director of AIER, in October 1938 in Portsmouth, New Hampshire. She critiqued and helped edit many AIER publications and authored *How to Balance Your Budget*. She was an avid bridge player, was active in local scouting, and helped to arrange the first formal ballroom dancing classes for boys and girls in Gt. Barrington.

Helen Longfellow Fowle Harwood
June 29, 1905 — February 15, 1999

In addition to her sister Lucy E. Ruiter of Brunswick, Maine, she leaves her son William F. Harwood and his wife Diana Piatkowski Harwood; her daughter Eve C. Harwood of New York; her son Frederick C. Harwood and his wife Michelle Linder Harwood; and her daughter Katherine S. Delay and her husband Christian of Marina Del Rey, California. She also leaves two step-children, Marjorie Greer and her husband James of Nottingham, New Hampshire; and Edward T. Harwood of Exeter, New Hampshire. In addition to 5 grandchildren and 8 step-grandchildren, she leaves 7 great grandchildren and 17 great step-grandchildren.

She has made an anatomical gift of her remains to the University of Southern California School of Medicine. A family memorial will be held in Gt. Barrington later this year. Those who wish to may make donations in her name to their favorite charity.

PRICE OF GOLD

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