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Summary

European integration is a fast changing subject and requires those who study it to do research very close to the present. While this makes the field both fascinating and relevant to policy-makers' concerns, it also makes it susceptible to academic fads and fashions. The scientific community in the field hardly ever finds the time to look back to evaluate self-critically whether the predictions made in the past and the policy advice put forward then have stood the test of time. The JCMS special issue – of which this article is the introduction – asks commentators who made seminal contributions to our understanding of the theory and practice of economic governance in the 1980s and 1990s to revisit their analyses with the benefit of hindsight.

This introductory article discusses a concrete example of a seminal contribution – the notion that there is an 'advantage of tying one's hands' – relating it to the other contributions in this issue along the way. It briefly recalls how the argument is constructed and then discusses the conceptual issues raised. The fourth section looks at the mixed record of commitment devices in EMU practice. The article ends with some reflections on what this tells us about economic governance in EMU more generally. The article will in particular identify an underlying dilemma of non-majoritarian policy-making in democracies for which academic policy advice is both a curse and a cure of sorts.

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Contents

I. Why this theme?

European integration is a fast changing subject and requires those who study it to do research very close to the present. While this makes the field both fascinating and relevant to policy-makers' concerns, it also makes it susceptible to academic fads and fashions. The scientific community in the field hardly ever finds the time to look back to evaluate self-critically whether the predictions made in the past and the policy advice put forward then have stood the test of time. This special issue asks commentators who made seminal contributions to our understanding of the theory and practice of economic governance in the 1980s and 1990s to revisit their analyses with the benefit of hindsight.[1]

The theme of economic governance in EMU is a good candidate for such an exercise. Economic governance of EMU can be characterized as consisting of three elements: an independent monetary policy of the European Central Bank (ECB), member states' fiscal policy coordinated only by a Stability and Growth Pact (SGP) that has been fundamentally altered since its inception, and various reform processes softly coordinated under the Broad Economic Policy Guidelines (BEPG). This framework of economic governance is still evolving and is not exactly a success story so far. A review of what we have learnt about economic governance therefore promises novel insights into a historically unique, ongoing process. In line with the distinction between governance and integration studies (Jachtenfuchs 2001: 250), the focus is on what these contributions had to say about how the EMU framework would affect policy-making and outcomes in member states and the union as a whole, rather than on how and why this framework came about.

To substantiate these intentions, this introductory article discusses a concrete example of a seminal contribution, relating it to the other contributions in this issue along the way. The notion that there is an 'advantage of tying one's hands' (Giavazzi and Pagano 1988) has obviously influenced our understanding of monetary integration in theory and the building of EMU institutions in practice.[2] The article explained why and how a stability-oriented exchange rate regime like the European Monetary System (EMS) could act as a disciplinary device for a high-inflation country like Italy. It became part of a burgeoning literature on commitment devices and credibility in policymaking, the weight of which could be interpreted as supporting a singularly high degree of independence of the ECB and the fiscal rules enshrined in the Pact.

The next section briefly recalls how the argument is constructed. I then discuss the conceptual issues raised. The fourth section looks at the mixed record of commitment devices in EMU practice. The article ends with some reflections on what this tells us about economic governance in EMU more generally. I will in particular identify an underlying dilemma of non-majoritarian policy-making in democracies for which academic policy advice is both a curse and a cure of sorts.

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[1] The contributions are based on seminar presentations at the European Institute of the LSE throughout the academic year 2005-06. The contributors received helpful comments from experts in the field, for which I would like to thank Jacques Le Cacheux, Chris Allsopp, David Soskice, Bob Hancké, Friedrich Heinemann, Simon Hix and Damian Chalmers. The seminar series has been funded by the European Commission through the Integrated Project 'New Modes of Governance' and the Research Network CONSENT which is gratefully acknowledged. Deborah Mabbett (Birkbeck) has provided excellent comments on a first draft.

[2] Francesco Giavazzi (Bocconi University, MIT) has given a seminar on this seminal contribution (download, along with comments by Kevin Featherstone, is available at URL: http://www.lse.ac.uk/collections/europeanInstitute/Events/events.htm). Unfortunately, he could not write an article consistent with the time constraint of the JCMS editors.

II. What was the original argument about credibility and commitment?

The seminal contribution of Giavazzi and Pagano (1988: 1055) sets out to explain what had by then become a commonplace, namely that 'the EMS is an effective disciplinary device for inflation-prone countries in Europe'. The authors point out that it is not clear why governments subject themselves to the discipline of low inflation in the EMS when they would not choose low inflation without the fixed exchange rate arrangement. Nor is it clear why the public should believe that the government will comply with the constraints on inflation imposed by EMS membership. To solve this puzzle, the authors explore the conditions that make it welfare-improving for monetary authorities with an inflation bias to become and stay a member of a club that imposes a lower inflation rate on the economy than would result in the second best optimum outside the club. A higher inflation rate is chosen outside the club because the public knows that the incentives of the monetary authorities, particularly for generating output growth with inflation surprises, lead them to renege on the promise of price stability. In a rational expectations equilibrium where all actors exploit their information sets optimally, the incentives of the authorities will be anticipated and wages and prices set accordingly so that inflation cannot generate any additional employment.

EMS membership can then be attractive to the government because it changes these incentives by imposing a penalty on high inflation, namely real appreciation and loss of competitiveness between realignments. The public recognise that incentives have changed; EMS penalises excess inflation in a clear and public way and thus reduces "the public's mistrust of the authorities" (Giavazzi and Pagano 1988: 1055). The public therefore adjusts its inflation expectations downwards, so the rational expectations equilibrium is achieved with lower inflation.

The Giavazzi-Pagano article was seminal because, as its ingenious title highlights, it examined the conditions for governmental *self-discipline* rather than imagining that a government might have discipline imposed upon it (which is generally a political impossibility). It thereby gave policy content and a real world application to a rather abstract concept from optimal control theory. 'The inconsistency of optimal plans' was invoked by Kydland and Prescott (1977) to criticize policy activism in general. Barro and Gordon (1983) followed in their foot-steps to target activist monetary policy and its credibility specifically while Rogoff (1985) showed a way out by interpreting institutions like central bank independence as a solution to the dynamic inconsistency problem.[3]

The general thrust of this literature is to show not only that government intervention is harmful to the economy but that it is not in the government's own interest to pursue these harmful interventions. This gives rise to a virtuous circle or self-validating commitment: if "the monetary authorities will be better off, […] they will be happy to tie their hands. This is in fact the only guarantee that they will feel committed to the system - and, in turn, only if their commitment can be expected to last, the system will enhance their current credibility." (Giavazzi and Pagano 1988: 1057) Rational policymakers commit to hands-tying arrangements not because they have changed their preferences but because it serves their given preferences better.

The model could readily be applied to what became soon after its publication a preoccupation of policymakers, namely monetary union. The model implies a continuum between a fixed exchange rate system and a monetary union (Giavazzi and Pagano 1988: 1060). The only difference is the length of periods between realignments, the key decision variable taken out of

[3] Forder (1996, 2001) provides a very insightful, non-technical critique of the time-consistency problem and the solutions proposed in the literature.

the control of any single member that creates the credibility gains for them. A monetary union lengthens these periods to infinity, thus reinforcing the discipline of the stability regime and lowering the optimal inflation rate. However, Giavazzi and Pagano pointed out that the EMS was not sustainable in the long term, as high inflation countries went through long periods of reduced competitiveness between realignments, which left their mark in chronic trade deficits and the accumulation of foreign debt. In this respect the 1988 article anticipates a central problem faced by EMU: that some countries have experienced sharp declines in competitiveness and now have no realignment instrument with which to achieve a quick correction.

III. What have we learnt in theory?

Some of the other seminal contributions in this issue can be read as implicitly or explicitly raising questions regarding the commitment and credibility rationale of EMU economic governance that the Giavazzi-Pagano (1988) framework provided.[4] I will address three conceptual issues: the diagnosis of the problem, namely government behaviour; the alleged solution, namely credible commitment; and the underlying economics.

First, it is part of this political economy tradition to assume that governments are like rational addicts. They will never get rid of their addictive preferences but can take precautions against succumbing to their self-harming affliction. This view is challenged by authors who stress the importance of ideas in policy-making (Hall 1989). More specifically, McNamara (1998) claims that it was a change in preferences and world views, the evolution of a neo-liberal consensus based on monetarism, which made governments sign the Maastricht Treaty. While it is an open question how lasting and deep this consensus was (see McNamara, this issue), it is hard to find policymakers these days whose campaign reveals preferences that imply a purely instrumental view of inflation. Price stability is seen as a goal in its own right. A plausible counterargument is that this only bears witness to the opportunism of politicians who praise their hand-cuffs now that they cannot do much else. But there are cases which are not easily explained in this way. The regime change in the UK, for instance, indicates that institutionalising ‘the economics of low inflation’ (Akerlof at al 1991) is part of a wider trend, in that the British government has chosen to stay out of EMU, but also to make the Bank of England independent and follow a ‘Golden Rule’ in its fiscal policy (Allsopp 2002: 9; 27).

This raises the spectre that the ECB and the SGP were built as defences against abuse by governments that is no longer a major threat (see De Grauwe in this issue; McCallum 1997: 107-108). And perhaps never was. The idea that the government can spring inflation surprises partly stems from the assumption that other actors operate atomistically, and are unable to coordinate their response to the setting of monetary policy. Once centralised trade unions are introduced into the analysis, the government may no longer have the stark choice between cheating and hands-tying as other signalling devices become available. The work by Calmfors and Driffill (1988), revisited by John Driffill in this issue, suggests reasons why centrally-coordinated wage bargaining systems may produce lower inflation. However, this work came more or less when it was thought that the era of centralised bargaining is or should be over. The popularity of hands-tying models could be seen as reflecting the real or perceived decline of wage coordinating arrangements.

Even if one doubts the existence of the problem as constructed, one may still endorse the solution. Hands-tying may also serve a purpose if an inflation bias results from misconceived or erratic, rather than dynamically inconsistent, policy (Forder 2001: 16). For devising an appro-

[4] Obviously, this reflects my interpretation and should not be ascribed to the other contributors.

priate solution, it is crucial to know what exactly creates credibility. Giavazzi and Pagano (1988: 1059) largely assume that the EMS makes the length of periods between realignments and thus the expected inflation rate exogenous for any single member. They discuss in passing the 'gaming' by a state to redress the cost-benefit ratio in its favour, should the loss of competitiveness between realignments become too costly. Once its currency has become somewhat overvalued, an EMS member may adopt an even more inflationary policy to bring nearer the date of realignment since other members would want to rein in the destabilising spillovers from this policy. Realignment would thus become an endogenous decision variable, just like devaluation before. The question thus arises what exactly makes this impossible. As Lohmann (2000: 397) puts it succinctly: "The problem with the standard theory is that it solves the problem of credible commitment by assuming the solution. By assumption, policy makers or central bankers take as given the parameters of the game, or the institutional constraints. […] This is a problem. After all, policy makers can create institutions by political fiat and they can do away with them by political fiat." Political economists have thus critically evaluated how exactly reneging becomes more difficult by introducing additional costs or multiple veto players.[5] .

More generally, any solution seems to be susceptible to the McCallum (1997: 108-109) critique: how come that a government is believed to have abandoned the attempt at optimal control for good if it would be optimal for the government to revoke it whenever the private sector believes in the government's commitment? In other words, what makes the commitment device resistant against the incentive to be itself used strategically? It is the reverse of the mythical sword that supposedly heals the wound it cuts: here the question arises how authorities can assure the public that their remedy is not used to inflict harm yet again. This seems impossible if authorities are believed to have the same preferences still and to exert inadvertently, in their very role as governments, some leverage over the constraints they imposed upon themselves. The public's expectations about the use of that leverage will then still enter government's constraint and can thus be exploited.[6]

Finally, the underlying economics in the Giavazzi and Pagano (1988) model cannot allow for uncertainty about 'Whodunnit'. The literature must, in order to locate the problem in optimal control, assume that inflation can be optimally controlled. Thus, the rate of growth of the money supply determines inflation and all instability is due to accommodation of the wage bargain or to cheating by the authorities. This is a feature even of models that deal explicitly with information asymmetries and shocks which leave the public uncertain about the government's action or precise intentions (Cukierman 1992: 27, Keefer and Stasavage 2002: 755). There is no textbook on monetary economics that would still endorse such a simplistic monetarist theory of inflation, yet it is a basic feature of these credibility models.

However, policy-making is sometimes afflicted by 'deep uncertainty' (Lohmann 2000) about the causes of surprise inflation and the behaviour of different public agencies. The policy environment of EMU is a case in point. If so, precautions must be taken for the foreseeable case that unforeseeable contingencies occur (Lohmann 2000: 394). A communication strategy for different observers of that contingency is then required but not a commitment device that conveys the message 'no more surprises if government's hands are tied', inadvertently blaming the authorities if surprises still occur for having stripped themselves of their handcuffs. This does not mean that the authorities have to trade off commitment in favour of flexibility.

5 See for instance Forder (1996), Lohmann (2000, 2002) or Keefer and Stasavage (2002).

6 This problem resurfaces in the practices of the ECB, as will be outlined with respect to the two-pillar strategy below.

A rule can be written such that the authorities are required to respond differently to inflation expectations, namely commit to treat them as given, and to shocks, namely to react decisively. The two issues are independent (McCallum 1997: 105).

What is more, Goodhart's Law implies that the problem of uncertainty cannot even be ruled out by rules-based policy. If "any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes" (quoted after Crystal and Mizen 2001: 4), then tying government's hands just shifts the locus of uncertainty. This is not only due to the changes in the expectations of the private sector which the authorities may not be able to fully anticipate. This may also be caused by other parts of the public sector adjusting their behaviour to the rules imposed on another part, as Goodhart's Law emphasizes in contrast to the Kydland-Prescott tradition (Crystal and Mizen 2001: 16). For instance, fiscal entities will respond to central bank independence, or social policies to overall fiscal constraints. The result is that the link between the intermediate target, here a fixed exchange rate parity, and the goal inflation rate becomes tenuous (Egebo and Englander 1992: 55). This is also a relevant source of uncertainty for EMU economic governance in practice.

IV, What have we learnt in practice?

This section will first summarize the evidence for the Giavazzi-Pagano rationale of the EMS to highlight a somewhat paradoxical result. It will be explored, second, how the practice of hands-tying changed with the transposition to EMU; and, finally, in what way uncertainty rather than dynamic inconsistency may have undermined the working of the Pact in practice.

The empirical evidence on the credibility effects of the EMS can be summarized in what amounts to a paradoxical and uncomfortable message for advocates of hands-tying.[7] In general, studies found that financial markets rewarded governments' new emphasis on price stability. The evidence was weaker and somewhat inconclusive for an EMS effect *separate* from the impact of the general move towards more stability-oriented monetary policies among OECD countries. The credibility gains materialised since the mid-1980s in a downward convergence of interest rates. No such credibility gains could be found in labour markets. They should have materialised in the form of lower costs of disinflation if the EMS had shifted inflation expectations downwards (Egebo and Englander 1992: 52). But studies have found such gains neither in the guise of lower sacrifice ratios (crude ratio between the increase in unemployment and the reduction in inflation) nor in econometric estimates of a downward shift in expectations-augmented Phillips curves.[8] In fact, for most EMS countries, the costs of disinflation seem to have risen in the 1980s as compared to the oil price shocks of the 1970s.

This rather disappointing result for the credibility rationale of the EMS was found again in a later study of central bank independence and credibility by Posen (1998). It suggests that if independence does not in and of itself convey the message of a strong aversion to inflation, then earning that reputation may be costly in the sense that the authorities are required to 'err on the side of caution'. Temporary jumps in the price level (such as those related to higher oil prices which are now occurring) may be a useful adjustment mechanism and should not be

[7] The following is based on the OECD study by Egebo and Englander (1992) that also contains a thorough review of the previous literature. Another and earlier review by Goodhart (1990) reports basically the same findings.

[8] Egebo and Englander (1992) provide evidence, using a VAR approach, that these results correspond to the varying degrees to which price formation in financial and in labour markets is forward-looking.

suppressed as ‘inflation’. Yet authorities concerned about their reputation may fear that they will lose in an instant what they have built up over time and thus overreact (Forder 2001: 23).

The paradox in all this is that the credibility gains accruing in financial markets, far from reinforcing credibility gains in labour markets, may have *prevented* them from materialising. Lower real interest rates boosted demand and made public and private borrowing cheaper, thus easing the pressure for adjustment in labour markets. For instance, Giavazzi and Spaventa (1990) conclude their study of the EMS after the removal of capital controls that “there have been no hardships; but there has been no disciplinary effect either.” (quoted after Goodhart 1990: 475) The conclusion of the OECD study is, not surprisingly, that commitment devices cannot substitute for structural reforms in labour markets (Egebo and Englander 1992: 79).

This brings us, secondly, to the practice of economic governance in EMU. The transposition of the hands-tying rationale from the EMS to EMU modified it in at least two respects. First, ever since the Lisbon Strategy was launched in 2000, the commitment to sound monetary and fiscal policy has been combined with a structural reform agenda. While this may or may not be sensible, it is noteworthy in the present context that this dual agenda of commitment and reform implies some doubts in the working of commitment devices on their own. These devices were expected to bring down inflation expectations, which in turn would lower actual unemployment to the levels of the non-accelerating inflation rate of unemployment. The dual agenda now echoes the conclusions of the OECD study cited above, that commitment to sound macropolicy is not enough to shift the equilibrium in labour markets. However, the dual agenda implies two concepts of government that are hard to reconcile: governments cannot be trusted as regards macroeconomic policy and have to be forced to be largely passive, while they are supposed to be extremely active in shifting the equilibrium rate of unemployment for the benefit of the economy as a whole. This is the ‘Dr Jekyll and Mr Hyde’ view of government which underlies the practice of economic governance in EMU.

The second modification that has taken place when the commitment device idea was put into EMU practice is rather ironic. It amounts to *second order optimal control* in that the commitment is used to actively change and ‘educate’ expectations. This is, to take the most prominent example, the rationale put forward in favour of the ECB’s two-pillar strategy, taking both the growth of money supply and a composite economic indicator as intermediate targets. ECB officials like the chief economist Otmar Issing, who never miss an opportunity to express support for commitment and rules-based policy, do not see any contradictions in describing their own policy thus (Issing 2005: 73): “A publicly announced strategy provides guidance for the markets, enabling them to form expectations more efficiently, enabling them to better anticipate interest rate decisions.” Similarly, Crystal and Mizen (2001: 21) endorse the ECB’s defence of its two-pillar strategy thus: “Central banks now shape expectations rather than ignoring them.” But the work of Giavazzi and Pagano (1988) and others implies that the idea that the authorities can shape expectations is a fundamental obstacle to a credible and dynamically consistent policy, because ‘shaping’ can elide into strategic exploitation. The ECB’s practice is the opposite of that required by the hands-tying model, where the markets form expectations so efficiently that the authorities cannot manipulate them.

One core argument of Giavazzi and Pagano (1988) has not been modified in the transposition from the EMS to EMU. The commitment devices, in the disguise of both an independent central bank and fiscal rules enshrined in the Pact, appeal to national interests. The hands-tying argument suggests that this makes them self-enforcing. And yet, the SGP had to be reformed, some would even say: scrapped, because it could not be enforced (see Buiter, De Grauwe and Pisani-Ferry in this volume). These authors diagnose the intergovernmental foundation of commitment as a problem rather than as a solution. Buiter et al (1993: 58, 90) criticized the Maastricht Treaty on the grounds that supranational enforcement of fiscal rules requires prior political integration. Even the ECB may be criticised on the grounds of excessive intergovernmentalism (Buiter 1999: 18-19): there is still a prerogative that the Council of Economics and Finance Ministers 'may formulate the general orientation of exchange rate policy' (Art. 111) and representation on the Governing and Executive Board still follows the nationality principle, as the recent handover from Otmar Issing to Juergen Stark illustrates. Pisani-Ferry (in this volume) traces the origin of the economic governance framework back to German and French visions of the monetary union, creating inherent tensions and providing too little institutionalised concern for the union as a whole. On that account, it seems that Giavazzi and Pagano (1988) grasped a basic feature of economic governance in emphasising the self-interested nature of hands-tying, yet the gain in sustainability – strict formal rules which are not questioned in principle but enforced opportunistically in practice – may have come at the cost of legitimacy and functionality in the aggregate (De Grauwe in this volume). This is all the more startling as the EMU framework of rules and surveillance amounts to a fairly intrusive presence of supranational public authority, in particular by comparison with a federation such as the United States (Sbragia 2004: 59).

Uncertainty is an alternative candidate for explaining why the economic governance framework of EMU is apparently still in need of reform. The framework did not take precautions against the 'foreseeable unforeseen contingencies' that Lohmann (2000) hinted at. The ECB chose a two-pillar strategy when she could easily have made the case[9] for leaving itself more flexibility in its monetary growth targets (which it has not met, in any case). Foreseeable unforeseen contingencies have occurred, for instance, when a prolonged depression in Germany dragged down the average growth rate of EMU at the same time as housing market bubbles developed in some smaller and medium-sized economies. One interest rate instrument cannot handle both. Nor is it necessarily comforting to observe that the statistical average of two heterogeneous phenomena, protracted depression in big member states and overheating in several smaller ones, is not completely out of tune with the rules regarding money growth and the inflation rate. This suggests that rules cannot substitute for the judgement of policymakers, in particular of central bankers themselves (Blinder 2000). Goodhart (in this volume) proposes more political 'ownership' by member states in order to support inflation targeting under uncertainty.

The Pact has been the most obvious example of a commitment device that did not work in practice as its architects intended. One major flaw, according to many observers, was that it fell to the Ecofin Council to decide on starting an Excessive Deficit Procedure (EDP) against a member. Even if the member under discussion is not allowed to take part in the vote, it is obvious that there is a moral hazard problem if 'the turkeys decide on the menu for Christmas', ie. potential sinners issue a verdict on actual sinners knowing that in the future they may be in the same situation. However, this should not be a major problem if there is an 'advantage of tying one's hands'. The collective of potential sinners should then remind those who slip that it is in their own best interest that they be punished so as to maintain the self-validating character of a credible commitment device. Either the rationality assumption is questionable, and the Schroeder or Chirac administration did not act in their best interests when they twisted the arms of other members to avoid the opening of an EDP, or the assumed setting of no uncertainty is called into question by the Pact's operation in practice.

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9 As the ECB (2001) actually pointed out, providing evidence for transmission uncertainty. See also De Grauwe and Senegas (2003).

One challenge to the rationality assumption is that each state is not a unitary actor, and compliance problems may reflect the interplay of multiple interests within the government. Buiter (in this volume) mentions towards the end of his contribution that the budget deficit in the US is largely a result of many uncoordinated decisions: 'it just happens'. In many countries, the Treasury does not have veto power that would enable it to enforce an overall budget constraint on other ministries. This budgetary institution has been extensively scrutinized in the literature, suggesting that a weak position of the Treasury is largely responsible for non-compliance, especially if combined with a coalition government (Hallerberg, Strauch and von Hagen 2004). Another reason may be the devolved set-up of fiscal policy in federations like Germany where the central government controls only a fraction of the overall budget (Joumard and Kongsrud 2003: table 1; cf. Wierts et al 2006: part II). This lack of steering capacity is particularly acute in member states where social security is largely financed by contributions and administered by semi-autonomous 'parafisci'.

Uncertainty can affect compliance in that both the steering of a budget deficit and the recognition of the cyclical situation are less straightforward than the Giavazzi-Pagano rationale must assume. Even if the Treasury has a strong prerogative and central government is largely in control of the budget, it may still be difficult to determine with any precision where the economy is in the business cycle in time to adjust the fiscal stance appropriately. Different methods of estimating structural deficits produce notoriously different results because there is large uncertainty in the projection of output gaps (Denis et al 2006).[10] This implies that governments may inadvertently engage in pro-cyclical policy while intending to act counter-cyclically.[11]

Jon Elster (1979) explores many ramifications of the story of Ulysses, who anticipates and therefore withstands the seduction of the Sirens by taking the precaution of tying himself to the mast. Provocatively for the issue at hand he asks: "...would Ulysses let himself be bound to the mast if he knew that the shallow waters around the Sirens' island were too difficult for anyone else but him to master?" (Elster 1979: 90) Thus, it is not enough to find that governments do not always keep their promises and sometimes engage in unsound policies. It also has to be shown that the remedy is not worse than the flaw it tries to mend.

V. What does this tell us about economic governance of EMU more generally?

The notion that there is an 'advantage of tying one's hands' raises political as well as theoretical-methodological issues that are of general relevance. The political issue is that of democratic legitimacy and accountability of economic governance in EMU and European scholarship can be either a cure or a curse in this respect. The theoretical-methodological issue is that

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[10] Horn (2006: 11) shows in his ex-post evaluation of output gap projections that both the IMF and the OECD had predicted a negative output gap for Germany in 2000 and 2001 ('real time'), suggesting that Germany should have a budget deficit to compensate for weak private demand. It turned out that Germany had positive output gaps in both years, as the OECD and IMF statistics show in April 2005, and the government was criticised for its pro-cyclical policy. The same holds for Italy, and to a lesser degree, for France.

[11] One response to this is to extend the hands-tying logic by ruling out discretionary adjustments to fiscal policy. The alternative view is that governments' hands should be enabled to respond more effectively to uncertainty, for example by ensuring that the 'automatic stabilisers' in the government budget can operate to full effectiveness. Schelkle (2005) discusses ways to reform the fiscal policy framework of EMU taking political and economic uncertainty into account.

seminal contributions to European studies may have the effect of inducing change in their object of study; while this creates difficulties it also provides an opportunity for learning.

The political dilemma created by precommitments in a democracy has been succinctly discussed by Elster (1979: 93-96): by protecting democracy against its flaws, one may destroy democracy. Precommitments are meant to protect policy-makers against opportunistic policy changes to ensure re-election, but by ensuring time consistency they undermine the democratic accountability of policy. Independent central banks or fiscal rules are cases in point.

The political issue of general relevance is the reliance of the European Union on non-majoritarian policy-making. The ‘supranational-hierarchical mode of governance’, as Scharpf (in this volume) calls it, ie. integration by law and regulation, has provided an escape route for the joint decision trap in a multi-level setting of decision-making. But effectiveness and dynamic consistency thus obtained may come at the expense of democratic legitimacy (Joerges in this volume). Majone (1998) and Moravcsik (2002) have forcefully and prominently challenged this perception of a tradeoff, arguing that effective non-majoritarian policy-making legitimizes the EU through its results and is complementary to majoritarian policy-making in member state democracies. In their careful evaluation of these arguments ‘in defense of the democratic deficit’, Follesdal and Hix (2005: 19) conclude, by contrast, that the output legitimacy of ‘Pareto Authoritarianism’ is not good enough. Elements of ‘constrained democracy’ such as election of the Commission President and party contestation over EU policies have to be introduced to stop growing apathy or outright hostility towards the emerging European polity.

While there are good arguments for ‘keeping politicisation out’ (cf. Scharpf) and for ‘bringing politics back in’ (cf. Joerges), it is also worth asking what role academic scholarship plays in this context. European Studies scholars teach generations of students about the EU and feed their research results, to a large extent funded by the European Commission, back into the policy-making institutions. European Studies can thus contribute to an informed debate about the EU. Yet, the research on economic governance was characterised by a ‘lack of interdisciplinary inputs’ and the ‘narrow professionalism’ of economists, as the economist Goodhart (1990: 482, conclusions) noted early on. Scholarship thus tended to become part of a technocratic infrastructure. In the area of economic governance, academics have narrowed down the perspective on European integration, rather than widening and enriching it.

This expertocracy is easily recognizable by pretending to have a ‘best practice’ or one solution to deal with what the researcher has constructed as a ‘policy problem’. If successful, academic economists turn into policy advisers to back up reformist governments. While this scholarly advice may serve as one reform lever among many that democratically elected politicians choose to apply, it seems more problematic if that reform lever operates through the European level. The EU is arguably susceptible to following the latest academic fads and fashions because scholarly advice partly fills the gap left by limited democratic contestation over EU policies among non-experts in parliaments and the media. Through its various policy processes, the latest fashion is then taken out of the original context and spread as good or best EU practice, putting pressure on every member state to follow suit or justify deviation.

The notion of the ‘advantage of tying one’s hand’ is exemplary in this respect: the Giavazzi-Pagano article bolstered a group of reformers, who were hired as advisers to the Treasury in order to turn the political economy of Italy around (Dyson and Featherstone 2001). This may have been necessary for Italy to stay in the EMS and get into EMU, against the odds of Maastricht criteria that made more sense as entry barriers for Italy than as the core of macroeconomic policy coordination in a monetary union (Buiter and Pisani-Ferry in this volume). Yet the prolongation of these entry rules into one operating deficit rule was not necessarily what fiscal policy coordination in EMU or reformers in other member states needed. The SGP proved not even to be an effective instrument permanently to tie the hands of fiscal authorities in Italy.

Seminal contributions to the theory and practice of economic governance in EMU thus run into a particular theoretical-methodological difficulty. A contribution in European studies becomes seminal not only because the scientific community discusses it but because it finds fertile and receptive ground in the Commission, always eager to get new ideas that feed its agenda-setting. Thus, the object of study is likely to change as a consequence of being studied. In physics, this is known as Heisenberg's Uncertainty Principle, and Goodhart's Law can be seen as a variant of it in institutional economics (Crystal and Mizen 2001: 11): "A system cannot be observed without a change to the system itself being introduced." This insight calls for reflective policy-making that takes into account the changes it introduces into the policy environment. It also calls for reflective advice on policy-making, asking the paradoxical question as to whether the advice will still be good advice if policy-makers take it seriously.

Again, the Giavazzi-Pagano article is a case in point: it fed into a new consensus about the priority of price stability in macroeconomic policy-making. But now that the 'economics of low inflation' (Akerlof et al 1991) has been firmly and successfully entrenched, the advantage of tying one's hands is no longer so obvious to policy-makers and the wider public. The benefits of turning a high inflation-cum volatile-exchange rate regime around are obvious and can be made apparent enough to gain popular support, but the fetters that achieved this do not generate the same benefits now that the consensus has become institutionalised.

The practical success may render a concept obsolete.[12] This theoretical-methodological challenge also provides a unique opportunity for learning, however. It allows us to evaluate what actually happens if our concepts become relevant for policy and institution building; and to see what the resulting policies and institutions tell us in turn about our concepts. Such a review is the very purpose of this special issue.

12 Subsequent work of Giavazzi and Pagano (1996) on the 'non-Keynesian effects' of fiscal consolidation can be read as evidence. These effects are generated by the expectation of a fundamental regime change; the advantage for policy-makers here is not a fear of punishment but the reward of an economic expansion despite fiscal contraction. This analysis looks for carrots in the SGP while the 1988 article stressed the importance of sticks.

VI. References

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