The European Central Bank: The Bank That Rules Europe?

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The power of the European Central Bank (ECB) is rooted in its independence established in the Maastricht Treaty of 1992. This power is reinforced though the bank's monetary policy credibility—achieved through meeting its price stability mandate, whilst resisting political pressures to manipulate monetary policy to other ends. This credibility contributes to the ideational power of the ECB which is rooted in widespread support for price stability, one of the core objectives of Economic and Monetary Union (EMU). The ECB's relative power, as one of the two leading central banks in the world, is determined by the relative size of the Euro Area economy and the growing importance of the euro as an international reserve currency. The ECB is the leading face of the Euro Area abroad and a new and important presence in several international economic fora. The ECB is effectively the 'captain' of the team of Eurosystem (Euro Area) national central banks (NCBs) as well as the wider European System of Central Banks (ESCB)—which includes all European Union (EU) NCBs. The ECB is responsible for coordinating the policy making of Eurosystem NCBs in a range of areas and NCB discussions on inflation forecasts.

However, there are clear limits to the ECB's power. It controls neither exchange-rate policy nor prudential supervision. Limits have been placed upon its international role. The ECB must work with governments to build support for low inflationary policies and maintain political support EMU. The ECB is one of the most consistent voices in favour of structural reform in the European Union (EU), yet there is little the bank can do to enforce reform in the short term. Furthermore, the ECB must share many core central banking operations with Eurosystem national central banks (NCBs). This chapter explores the confines of European Central Bank power.

Monetary Policy Power

The basic power of the ECB is to define and implement the monetary policy of the Euro Area. The ECB enjoys unrivalled goal-setting and operational independence in the pursuit of its price stability goals, and its Governing Council members enjoy *ad personam* independence. The Bank is further sheltered from political interference by the need for the unanimous approval of member states to change the Treaty provisions on independence. The Statute of the ECB and the ESCB (principally Article 3) sets out the tasks of Eurosystem NCBs as: 'to define and implement the monetary policy of the Community'; 'to conduct foreign exchange operations'; 'to hold and manage the official foreign reserves of the member states'; 'to promote the smooth operation of payment systems'; 'and to contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system'. The ECB can make regulations (Article 110(1) TEC), principally with regard to the operation of the ESCB and can impose fines or periodic penalty payments for failure to comply with obligations contained in its regulations and decisions (Article 110(3)). This competence applies notably with regard to the reserves that credit institutions should hold with the ECB and the prudential supervision of credit institutions—although the Council of Ministers must first establish the broader framework of rules on these matters.

The ECB's Governing Council (comprising six Executive Board members and, in 2009, 16 NCB governors) is the monetary policy committee of the Euro Area. It formulates the monetary policy of the Eurosystem with the aim of maintaining price stability as the Governing Council defines it, including decisions relating to specific monetary objectives, monetary strategy, key interest-rates and the supply of Eurosystem reserves (Article 12.1, ESCB Statute). The Governing Council adopts the internal rules of the ECB and may decide by two-thirds of the votes cast to modify operational methods of monetary control. It exercises advisory functions *vis-à-vis* other Community bodies. Moreover, it has the power to form opinions on its own initiative on the economic policies adopted by the Community and member state governments on matters which fall within its jurisdiction, crucially with regard to the pursuit of ‘stability-oriented’ economic policies.

The six-member Executive Board implements the Eurosystem’s monetary policy—giving necessary instructions to the NCBs—in accordance with the guidelines and decisions established by the Governing Council. It decides upon the precise instruments to be used. It also prepares the meetings of the Governing Council. The Executive Board may have certain additional powers delegated to it by the Governing Council (Article 12, ESCB Statute).

Power and Credibility

The power of the ECB relies to a large extent upon the credibility and legitimacy of its monetary policy (see the chapter by Eichbaum in this volume). Despite widespread pessimism about the longevity of EMU and the rapid drop in the value of the euro during the first three years of EMU, the ECB has had considerable success in achieving credibility thanks to its successful pursuit of its price stability mandate. The ECB is frequently seen as the ‘the most predictable central bank’—a virtuous reputation in central banking, where controlling expectations about future inflation is seen as crucial in increasing the effectiveness of monetary policy. Its monetary strategy was modelled largely on that used by the respected Bundesbank and was overseen by Otmar Issing, Chief Economist at the ECB from 1998 to 2006 and former director at the Bundesbank. The two-pillar strategy combined an analysis of conventional price and growth indicators with money supply and credit data. Many economists and central banking officials are sceptical with regard to the analytical usefulness of monetary aggregates as a core part of the ECB’s monetary strategy (OECD 2007). However, this scepticism has not undermined the credibility of the ECB’s policy. The bank has maintained a tight interest-rate policy, successfully targeting inflation that is ‘below but close to 2 per cent’ over the medium term, even though the actual figure has been frequently just above the target. Yet it appears to have been more flexible with regard to M3 growth, which has regularly far exceeded the bank’s official reference value of 4.5 per cent.

During its first decade, the ECB had to deflect regular criticisms of its monetary policy from national politicians and economists. Criticism became particularly vocal with regard to the strong euro from 2003 and its perceived impact upon exports. The

ECB was regularly attacked for its pursuit of low inflation, and its tight monetary policy was regularly juxtaposed with the accommodative interest-rate policy and dual mandate of the US Federal Reserve—as in the months following the September 2001 attacks on New York and Washington and following the onset of the credit crunch in the autumn of 2007.

The size of the Euro Area—the second largest economy in the world—and the confidence of financial markets in the credibility of ECB monetary policy has reinforced the euro's position as the world's second international reserve currency. There are debates as to the degree to which the euro can challenge the position of the US dollar as the leading international reserve currency. However, euro's present position works not only to bolster the position of the ECB as an international actor (in the IMF and other international economic fora) but also to strengthen its position in relation to national governments and EU institutions in European economic governance.

Transparency and Credibility

In several respects, the ECB lacks transparency compared to the US Federal Reserve and the Bank of England. Notably, the ECB has opted not to publish its minutes, principally for fear that NCB governors would come under pressure at home to justify where they had stood in debates. Yet, the ECB has achieved a credibility-enhancing transparency with the markets. The ECB president gives the only press conference following interest-rate setting meetings, thus avoiding the potential for cacaphony that could arise if the NCB governors were allowed this responsibility. Moreover, like the Federal Reserve and the Bank of England, the ECB discloses the formal macroeconomic model its uses for policy analysis (Eijffinger and Geraats 2005), which most economists applaud for reducing private-sector uncertainty about the ECB's policy making process and making monetary policy actions more predictable (Geraats 2005 and 2006). There remains criticism of ECB transparency. To many economists, its interest-rate setting process and economic analysis remain too opaque (OECD 2007: 7).

Limits to ECB power over monetary policy

The ECB does not have complete control over all aspects of European monetary policy. The Council of Ministers (the Council of Economics and Finance ministers, Ecofin) is given limited powers over monetary policy and the management of Eurosystem NCBs. These powers are *de facto* exercised by the Euro Group, consisting of the finance ministers of only the member states participating in the Euro Area. Lacking a legal personality, the Euro Group must have Ecofin confirm all its decisions. The Council can adopt complementary legislation concerning the operation of the entire ESCB in a limited number of areas, by qualified majority voting on a recommendation from the ECB after consulting the Commission or by unanimity acting on a proposal from the Commission and after consulting the ECB (Art. 42 ESCB statute). In both situations the European Parliament must be consulted. These areas include, *inter alia*: the 'basis for the minimum and maximum reserves to be held by national credit institutions with the ECB, and the maximum permissible ratios between these reserves, as well as the appropriate sanctions in the case of non-compliance' (Art. 19.2); the limits and conditions on any increase to the ECB's capital (Art. 28.1); and further calls for foreign reserve assets beyond the limit set in the ESCB statute (Art. 30.4). (See Howarth and Loedel (2005) for a more exhaustive list and analysis).

Ecofin (the Euro Group) is thus empowered to influence future developments of the operation of the ESCB, even though it is unable to modify the objectives or tasks of the ESCB or the provisions regarding its independence. It is responsible for setting the rate at which currencies of the new Euro Area member states are irrevocably fixed in relation to the euro, while the European Council makes the final decision on entry on the basis of a recommendation from the Commission. Notably, Ecofin is responsible for the establishment of exchange-rate agreements with third countries and has final say over most aspects of external monetary policy. However, when performing these tasks, Ecofin must consult the ECB, attempt to reach a consensus, and respect the goal of price stability. The organization of co-ordination in the area of external monetary policy is discussed in greater detail below.

Lack of Control over Prudential Supervision

During the 1991 Intergovernmental Conference on EMU, it was decided to strongly limit the ECB's potential role in the area of prudential supervision. As noted above, the Maastricht Treaty grants the Eurosystem NCBs the responsibility ‘to contribute to the smooth conduct’ of prudential supervision and the monitoring of financial stability. The so-called BCCI Directive (96/25/EC of 29 June 1995) lays the foundations for cooperation (exchange of information) but does not contain specific provisions or institutional arrangements to this end. The ECB must be consulted on the adoption of EC and national legislation relating to prudential supervision and financial stability and has the right to perform specific tasks concerning policies relating to this supervision. Moreover, the Maastricht Treaty establishes a simplified procedure (Article 105(6) TEC) that makes it possible, without amending the Treaty, to entrust specific supervisory tasks to the ECB.

The precise role of the ECB in prudential supervision remains the subject of ongoing debate. It is not unusual that the ECB lacks control over banking supervision, in that the central banks in many advanced industrialized countries do not have this power or share it with ministries of finance (more often there are completely separate institutions responsible for supervision). However, the Euro Area is rather unique in that the areas of jurisdiction over monetary policy and over banking supervision—which remains nationally based—do not coincide. ECB Executive Board members thus argue in favour of improved cooperation between Eurosystem central banks (including the ECB) and national banking supervisors on the grounds that central banks are, because of their responsibilities, necessarily concerned with the health of the banking system, and central bank credit control is managed in 'a situation that is generated by problems of interest to the supervisor' (Padoa Schioppa 1999a; see also Duisenberg 2002; ECB 2001a and b; and Padoa Schioppa 1999b).

The Basle Committee on Banking Supervision assumed the task of promoting cooperation between the ECB, the NCBs and national supervisory authorities. To give the EU members of this Committee a more specifically Eurosystem profile, their gatherings were officially labelled the Banking Supervision Committee of the ESCB. The ECB has sought to develop this cooperation further: to ensure that the system of national supervisors can operate as effectively as a single authority when required, in particular when dealing with local or national banking problems which may have wider effects.

ECB Executive Board members tend to argue in favour of transferring full supervisory powers to the NCBs rather than centralizing them in the ECB. The emphasis placed on the role of NCBs as opposed to the ECB is due in large part to their role managing the TARGET payment system, which gives the NCBs much greater awareness than the ECB could ever have of the situation of the banks. The precise role of the ECB in the handling of solvency crises remains unsettled, and the lack of crisis management capacity of the Eurosystem has been criticised (see IMF 1998).

The 2002 decision by the German government not to grant the Bundesbank full control over prudential supervision dealt a blow to hopes of an eventual transfer of supervisory powers to NCBs and the ECB (Engelen 2002). In the new Federal Agency for Financial Market Supervision, the Germans opted instead for the British single regulator model. Shortly, thereafter, the British and Germans further shored up the central role of national prudential supervisors by supporting the conclusions of the Lamfalussy Committee on the regulation of European securities markets (Quaglia 2007). The Brown-Eichel plan (subsequently approved by the Council) proposed the creation of an umbrella EU financial-sector supervisory body which would seek to improve coordination between national regulatory authorities. The creation of such a Lamfalussy-style committee structure for banking and insurance markets was a blow to the existing ESCB Banking Supervision Committee, and ECB President Duisenberg warned that a sideline role of the ECB in bank supervision would risk violating the Maastricht Treaty (Engelen 2002).

The ECB asserted the need for its improved control over banking supervision and unease at the regulatory arrangements in place during the worsening international credit situation of 2007-08. Executive Board members expressed the concern that warnings about threats to the Euro Area’s financial systems might not be passed on fast enough at times of crisis because of the fragmented regulatory system in the EU and the insufficient cooperation and exchange of information both between supervisory authorities in different member states and between them and central banks (Stark 2008b). Executive Board members (Bini Smaghi 2008) claimed that the effective conduct of the Eurosystem's liquidity boosting operations from August 2007 relied upon the ECB's access to necessary information concerning the liquidity and solvency problems of the markets and institutions. They argue that banking supervisors needed to strengthen their cooperation to 'exert strong pressure on financial institutions to disclose in a prompt and coherent fashion their balance sheet situations' (ibid). The ECB also argued that member states—Germany has been frequently cited—must be required to remove all national legislative obstacles preventing supervisors from providing information to the ECB about specific banking institutions.

A Developing but Limited International Role

Since the Delors Committee began meeting in 1988, there has been debate about the role to be played by the ECB in the external representation of the Euro Area in international fora. This issue links into the broader problem of the division of responsibilities among EU institutions over the major elements of economic policy and the respective roles of the Council (Euro Group), the Commission and the ECB in external representation (Henning and Padoan 2000; McNamara and Meunier 2002). Where the Council represents the Euro Area externally, ECB representatives nonetheless engage in the preparation of Euro Area positions for meetings in international fora within the EU's Economic and Financial Committee, prior to these positions being finalized in the Euro Group.

The ECB made its initial demands for right to external representation on the basis both of Treaty provisions that stipulate that the Community express a single position in external monetary policy, and of ESCB Statute provisions (Article 6) that allow the ECB to decide how Euro Area NCBs shall be represented by the ECB and/or by Euro Area NCBs, on matters falling into its jurisdiction (Padoa-Schioppa 1999c). Thus in central banking fora, the participation of the ECB has been straightforward. For example, the ECB president participates in the meetings of the G-10 Governors organized in the context of the BIS and in the committees under the aegis of the governors, notably the Basle Committee on Banking Supervision and the Committee on the Global Finance System. Eurosystem finance ministers also have an interest in ECB participation in intergovernmental fora. For example, the potential success of (eventual) international exchange-rate cooperation (under the aegis of the Group of 8 (G-8)) or concerted intervention in the currency markets relies very much on both *ex ante* and *ex post* internal Euro Area co-ordination that ensures that the ECB will be willing and able to implement the policy bargain.

The ECB's status at the IMF is limited to that of observer. Its representative attends and has the right to speak at meetings on the role of the euro in the international monetary system, multilateral surveillance of the Euro Area and individual countries within the zone, international capital market reports, and world economic and market developments. The ECB has the right to send a representative to Executive Board meetings when agenda items are recognised by both the ECB and the IMF to be of mutual interest for the performance of their respective mandates. The representative can also be invited to other Executive Board meetings, although s/he does not have the *right* to attend. The official Euro Area representative on the IMF Executive Board is the Euro Group chair. The ECB also obtained observer status in the meetings of the G-10 Ministers and Governors, which are organized in connection with the IMF Interim Committee meetings. Although, the ECB's role is limited compared to that of the member state governments, its presence may help to unify the views of the EU participants on particular matters. Moreover, the ECB's observer status does not mean that it assumes a passive role. ECB and Euro Area NCB representatives have taken strong, outspoken positions on major international monetary, financial and other economic issues (see Issing 1998 for one early example).

ECB membership of the OECD, another intergovernmental institution, was also out of the question. However, the organization deals with issues—notably surveillance of the Euro Area—relating to the tasks assigned to the Eurosystem. In February 1999, the OECD Secretary General confirmed that the ECB would be allowed to participate in the work of the relevant committees and working groups as a member of the EC delegation alongside the European Commission. The ECB can make use of its presence in both the IMF and OECD to emphasise the need for on-going structural reform in the Euro Area (Stark 2008a). In the G-8, the ECB president replaces Euro Area NCB governors during the first part of finance minister meetings when monetary matters are discussed. In the G-20, the ECB president attends in addition to the NCB governors from the four member states with the largest economies.

The ECB has called for the reinforcement of the ECB's position in these international fora. Duisenberg (2000b) further argued for the gradual but fundamental adaptation of the traditional institutional framework of international relations on the grounds that the existing framework—based on the representation of national governments—'was not tailored to the involvement of monetary unions, nor to the advent of the Eurosystem, and more generally the [Euro Area], as a new actor in international relations'. With regard to Eurosystem representation in international fora where both ministers and bank governors are represented (G-8 Finance, G-20), Duisenberg focused on the capability to speak with one voice (if and when appropriate) and a clearer Euro Area political counterpart for the ECB. Instead of the four Euro Area member state finance ministers (in the G-8 and G-20), he preferred a single Euro Group representative with a higher profile. He wanted to overcome the co-ordination problems among Eurosystem member states on external monetary policy.

Given the diverse circumstances of bilateral economic relations with third countries, the EU finance ministers did not set arrangements for Euro Area representation. The presence of the ECB in these bilateral discussions is now left to the Euro Group chair. The ECB has forged and reinforced bilateral relations with other central banks on issues of mutual concern, including operational facilities, financial stability and the provision of technical assistance. Notably, since November 1999 it has become involved in the EU enlargement process by providing assistance to the central banks of central and eastern European candidate countries to prepare them for participation in the ESCB following accession and their eventual participation in the Eurosystem. In addition to central banks, the ECB has developed contacts with other relevant foreign institutions, such as banking supervisory authorities, local banking associations, stock exchanges and national public administrations.

Power in Relation to NCBs

The ECB's relatively small Executive Board and its weight on the Governing Council (six out of 21 places, or less than third) demonstrates an important feature of the Eurosystem. Compared to other federal banking systems, the Eurosystem is relatively decentralized: NCBs have more sway collectively than, say, representatives from the Federal Reserve District Banks. This reflects practical reality: the NCBs are well-established, whereas the ECB is a fledgling, small institution. Eurosystem NCBs perform several operations vital to the operation of the Euro Area: notably, they conduct foreign-exchange operations and ensure the smooth operation of payment systems (including TARGET). The NCBs hold and manage the official foreign reserves of the member states (of which they can provide up to 40 billion euro to the ECB) and hold the capital of the ECB (just under 4 billion euro). However, NCBs must follow the regulations, guidelines and instructions of the ECB in these and several other areas: buying and selling securities and other claims; borrowing and lending securities; dealing in precious metals; conducting credit operations with banks and other financial institutions based on adequate collateral; acting as fiscal agents for public entities (although they may not grant them credit facilities or buy their debt instruments directly from them). The ECB can also engage in these activities. The precise role of the ECB in relation to the NCBs depends on the kinds of open market operations selected (with regard to aim, regularity and procedures). NCBs are able to perform tasks beyond those specified in the ESCB Statute, except if the Governing Council decides that these activities interfere with the work of the ESCB. The ECB alone attends Euro Group meetings and Ecofin Councils. However, Eurosystem NCBs (and ESCB NCBs) will occasionally attend informal meetings of Ecofin with varying degrees of participation as well as meetings of the EU's Economic and Financial Committee when macro-economic policy coordination issues discussed directly impinge on them. In 2003, Euro Area NCBs lost their right to sit in Economic and Financial Committee meetings—much to the opposition of several NCBs, including the Bundesbank (Dyson 2008)—which has reinforced the importance of the ECB in European economic governance.

The degree to which the Eurosystem is centralised will develop over time. The important role of the NCBs in ECB decision making (in the working groups, committees and the Governing Council) reflects the ongoing importance of the analytical—including statistical—resources available in the NCBs and in particular the largest. The relative dependence of the ECB on the NCBs has reduced over the past decade, nonetheless the US Federal Reserve remains better endowed analytically than the ECB and less reliant on the state reserve banks. The importance of the NCBs in ECB decision making encourages a combination of collaborative and competitive work (Goodfriend 1999; Hochreiter 2000; Mayes 1998 and 2000). In their attempt to have an impact on Governing Council decision making, each NCB governor will use the resources of his own NCB to provide the necessary information and strengthen his position in the on-going debate with other NCBs and the ECB Executive Board on appropriate policy and the way that the Euro Area economy works. The development of the ECB's autonomous analytical capacity in relation to that of the NCBs will be important in determining the level of centralization in Eurosystem policy making. The ECB has already become the most important centre for monetary policy research in the EU (see below) hiring some of the best monetary economists from NCBs.

Members of the Governing Council are expected to speak with one voice on the basis of the agreed-upon forecasts, although there is no legal requirement to do so. Efforts have been made to ensure a tight coordination of official statements on ECB monetary policy: the President is spokesperson in the official press conference following the bi-weekly meetings, while the other members of the Council have to explain Eurosystem policy in the member states in their own languages. There have been a number of incidents where different NCB governors made ambiguous remarks between Governing Council meetings that led to false predictions of monetary policy decisions (Louis 2002). However, there has yet to be a publicly expressed substantive difference of opinion between members of the Governing Council. Another potential source of divergence in the public expression of policy is the separate national forecasts published by the independent NCBs. Varying NCB forecasts could send different signals to market operators about the development of ECB policy. However, it is the role of ECB working groups and committees to iron out differences and ensure coherence in all the forecasts of the Euro Area prior to their publication.

The relative importance of the NCBs in the Eurosystem also arguably reflects the highly decentralized nature of the EU political system and the problematic legitimacy of the EU in the eyes of many member state citizens. Arguably, European citizens are more likely to accept ECB monetary policy if they know that they are represented, however indirectly and unofficially, by NCB governors, and that policy is designed in the fora of working groups, committees and the Governing Council, where NCB experts and officials predominate. This concern was of great relevance to discussions in the ECB in 2002-2003 on Governing Council reform in the context of Euro Area enlargement (see below).

The ECB Executive Board has been very cautious in its interventions into the operation of NCBs. One of the most controversial developments during the first decade of EMU was the Banca d'Italia Governor Antonio Fazio's handling of the takeover battle for Banca Antonveneta. Despite much criticism, the ECB Executive Board initially took a 'hands-off' approach and warned of a dangerous precedent for ESCB independence if the Italian government used legislation to remove Fazio (*Financial Times* 16 September 2005). The ECB finally adopted a much tougher tone in mid-December 2005, after it was made public that Fazio had received gifts from the former head of a major Italian bank. President Trichet warned that, in accepting gifts, the Italian governor might have breached the ECB's code of conduct (*Financial Times* 17 December 2005). However, the ECB has no investigative powers and was unable to pursue matters further. Ultimately, Fazio's resignation saved the ECB further damage to its credibility and the danger of public battles between Governing Council members.

Independent but in Search of Dialogue

Although the ECB regularly insists upon its independence and directly challenges political leaders who call this into question, it needs to maintain a constructive dialogue with democratically elected officials. The ECB does this in its dealings with the Euro Group of Euro Area finance ministers. The ECB also maintains direct relations with the European Parliament (EP), notably in terms of *ex-post facto* reporting and questioning. The EP must be consulted on appointments to the ECB Executive Board. It receives and debates the ECB's annual report and requests that the president and other Executive Board members appear before the Committee on

Economic and Monetary Affairs (TEC Article 113) (see, for example, Duisenberg 2000a). Overall, however, the EP has little say over the ECB's management of monetary policy. As Dyson (2000: 69) notes, the model of ECB-EP relations is no match for U.S. Federal Reserve–Congress relations, where a well-staffed and financed Congressional committee maintains constant scrutiny over the central bank. The ECB is not responsible to the EP or other EU institutions; none have the power to dismiss ECB Executive Board members on the grounds of unsatisfactory performance in fulfillment of the Bank's own goals (Taylor 2000).

However, there are signs that the ECB has been responsive to the concerns of the European Parliament and that a certain form of ECB accountability has developed (Magnette 2000; Jabko 2003). While the Treaty and the ESCB Statute establish no specific appearance requirements, the EP succeeded in obtaining Duisenberg's agreement that he would appear before the Committee on Economic and Monetary Affairs four times a year. This accountability has been good for the ECB's legitimacy. The wide-ranging review of the ECB by the Committee on Economic and Monetary Affairs can ensure that the Bank's technical decisions are subject to scrutiny from beyond the ESCB. This review can increase awareness and widen support for the Bank's underlying policies and principles. Accountability to the EP has also arguably induced improvements in ECB transparency, despite the absence of formal disclosure requirements (Jabko 2003). For instance, (nonbinding) EP resolutions on the ECB Annual Report have repeatedly urged the ECB to be become more transparent, and the publication of the ECB's macroeconomic projections appears to have been triggered by the quarterly 'monetary dialogue' between the ECB and the Committee on Economic and Monetary Affairs.

Intervention in Government Policy

The ECB has actively promoted structural reforms with the aim of reducing the public-sector debt burden, in Governing Council member speeches, press conferences, monthly bulletins and annual reports. It has consistently defended the Stability and Growth Pact, criticised the suspension of the Excessive Deficit Procedure with regard to France and Germany in 2003, and sent strong warnings about the dangers of watering down the Pact in the March 2005 reform (Howarth and Loedel 2004). For the ECB, the Pact is a vital tool to entrench a stability culture in the Euro Area and to avoid conflictual relations with profligate governments. The ECB's pro-reform agenda has been challenged by government and opposition politicians in several member states and labour leaders.

Research and Analytical Capacity

Under the leadership of Otmar Issing, who worked as an academic economist for over thirty years prior to joining the Bundesbank, the ECB developed an impressive research capacity. In addition to its own expanding research staff, the ECB funds a visiting researcher programme to attract some of the best monetary economists in the world. One of the direct effects of the ECB's own research capacity was the development of the New Area-Wide Model—the principal inflation forecasting model—by the staff in DG Research for simulation tasks and scenario analysis. The model is also regularly used to produce research papers that are presented in academic conferences and central bank workshops, thus providing a constant quality check (Trichet 2007). The ECB has funded policy-relevant research that is not yet available at universities or other research institutes. With the Centre for Financial Studies at the Goethe University of Frankfurt, the ECB runs the Research Network on Capital Markets and Financial Integration in Europe. The ECB has also led and co-ordinated the research efforts of Eurosystem NCBs through four networks on Monetary Transmission, Inflation Persistence, Wage Dynamics, and the Euro Area Business Cycle, the latter also involving the Bank of England and the Centre for Economic Policy Research. In addition to internal and open seminars given by staff and invited speakers, the ECB has become a major venue for conferences on monetary policy and other economic matters of direct relevance to monetary policy. The dissemination of research at the ECB is achieved through the publication of research papers, presentations at international workshops and conferences, and the publication of the ECB's own Working Paper Series. In 2006, 137 working papers were released, with 90 papers authored or co-authored by ECB staff, considerably more than the output of the US Federal Reserve.

There were concerns that, following the departure of Issing and with the decision to divide the management of Directorate Generals economics and research, the latter would lose influence on policy making and resources. However, Lucas Papademos, the Executive Board member in charge of DG research since 2006, sought to allay fears by directing it 'to focus more on policy-related issues' (*Financial Times* 1 June 2006). With a PhD from the Massachusetts Institute of Technology and a stint as an academic at Columbia University, he has a strong background in academic economic research.

Internal Reform

Unlike several NCBs in the Eurosystem, which have had to undergo painful internal cuts and significant reform, the ECB expanded its staff numbers every year since its creation. It remains a comparatively small and efficient central bank. At the end of 2007, 1375 members of staff (full-time equivalent) were employed on permanent or fixed term, up from 1217 staff members at the end of 2003. This number is dwarfed by the number employees working in the largest Eurosystem NCBs. However, the ECB's capacities have been increased considerably, and in some areas (notably, research) its reputation has overtaken that of the other Eurosystem NCBs.

Despite the ECB's reputation for efficiency, bank management had to counter a great deal of publicly expressed discontent from ECB staff who complained that it suffered from poor management, was too bureaucratic, and failed to communicated with its employees (*Financial Times* 5 November 2003). In October 2003, the ECB approved internal reforms aimed at improving working conditions, communication with staff and management training. A 2003 audit of the bank's information technology services by McKinsey, the consultancy group, found severe management failure in the IT department's project planning, causing heavy budget overruns and major delays (*ibid.*). Trichet dedicated his first years as president to engineering reform throughout the bank and, in IT, saw off strikes by staff, who were concerned about the potential redundancies resulting from reorganisation.

Euro Area Enlargement and Governing Council Reform

The most controversial internal reform undertaken by the ECB was the adoption of a new rotation system for voting in the Governing Council. The complicated nature of the new system has been criticised by many observers, including the well-known monetary economist Daniel Gros (2003). According to the reform agreement, the number of NCB governors exercising a voting right is to be capped at 15, while all governors are to continue to attend and be able to speak at meetings. When the number of NCB governors in the Governing Council exceeds 15 voting rights is to be exercised on the basis of a rotation system, designed to ensure that the NCB governors with the right to vote are from member states which, taken together, are representative of the Euro Area's economy as a whole. Consequently, the NCB governors are to exercise a voting right with different frequencies depending on an indicator of the relative size of the economies of their member states within the Euro Area. Based on this indicator, NCB governors are be allocated to different groups.

Initially, two rotating groups are established (as took place on 1 January 2009 following the accession of Slovakia to the Euro Area). The governors from the five member states with the largest economies (currently, Germany, France, Italy, Spain and the Netherlands) form one group, possessing four votes (and thus each have a voting frequency of 80 per cent). The governors from the other member states form the second group, sharing eleven votes. Once the total number of member states in the Euro Area increases beyond 22, three groups are to be established with members of the third group possessing the lowest voting frequency. The members of the Executive Board are to preserve their permanent voting rights.

In 2003, the European Parliament opposed the reform on the grounds of its complicated nature but also because it was felt that population size should have been a factor determining membership of the rotating groups. Many economists and central bankers have also attacked the reform because it does not cut down the number of Governing Council members, which was already considered to be too many to allow for efficient monetary policy making (see for example, Baldwin *et al*. 2001; Berger *et al*. 2004; Buiter 1999; Eijffinger 2006; and de Haan *et al.* 2005). Some argue for a system emulating the Federal Reserve Board, with the ECB Executive Board possessing a larger percentage of the total vote to allow for more efficient policy making (de Haan *et al.* 2005; Eijffinger 2006; Favero *et al*. 2000). Others see an entirely centralized system—the creation of a Monetary Policy Board detached from the member state NCBs—as the only effective way to resolve the efficiency problem (Baldwin *et al* 2001).

It can be argued (see Dyson 2008; Howarth 2007) that concerns with the efficiency and credibility of monetary policy making were secondary in the design of the rotational groups. More relevant were the corporate interests of the existing twelve NCB governors who agreed the reform—none of whom would be placed initially in the third group. Moreover, legitimacy concerns may have directed the reform. Ensuring representation according to national economic size was potentially important to the legitimacy of ECB policy making, even though this undermined the treaty-established *ad personam* status of the NCB governors. At the same time, the decision to grant all NCB governors the right to attend and speak at Governing Council meetings, and the imposition of rotation—albeit at different frequencies—on all governors (from the Maltese to the German), allowed the ECB to claim that the reform respects the principle of equal treatment.

Conclusion

EMU embodies 'the triumph of technocratic elitism over the idea of political democracy' (Dyson and Featherstone 1999: 801). The ECB can be said to be the principal victor in terms of real power, determining most aspects of monetary policy for the world's second largest economic entity. The burgeoning research and analytical capacity of the ECB has reinforced its power, in relation both to European and national political officials and to the Eurosystem's NCB. Credibility also brings power, and the ECB can be judged to have achieved a considerable amount of credibility thanks to the consistency of its monetary policy and its ability to adopt greater transparency in explaining this policy to both financial markets and democratically elected officials.

The democratic legitimacy of the ECB remains contested by some politicians. However, Governing Council members insist upon its legitimacy. They argue that the ECB's mandate was established by democratically elected governments and is more tightly circumscribed than a dual mandate including growth and employment alongside price stability; that public support for both EMU and the goal of price stability remains high; and that the bank has been accountable to democratically elected officials and the public—without compromising its independence—through the efforts of Executive Board members to explain bank policies regularly to members of the European Parliament, governments and the public in speeches, press conferences and other public appearances.

The title of this chapter makes direct reference to the title of a much earlier work that focuses upon Bundesbank power (Marsh 1992). On 1 January 1999, the ECB supplanted the Bundesbank as the leading central bank on the European continent. To the extent that we can claim that the ECB 'rules' Europe it does so differently than the Bundesbank of the era of the European Monetary System. The ECB sets the interest-rates for fifteen member states, countries in the Exchange Rate Mechanism (ERM-2) and will have strong influence on interest-rates for those satellite economies whose currencies shadow the euro. Yet NCB governors participate in the setting of these rates—which was certainly not the case prior to 1999, when the Bundesbank was notoriously hostile to interest-rate coordination and set rates to meet its statutory mandate of domestic price stability. Even though the ECB's rates might not be entirely appropriate to the economic conditions of many individual Euro Area member states, they are not the reflection of economic developments in a single member state. The ideational power of the ECB is at least as great as that of the Bundesbank: the former is the guardian of price stability in Eurosystem and one of the world's most visible promoters of the virtues of low inflation. The augmentation of the ECB's research capacity reinforces its ideational power and it is supported by the Eurosystem NCBs which all share the same mandate. However, the Bundesbank's influence lay not only in its success in maintaining low inflation but also, to a large extent, on the comparative size and strength of the German economy. The ECB manages the monetary policy of a far larger economic entity—clearly a source of its great clout both at home and abroad—but the Euro Area is, in its great diversity, less economically successful than pre-unification Germany, a fact that inevitably undermines the power of the ECB's anti-inflationary message.

This chapter has shown that the power of the ECB is limited in several important respects. The resistance of member state governments limits the ECB's influence in European economic governance, national macroeconomic policy and prudential supervision. Despite the ECB's important international profile, EU member states are unlikely to modify its observer status in the IMF and OECD. The resistance of Euro Area NCBs also prevents the extension of ECB activities into several core central banking operations. International developments—and notably the rise of China and India—will both limit the relative economic importance of the Euro Area and, eventually, the importance of the euro as an international reserve currency. Increasingly complicated financial markets—notably the rise of derivatives and hedge funds—have potential to further undermine the credibility of ECB monetary policy.

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