Independence and Accountability in the European Central Bank

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In the last years, many studies attempted to create an index capable of measuring central bank independence (CBI). The aim of these works was to verify the existence of an inverse relationship between CBI and inflation; or, in other words, if it is true that the more independent a central bank is, the lower is the inflation in the central bank's country. Bade and Parkin (1988) defined the first index through the analysis of twelve central banks' statutes, and found four degrees of CBI. Their most important finding was that the average rate of inflation is "significantly lower in countries that have highly independent central banks compared with those that do not", confirming the hypothesis of the inverse relationship. However, this index was too superficial, as the number of features analysed per each central bank was too low, and did not distinguish political (the capacity to choose the final goals of policy) from economic independence (the autonomy of choosing the instruments of monetary policy), but consider it as a whole. In order to overcome these limits, Grilli, Masciandaro and Tabellini (GMT, 1991) developed a new index, which was obtained adding together two separate indices: the political independence index and the economic independence index. GMT's index was more precise, as it considered fifteen features in total, against the three features selected by Bade and Parkin. Although it had significant differences with the former, this index presented a negative relation with inflation too. The same result was obtained by Eijffinger and Schaling's index[1] (1993), which, in addition to GMT's, took into account the different weights that every feature considered presented. Finally, Masciandaro and Spinelli (1994) compared the indices created by these and other authors, intending to find the most precise of them. They concluded that Grilli et al.'s was the most complete index, as it was the one considering the largest number of features. For this reason, although it considers only the statutes of the central banks regardless of their behavior, and it does not ponder the various features, GMT's is the index chosen to proceed in the study of the European Central Bank (ECB) structure.

Before doing so, it is useful to understand the *ratio* of the negative relation between CBI and inflation. The Political Business Cycles Theory (PBT), elaborated by Nordhaus (1975), argues that independent central banks are efficient at maintaining inflation low, because they are not subjected to politicians' pressures. According to the PBT, in fact, politicians only aim to maximise their chances of being re-elected by the voters, considered backward-looking and short-sighted in this framework. In this scenario, every incumbent/government will stimulate the aggregate demand at the end of its

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[1] Eijffinger and Schaling index, developed as a critique to Grilli et al.'s index, was focused only on political independence.

mandate, immediately before elections. Cukierman and Meltzer (1986), and Rogoff and Silbert (1987) agreed with this approach, but demonstrated that the same behavior would be applied even if the voters were rational. This theory, known as the Rational Political Business Cycles Theory (RPBT), is based on the idea that even if the voters were rational, the behaviour of the government would not change, but it would be the one described by Nordhaus. The reason is that even if rational voters' view is not distorted for itself, it will anyway be subject to a temporary illusion of prosperity. This means that the negative effects (like high levels of inflation) of an expansive economic policy implemented at the end of a governmental mandate would emerge only after the elections. For Hibbs (1977) the PBT is too simplistic, as it considers all the governments similar, irrespective of ideological differences. The theory introduced by Hibbs, called Partisan Theory (PT), highlights that left wing governments' preferences (and consequently their behaviours) are different from those of the right wing. Left wing governments give more importance to unemployment rather than inflation, while right wing governments pay more attention to the latter. For this reason during the whole mandate of a left wing government, a country will be characterized by high inflation and low unemployment, and viceversa for a country ruled by right wing politicians. Alesina (1998), as it was done with the PBT, introduces in the PT the rational variable, which implies that the trade-off between unemployment and inflation, as postulated in the Phillips curve, does not take place in the medium and long term due to rational expectations on inflation, creating what himself calls the Rational Partisan Theory (RPT). According to this approach, left wing governments would be characterised by an initial expansive phase and a recessionary one at the end of their mandate. The opposite holds true for right wing governments. Therefore, whether it depends on the mere maximisation enhancement of political support or on ideological reasons, it seems that government turnover has a negative influence on price stability. The creation of an independent central bank, hence, would guarantee a low level of inflation, irrespective of which government is ruling the country. A comparsion between the level of political independence of eleven European countries' central banks with their inflation rate in the 80s (on the average), it is possible to notice a negative relation between these two variables. Considering the theories analysed in this chapter, it is possible to state that the negative relation depends on governments' pressures on the central bank: a higher level of political independence corresponds to a higher degree of political freedom. This allows the central bank to maintain stable prices in a more efficient manner.

Given these assumptions, the ECB's level of political indepence is calculated using GMT's index through an analysis of the central bank's statute. The European Central Bank reports a very high degree of political independence (6 points), which is reached only by the German Bundesbank and the Nederlansche Bank, while all the other central banks present lower values (with the only exception of Suomen Pankki, the Finnish central bank, whose index is equal to 7). Furthermore, all the European values are distant from the ECB's one by 2 points or more. Not only does the Bundesbank share the level of independence with the ECB, but it also has the same features of political independence: therefore the ECB can be considered a central bank strongly inspired in its structure by the Bundesbank. The German model, however, is not the most common in Europe. Some countries like

Portugal, Spain, Greece, France, Belgium, have values of 4 or even 5 points lower than it (and so their central banks are highly different from the ECB). Nevertheless, the ECB is actually more independent than the Bundesbank: while the Bundestag, the German Parliament, has the power to change the statute of the German central bank, the European Parliament cannot modify the ECB's law, as it is contained in Protocol n. 4 (Protocol on the Statute on the European System of Central Banks and of the ECB) of the Maastricht Treaty. Being part of an international treaty, the ECB's statute can be modified only by the unanimity of all the parties (member states).

Regarding the targets prescribed in the statute, the primary objective of the ECB is to guarantee price stability (art. 282.1 TFEU). There are also other objectives, like full employment (art. 282.1 TFEU and art. 3 TEU), but these targets are considered less important than price stability by the statute. The presence of a hierarchy is not a "default option" for central banking. As Paul De Grauwe (2012) pointed out, there are two main models of central bank: the Anglo-French model which pursues more than one objective with no hierarchy between them, and a German model, which has price stability as main objective, while the others are secondary issues. The ECB has clearly followed the latter model, choosing the "German way" not only in its structure (strong independence), but also in its target. The preference toward price stability means, as the Taylor rule explains, that the ECB strongly gives more importance to inflation than other macroeconomic issues, like unemployment. However, this set of preferences may not be shared by every member state: as De Grauwe explains, other central banks, like the Banca d'Italia, may give more importance to unemployment than inflation. Hence, it is important to verify if the ECB reflects the preferences of the average of the European countries.

Hayo's study (Hayo, 1998) on inflation culture is useful in this sense. Hayo's database consists of public opinion polls taken from some Eurobarometer's surveys from 1976 to 1993. Four goals were presented to the respondents, who had to name which one they considered the most important for their country in the long-run: (1) Maintain order; (2) More democracy; (3) Fighting rising prices; (4) Protecting freedom of speech. The respondents' inflation culture was measured on the variability of the preferences for the third option. Hayo notices that Germans and Dutch record the lowest values, while Greece and Portugal two of the highest. This is explained by the fact that in countries were inflation is already low (average inflation in those years in Germany: 3.3; and in the Netherlands: 3.5) "fighting rising prices" is considered less important than the other objectives. On the contrary, in Greece and Portugal, where lowering inflation was regarded as an important issue, the average inflation between 1976 and 1993 was rather high, respectively 18.9 and 11.5. Therefore, these data are useless without a coefficient (β) that shows how much inflation's variation influence citizens' response in each country. Coefficient β, obtained by an Ordinary Least Squares regression, has a negative relation with inflation: where inflation is higher, β is lower and viceversa. In other words, in those countries where people react strongly to inflation (higher level of β, which represents the "degree of reaction to inflation"), prices are more stable. On the other hand, where reaction is lower (with inflation increasing by the same amount, fewer people consider it an important issue), inflation is higher. A comparison between the β coefficients

of the countries analysed, demonstrates that this statement is correct. For example, Germany's coefficient is 5.81, while Greece's is 0.43. This means that with an equal increase of inflation in both countries, say of 2 per cent, many more Germans than Greeks would consider inflation the main goal of their country. This is also an explanation for the high level of inflation in countries like Greece, where people are more indulgent toward inflation (and maybe less toward other problems like unemployment). As stated before, the preferences of the ECB take after the Bundesbank. To understand if they reflect the average inflation culture, it is useful to compare the German coefficient with the average one. The average β coefficient in the Eurozone, 2.28, is much lower than the German one, 5.81 (+3.42). This means that ECB's preferences do not reflect the preferences, or inflation culture, of the European[2] average.

This gap is even more significant considering that the ECB is an independent institution, not legitimated by any democratic election, and as such affected by the so-called "democratic deficit" (Majone, 1998). This problem lies on the member state governments' delegation of power to the ECB. The central bank, in fact, received from the single European governments the power to determine monetary policy within their boundaries. Nevertheless, its actions are not subject to any control by democratic institutions. If they were, governments would be able to minimize the ECB's policy drifts, making its policies closer to their will, which reflects the will of the national electorates.Today, however, by avoiding any democratic control, the ECB is not accountable, as it is not "obliged to give a reckoning or explanation for its action" (De Haan and Eijffinger, 2000). To prove this point it is necessary to "measure" the degree of accountability of the ECB and compare it with other monetary authorities. De Haan et al. (1999) give a quantification of the accountability of the central banks in their work, which consists of an analysis of the statutes of the central banks. Three main aspects of accountability were considered: (1) the definition of the ultimate objectives of monetary policy; (2) transparency; (3) final responsibility on monetary policy. The result of this study was that the ECB has the lowest degree of accountability (4) compared to the other central banks examined (Bank of Canada, 7; Bank of England, 11; Bank of Japan, 6; Federal Reserve System, 7). Secondly, the ECB is highly independent, as this structure guarantees to efficiently maintain prices low, but it is not accountable. This problem, which is not independence itself, but the lack of equilibrium with accountability, could be solved by finding an "optimal relation" -as De Grauwe names it- between these two elements.

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[2] The term "European" here includes only those countries that were members of the Eurozone from 1976 to 1993.

Indipendenza
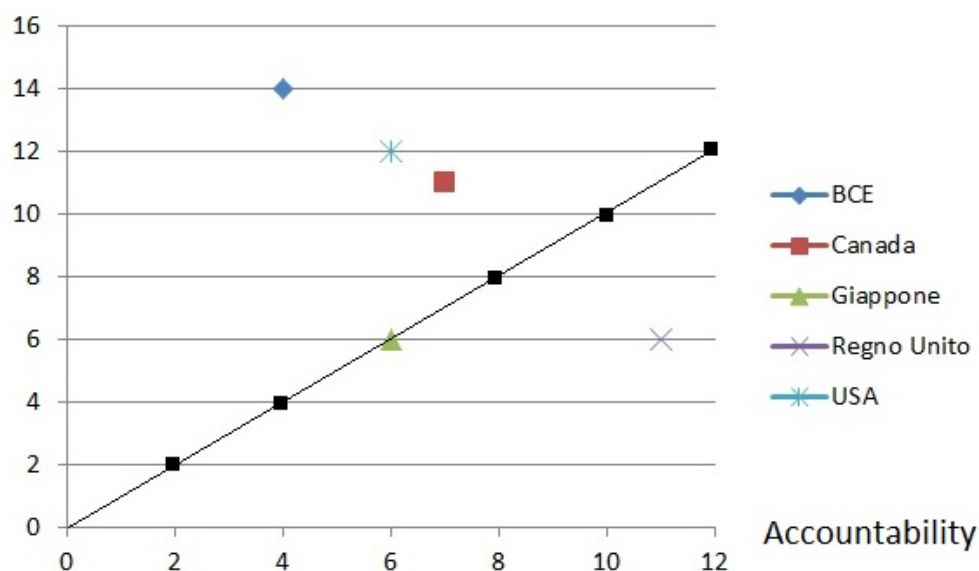
Given the high level of independence (14) and the low level of accountability (4), the ECB is distant from the optimal relation, as the graph shows. However, there are some policies that it could adopt to become more accountable without losing its strong independence. As Fitoussi and Creel (2002) suggest, for example, the quantitative definition of price stability should not be defined by the ECB itself, but by the European Parliament, like in New Zealand with the Policy Target Agreement between the Reserve Bank and the government.[3] Furthermore, regarding transparency, the "open mouth operation" enacted by the Bank of England could represent an interesting example to make the ECB's policies easier to be evaluated by the citizens. On the last aspect of accountability, which is the final responsibility on monetary policy, there should be an institution capable of modifying the ECB's statute, in order to choose the targets the ECB should pursue according to the will of the majority of the European citizens.

In conclusion, increasing the ECB's accountability is important to overcome its democratic deficit. Certainly, "the idea behind democracy is that decisions are legitimate if they are supported by the largest possible share of eligible voters" (Fitoussi and Creel, 2002), but this does not mean that the ECB should renounce to its independence. The model presented in this thesis is that of an accountable central bank, whose policy is democratically legitimated, still maintaining its independence (and therefore its

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[3] Fitoussi and Creel's proposal is even stronger than the New Zealand's example, as it sees as central bank's counterpart the Parliament, which is more directly legitimated by the citizens, and not the government (which does not exist in the European Union yet).

efficiency). A more accountable central bank is also "a more credible one"[4] as it combines efficiency, democratic consensus and transparency, reducing the costs of each of these elements. Nevertheless, today the applicability of this model finds a strong political limit, which is the lack of a political union in Europe. For this reason, the reform of the ECB cannot be implemented without the will of European governments.

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[4] Ibid.