

# THE EUROPEAN CENTRAL BANK: TWIN SISTER OF THE GERMAN BUNDESBANK?

The European Central Bank (ECB) is widely perceived as being 'genetically' close to the German Bundesbank, notably in its institutional independence from political 'interference', its emphasis on a conservative definition of price stability and the explicit attention paid to monetary aggregates within its monetary policy framework. But if this perception is accurate, why should any member of Europe's economic and monetary union (EMU) - Germany included - have wanted to substitute the Bundesbank with its 'twin sister'? And what are the implications for EMU's future development? **Xavier Debrun** addresses these questions in the latest issue of the *Economic Journal*.

Debrun notes that from a strictly economic perspective, the image of the ECB as a supranational Bundesbank is puzzling:

- First, it defies mainstream macroeconomic analysis, which thinks of the ECB as a blend of the national central banks of EMU members.
- Second, it runs against the logic that sees participation in EMU by countries other than Germany as a way to regain part of the monetary power lost in the exchange rate mechanism of the European Monetary System (EMS), which was notoriously dominated by Germany.
- Third, it raises the question of why Germany would prefer a supranational clone of the Bundesbank to the Bundesbank itself within an EMS under German hegemony.

Debrun solves these puzzles and reconciles standard macroeconomic analysis with the perception of a German legacy to the ECB. His analysis studies the interaction among national governments, members of a fixed exchange rate system, negotiating the constitution of a full monetary union and, more specifically, the characteristics of its common central bank. The analysis emphasises the following aspects:

- Given the explicit co-ordination it creates among members on the area-wide monetary stance, a monetary union provides a more fertile ground for efficient policy choices with respect to a system of fixed exchange with forced convergence of national monetary policies (and the related risk of crises). This offers a rationale for the German preference for EMU with a German-style central bank over a hegemonic EMS dominated by the Bundesbank itself.
- Two arguments, beyond the often-invoked reputation gains, may explain the institutional similarity between the ECB and the Bundesbank:
  - First, non-German negotiators, conscious of the complexity of achieving domestic consensus on the optimal low inflation rate, may view EMU participation as a short cut to benefiting from credible monetary institutions. The existence of a domestic

consensus on price stability in Germany therefore offers German negotiators a greater bargaining power in the determination of the institutional characteristics of the ECB.

- Second, the bargaining power of Germany is further reinforced by the fact that a likely alternative to EMU would be a system of pegged exchange rates under German dominance like the EMS and its ancestor, the 'snake'.

Regarding the future of EMU, Debrun's analysis hints at the following:

- The suspected German bias of the ECB might fade away as the perception of EMU's irreversibility is strengthened and the threat of falling back on an EMS-like arrangement disappears. Possible changes that would not require an adjustment of the legal framework might involve a less conservative inflation range targeted by the ECB or abandoning the explicit reference to monetary aggregates in the policy framework.
- The entry of new members with a weak reputation for price stability will not necessarily threaten the ECB's anti-inflationary credentials, as newcomers will enjoy little bargaining power to alter them. One scenario is that they might be prepared to enter 'constituencies' like those of the International Monetary Fund (IMF), headed by a delegate of a founding member of EMU, without significantly impinging on the established decision pattern within the ECB board.

**Notes for Editors:** 'Bargaining over EMU versus EMS: Why Might the ECB be the Twin Sister of the Bundesbank?' by Xavier Debrun is published in the July 2001 issue of the *Economic Journal*. Debrun is at the International Monetary Fund.

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