DOES EUROPE NEED A FEDERAL RESERVE SYSTEM?

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Does Europe need a Federal Reserve system? During 1988 and 1989, this question went from being a completely academic one to being one of the most controversial issues of the day. In June 1988, the leaders of the European Community (EC) member governments agreed at their Hannover summit to form a committee under Jacques Delors, president of the European Commission, to investigate alternative routes to economic and monetary union and to recommend the most appropriate direction. The Delors Report, submitted in April 1989, offered nothing less than a blueprint for a federal European superstate (see Delors 1989).[1] Apart from a radical centralization of fiscal powers, the report also recommended that the separate European national central banks be merged into a new European central bank organized along Federal Reserve lines. To achieve this objective, the United Kingdom was first to join the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS). The exchange rates of the EMS currencies would then be fixed irrevocably; the existing central banks would become part of a European version of the Federal Reserve system with a status much like that of the Federal Reserve banks in the United States, and the separate European currencies would be merged into one new currency.

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[1]The Delors Report has been subjected to scathing criticism in the United Kingdom. See, for example, Goodhart (1989a), Wood (1989), Eltis (1989), and Dowd (1989b). For the Treasury response to it, see Treasury (1989). Goodhart (1989a, p. 24) captured the essence of the criticism when he wrote that the report "reads as if its authors were convinced that there is only one currently feasible strategy for the coming stages of European unification: this is a federal strategy, a Hamiltonian strategy, to transfer increasing powers to a federal centre of the United States of Europe. No alternative is even considered."

This paper offers a critical assessment of the proposal for a European central bank. Because the arguments for a central bank and monetary union are often run together, I will begin by looking at the costs and benefits of different forms of monetary union and will suggest that the argument for the extreme degree of monetary union implied by a common currency is dubious. Because one of the purposes of a European central bank would be to provide a common currency, these considerations indicate that the case for a European central bank is much weaker than is often appreciated. In any case, the costs and benefits of monetary union cannot be assessed in isolation, and it is especially important to establish whether or not the central bank would produce stable monetary conditions. I then investigate the likely relationship between the central bank and the EC and the impact of the EC's financial problems on central bank policy. It is very probable that substantial fiscal pressure would be brought to bear on the central bank, resulting in both higher inflation and a drive toward re-regulating the European banking system. I also will consider America's experience with its Federal Reserve System. There is considerable evidence that the Fed has significantly destabilized the U.S. economy, and there is reason to believe that a European Fed would do even worse.

There are some alternatives to a European central bank. One option is simply to continue with present EMS arrangements. While this option would leave Europe with some unnecessary monetary instability, it is nonetheless demonstrably superior to a European central bank. An even better alternative is to institute a currency reform that pegs the value of the currency to a basket of real commodities, eliminating inflation once and for all. Having stabilized the currency, we could then do better still by opening up the issue of currency to free competition and by eliminating existing central banks altogether.

The Benefits of European Monetary Union

Much of the controversy over a European central bank centers on the question of monetary union. "Monetary union" can be used to describe an arrangement where the exchange rates between different currencies are fixed, and are widely perceived to be permanently fixed, but where currencies are still distinguishable. The term can also be used to describe an arrangement where everyone uses a common currency. It is important to keep these two types of monetary union separate because they give rise to quite different issues.

The main benefit from adopting fixed exchange rates stems from the reduction in uncertainty about future changes in exchange rates. While exchange rates are still flexible, firms that engage in international trade have to cope with fluctuations in their profit margins that arise from unforeseen changes in exchange rates. Sometimes firms can cover themselves against these risks by engaging in futures operations, but that kind of cover is costly even where the market is relatively thick, and elsewhere the thinness of markets (for example, for cover years ahead) makes cover so expensive that firms often prefer to take the exchange rate risk instead. It is hard to quantify these benefits from the elimination of exchange rate uncertainty, but intuition suggests that they are probably quite important.[2] We must weigh the costs of a fixed-rate system against these benefits. There is some controversy over what the costs might be, but the main one seems to be implied by a move away from optimal currency areas. There is a cost to tying currencies together if they belong to different optimal currency areas, but the potential loss is hard to assess because we have little idea what the optimal currency areas might be.[3] It follows, then, that it is not clear whether or not fixing European exchange rates generates a net gain.

Whether there are any net gains from then merging separate currencies is also problematic. The main benefit from adopting a common currency is the reduction in transactions costs that arise in

[2]Artis (1989, p. 5) estimated the benefits to be about 1.5 percent of GDP, but this is little more than an informed guess. Artis (p. 18) also suggested that "there is an irreducible incipient instability" with fixed-rate systems because there is always a positive probability they might be dissolved. He concluded that a fixed-rate system cannot eliminate all exchange rate uncertainty but a common currency can. But the subjective probability that individuals form of a future dissolution depends on the institutional structure that lies behind the monetary system, not on whether we have fixed exchange rates or a single currency. Even a common currency might be dissolved if countries subsequently withdrew from the EC, and there are historical precedents (for example, the dissolution of the common currency after the breakup of the Austro-Hungarian Empire).

[3]Vaubel (1989, p. 6) argues that there is "no operational scientific method of measuring and comparing the costs and benefits" of a fixed-rate system. His real exchange rate criterion for optimal currency areas allows for such factors as labor immobility, diversification, and fiscal integration, so these factors should not be considered as costs in addition to those covered by the theory of optimal currency areas. According to Vaubel (p. 9): "The traditional criteria of optimum currency areas are mostly ambiguous [and] difficult to measure." Thus, "the availability of a comprehensive and operational measuring rod, the real exchange rate criterion, is important." However, for Vaubel, "It is not comprehensive enough. It ignores the other cost of currency unification: the weakening of currency competition; and it does not take full account of the benefits of currency unification."

changing from one currency to another.[4] The costs involved seem to vary from perhaps 3 to 4 percent for tourist exchanges to trivial amounts for large business transactions,[5] and one could probably get some idea of the magnitude of potential cost savings from the resources currently used up by *bureaux de change*.[6] As a rough order of magnitude, cost savings probably amount to 0.1 percent of GNP, and we must weigh the costs of adopting a common currency against those savings. Prices, salaries, accounts, and other nominal values would all have to be altered, and machines would have to be adapted to deal with the new currency. People would have to adjust to it, and these psychic costs could be more significant than any other. There is no hard evidence on these costs, but the British experience with decimalization in 1971 is instructive. Also bear in mind that decimalization only changed the constituent elements of the basic monetary unit: Shillings and old pennies were replaced by "new pence," but the pound remained untouched. Adopting a common currency would be a more radical change, because the basic unit itself would be altered. The implication, then, is that these costs would eat significantly into the gross saving to produce a very small net gain—and there may be no net gain at all.

It should be clear that the case for monetary union in either form is far from obvious. It should also be clear that the question cannot be resolved by arguing about it in the abstract, because no one has the information needed to predict confidently the relevant gains or losses. In the final analysis, the only way to resolve the issue would be to create the conditions for free competition between different

[4]Goodhart (1989b, p. 12) reckoned that these savings "are of some considerable importance, but are not massive by any standards."

[5]Eltis (1989) suggested figures of 2.5 to 3 percent for tourist exchanges and 0.5 to 1 percent for large business transactions. The first figure understates the cost because it includes only the pecuniary cost of exchange and ignores the inconvenience cost of having to go to a *bureau de change*. The second figure seems to be an overstatement. Large business transactions are paid for by using credit instruments (e.g., checks and credit cards), and it is not clear why carrying out such transactions across different currencies adds significantly to their cost; whether there is a single currency or not, the settling up procedures are not fundamentally different. Even so, Eltis (1989, p. 1) estimated that the total savings from moving from flexible rates to a single currency amount to only 1 to 1.5 percent of GDP at most, a figure that is not far different from mine.

[6]The resources used by *bureaux de change* overstate the relevant cost in one respect and understate it in another. They overstate it because the only *bureaux de change* activity that would be eliminated is between the currencies that are merged. They understate it because not all currency exchanges actually take place through such *bureaux*.

currencies and see what happens.[7] If the public feels that fixing exchange rates is worthwhile, then it will exercise market pressure on the issuers to peg their currencies; if the public wants a single currency as well, one will evolve from the competitive process. As Vaubel (1989, p. 11) observed:

> I used to believe that the desirability of European currency union was a foregone conclusion and that currency competition would merely show us the optimal path to that end. I now realise that the end itself has to be questioned and that currency competition is not only the optimum currency unification process, if currency union is desirable, but also the optimal procedure of finding out whether currency union is desirable.

The Importance of Price Stability

The monetary union issue can never be resolved in isolation. What we are really interested in is the monetary environment, and monetary union is only one part of that environment. Another aspect is its stability, and it is impossible to responsibly support a plan for monetary reform without first knowing that it will produce stable monetary conditions. Monetary instability must be avoided for several reasons. It injects unnecessary "noise" into the price "signals" on which the market mechanism relies to allocate resources properly; therefore, it leads individuals to make costly "mistakes" they would otherwise have avoided. Monetary instability obliges people to invest time and resources trying to cover themselves against the risks to which it exposes them, and it leads them to neglect socially worthwhile, long-run projects and to concentrate excessively on short-term survival. It distorts investment activities and fuels speculative "bubbles" by encouraging people to seek out allegedly safe assets as a hedge. Monetary instability produces arbitrary gains and losses that have nothing to do with any socially worthwhile activity, that undermine the institution of private property, and that erode confidence in the integrity and fairness of the market system. Both recent and historical experiences of high inflations suggest they cause hardship and massive social and economic disruption. I expect that the costs of inflation vastly outweigh any gains that may be

[7]To the extent that the case for a central bank depends on the case for a single currency, the only way to advance the case for a central bank would be to establish free competition to indicate whether there should be a single currency (although it is well established that a single currency does *not* require a single issuer; see White 1984, Selgin 1988, Dowd 1989a, and Glasner 1989). However, I certainly do not dispute Schwartz's claim in her discussant's comment that competition among currencies might involve large information costs. I would claim only that we simply do not know enough to justify imposing a single currency by fiat.

obtained from European monetary integration. Although monetary union *might* be worthwhile *if* it comes with price stability, we would be ill advised to sacrifice price stability for mere monetary union. Price stability is the central issue, and monetary union *per se* is only secondary in comparison.

Given the importance of monetary stability, we might have expected the Delors Report to have offered some guarantees that the new European central bank would deliver stable prices, but the report offered no reassurance on this issue. It stated only that the bank "would be committed to the objective of price stability" (p. 18), but it made no suggestions about how the bank would achieve that objective. It reads as if the statement of intent (that the bank is expected to achieve price stability) would be sufficient to ensure that the bank *would* actually achieve it. Central bank statutes the world over are littered with similar "commitments" to price stability, and none of them actually achieves it for long, if at all. There is no reason to expect that a new European central bank would succeed where other central banks have failed. The Delors Report further undermines price stability by insisting that it is not its only objective. Monetary policy is also to be coordinated with national and EC fiscal policies and with general macroeconomic policies as set out by the Council of Ministers, which have a wide range of differing objectives (e.g., "balanced growth, converging standards of living, high employment and external equilibrium" (Delors 1989, p. 8).[8]

It is also doubtful that the European central bank would achieve price stability because it would have relatively limited independence from political interference. While the Delors Report stated that the central bank "should be independent of instructions from national governments and Community authorities" (p. 20) and suggested how the bank might be constituted to give it some independence, the report undermined that independence by suggesting that the bank be held accountable to the Council of Ministers and the European Parliament. Such accountability, however, would almost inevitably make it difficult for the central bank to pursue policies of which European politicians would strongly disapprove. The Delors Report also undermines the central bank's independence by recommending that the Council of Ministers have overall responsibility for macroeconomic—and, presumably, monetary—policies. Whatever the bank's independence on paper, the politicians would inevitably have considerable leverage over it in practice, and the empirical

[8]A related issue is *why* certain people want a European monetary union or a European central bank. George Selgin covers this issue in his accompanying comments.

evidence clearly indicates that "the average rate of inflation is significantly lower in countries that have highly independent central banks compared with those that do not" (Bade and Parkin 1981, p. 33).

Central Banks and Inflation

There are various reasons to expect a central bank to inflate and be more prone to inflation the less independence it has. Suppose we have a monetary authority that has a monopoly over the issue of inconvertible currency.[9] This monetary authority can be considered a combination of central bank and government, and the objectives it follows depend on the underlying objectives of governing politicians and central bankers and on the balance of power between them. The less independence the central bank has, the more weight is assigned to the interests of the politicians. The politicians are primarily interested in manipulating the economy to get re-elected and in collecting seignorage as a disguised tax that enables them to avoid the unpopularity of more explicit forms of taxation. The central bankers do not have to face popular re-election, and they get little or no direct benefit from seignorage, at least at the margin.

The monetary authority is self-interested, and it aims to manipulate inflation in its own interest; that is, it aims to create sufficient inflation to bring the marginal benefit that it derives from inflation down to the marginal cost that inflation imposes on it. The marginal benefit derives from the reduction in unemployment generated by unanticipated inflation and from the seignorage that the monetary authority collects. The cost derives from the adverse criticism that inflation provokes and the erosion of the monetary authority's credibility. If the monetary authority were to produce zero inflation, then the marginal benefit of inflation would exceed the cost; thus the monetary authority would not produce price stability, and the public would not expect it to. The public would expect the inflation rate that was in the bank's own interest, so the equilibrium inflation rate would be some rate above zero. This rate will also vary with changes in the marginal costs and benefits of inflation. These changes will often be unpredictable, because many of the benefits of inflation to the monetary authority stem from it successfully surprising the private sector. Therefore, there would be not only inflation, but unpredictable inflation as well.

[9]This discussion is based loosely on the literature stemming from Barro and Gordon (1983). For a good evaluation of it, see Blackburn (1989).

It should also be clear why a central bank that lacks independence will produce more inflation. The benefits of inflation accrue primarily to governing politicians rather than central bankers, but there is no such obvious discrepancy in the distribution of the costs of inflation. The less independence a central bank has, the greater the influence of the politicians on central bank policy, and the more it will reflect their desire for relatively high inflation. The politicians' desire for high inflation also implies that a central bank that is under the thumb of its government will have less credibility with the private sector as an institution that is serious about controlling inflation, and this lack of credibility will push the equilibrium inflation rate even higher than it would otherwise be.

The State of EC Finances

The likelihood that the new central bank would inflate is further reinforced by the state of EC finances. The basic problem is the European Community's failure to control its expenditures. Uncontrolled expenditure growth had already pushed the community into technical bankruptcy by 1983.[10] The "solution" was to massage the budget and defer spending; and, as Swinbank (1988, p. 3) observed, "Crisis management, and budgetary chicanery [have] prevailed ever since."[11] In 1985, member governments tried to ease the pressure on the Community's budget by increasing its share of VAT revenues from 1 to 1.4 percent of the notional VAT base—an increase of about 26 percent in its resources (Koester and Terwitte 1988, p. 103)—but the budgetary crisis continued to mount. By 1987, even the Commission (1987, p. 2) was forced to admit that

[10]One might wonder how the EC could be technically bankrupt when its budget is theoretically always in balance. In practice, the EC was able to maintain the fiction of a balanced budget by pushing unfunded liabilities into the future where it lacked the means to honor them.

[11]The EC had many ways of disguising its true budgetary position. One was to manipulate the accounts for its Structural Adjustment Funds. Another was to over-value agricultural stocks by valuing them at purchase prices instead of disposal prices. The EC also massaged its accounts by diverting agricultural surpluses into its stockpiles instead of exporting them. The EC has to pay the cost almost immediately if CAP surpluses are exported, but if surpluses are stored, member governments pay the immediate costs and the EC pays them back later. Although this enables CAP expenditures to be put off to another day, the "eventual Budget costs can be horrific, . . . for throughout the storage period storage and finance costs must be paid, and when the stocks are eventually released then the Member States must be reimbursed for the 'loss' in value. If intervention, rather than export, is systematically pursued for short run gains, then the inheritance is burgeoning intervention stores *and* running costs" (Swinbank 1986, p. 2).

> the community is . . . faced with a budgetary situation which can only be characterised as being on the brink of bankruptcy. . . . the Community has sunk into a morass of budgetary malpractices needed to conceal or postpone the real financial implications of Community policies. Thus, the budgetary effect of the unprecedented build-up of agricultural stocks has been disguised by gross over-valuation of the stocks: actual budgetary deficits have been carried forward and only covered belatedly by ad hoc solutions; and Community commitments have been allowed to accumulate without proper financial provisions. . . . the Community has not been equipped with the necessary means to adapt policies to the desired expenditure scenarios [that is, the Community cannot manage its budget properly].

The escalating financial crisis led the Brussels summit in February 1988 to agree on a package of measures designed to put EC finances on a firmer basis. Principal among those measures were agricultural price "stabilizers" intended to limit intervention if EC production quotas were exceeded. The summit also agreed to grant the Community a 25 percent increase in its revenues by agreeing to a new contribution by each member state on the basis of its GNP (Koester and Terwitte 1988, p. 103)—equivalent to a rise in its implicit VAT rate to 2.2 percent. This new revenue source was "residual finance" to provide the Community with just enough funds to balance its budget, but it was to be subject to a ceiling intended to keep EC spending under control. The spending ceiling was initially set at 1.12 percent of Community GNP in 1988, to increase by steps to 1.2 percent in 1992 when it would be reviewed.[12]

It is highly unlikely that these measures actually achieved anything more than a short-term respite for the EC's budgetary problems. The stabilizer mechanisms were relatively limited, and the underlying incentive to over-produce agricultural products remained intact. As one study (Field, Hearn, and Kirby 1988, pp. 32–33) observed:

> In view of the [political] pressures for [agricultural] price increases, technological changes which will increase production, and the gradual application of EC measures and prices to Spain, the Community will have difficulty keeping support expenditures within the targets set . . . there will be considerable pressure to exceed the amounts agreed on and to borrow or transfer funds supposedly allocated [elsewhere]. . . . Any assumption that . . . genuine reform has been achieved in EC agriculture, would be highly misleading.

[12]The EC also engages in a considerable amount of off-budget financing. In 1988, such financing amounted to about 25 percent of its total budget (Commission 1989b, p. 10).

This conclusion was echoed by Koester and Terwitte (1988, p. 104): "In [the] future the CAP will cost more, not less. The decisions regarding 'stabilizers' and land set-aside schemes . . . will probably have little impact." But perhaps the main weakness of the Brussels package was that there was no means to make its theoretical limits on EC spending effective in practice. There was no mechanism by which support could be cut off or other penalties imposed if limits were exceeded. Furthermore, the Commission had no incentive to keep its costs down.

The underlying dynamic of Community finance is therefore quite clear. Member governments impose limits on EC spending, but they do not enforce them and implicitly encourage the EC to violate them. Whenever those limits were exceeded and a financial crisis ensued, as in 1983 and 1987–88, member governments did nothing to penalize those involved and to bring expenditures under control. Instead, they rewarded the Community each time by giving it substantial increases in resources that would put off the crisis for a while. Meanwhile, EC expenditures continued to escalate, and we are now presumably heading for the next crisis in a year or two. This is the fiscal context within which the proposal for a European central bank needs to be viewed.[13]

EC Finances and the European Central Bank

The establishment of a European central bank would give the EC a major new source of finance: the seignorage from money creation. The amount of seignorage that European governments currently collect varies from one country to another.[14] Some indicative figures for the early- and mid-1980s are 0.1 percent of GDP for the United Kingdom and Belgium, 0.2 percent for Germany, 0.7 percent for France, 2 percent for Italy, 3.4 percent for Greece, and 4.8 percent for Portugal (Grilli 1989, Table 1). As a general rule, the higher figures are due to reserve requirements that increase the demand for

[13]This account of Community finances gives a rather optimistic picture because it ignores certain other problems. One is the problem of outright fraud. Tiddeman indicated that from 10 to 20 percent of Community subsidies are defrauded (in Tutt 1989, p. 100). Another is the sheer inefficiency of the Community. See Tutt (1989, p. xiii).

[14]The measure of seignorage referred to below are the increases in monetary base, but increases in monetary base are not the only revenues that governments can appropriate using inflation, or even the most important ones. As Friedman and Schwartz (1986, p. 56) observed, decreases in the real value of outstanding government debt due to inflation are at least as important. It follows, then, that the Community could increase its seignorage revenues considerably beyond the levels suggested in the text if it were to start issuing debt whose value is then depreciated by inflation. This consideration, of course, further magnifies the problems already highlighted.

the monetary base (e.g., in Portugal), but seignorage revenues are tending to fall in these countries as their reserve requirements are phased out. If we take this factor into account, it seems reasonable to suppose that the average seignorage revenue in the EC will settle down to perhaps 0.2–0.3 percent of GDP. Were the European central bank to collect the same amount and pass it back to the Community, seignorage revenue would increase the EC resource base by 17 to 26 percent.

Nonetheless, it would be a mistake a view seignorage as a relatively fixed addition to Community resources, comparable, for example, to the VAT revenues over which it has no direct control. The EC could always increase its seignorage revenues by pressing the new central bank to reimpose reserve requirements to buttress the demand for monetary base, and the figures for France and Italy give some indication of how reserve requirements and other regulations can substantially increase seignorage revenues. If reserve requirements could push up average seignorage even to the relatively low French figure of 0.7 percent, then seignorage revenues would increase by a factor of two and a half and constitute an addition to total Community revenues of around 60 percent.[15] The Community could also generate additional seignorage by leaning on the central bank to inflate at a faster rate. Some indication of the amounts involved can perhaps be obtained from the increases in seignorage that occurred when inflation rose substantially during the 1970s. Grilli's figures for the 1960s and 1970s indicate that decade-average seignorage/GDP ratios rose for 8 of the 11 current EC member countries (excluding Luxembourg), and the average rise was about 0.4 percent of GDP.[16] Such a figure implies that pushing inflation back up to the levels of the 1970s would approximately double seignorage revenues, and seignorage would presumably increase further if inflation was pushed even higher.

These figures suggest that a European central bank would substantially increase EC resources even if it kept inflation down to current EMS levels and refrained from reimposing reserve requirements. Apart from increasing the Community's resources, a central bank would also significantly soften the budget constraint that the Community faces, and that constraint is arguably far too soft already. At the

[15]The case of France is taken only for illustrative purposes, but it may well understate the potential revenues involved. We would get considerably higher revenues if we used Italy or Portugal as examples or if the new central bank imposed more stringent reserve requirements.

[16]Again, these figures are illustrative, but the average figure of 0.4 percent is relatively robust to how one takes the average.

moment, the cost to the Community of exceeding its budget is a lot of bad publicity and the probability that member governments might become sufficiently incensed that they stop arguing with each other and agree to do something about it. While still allowing the Community its traditional option of increasing its resources by spending itself into a crisis and looking to member governments to bail it out, the new bank would give the Community the additional option of increasing its resources by taking subsidized loans from the central bank that could be disguised to divert criticism and the danger of outside interference. A European central bank, therefore, would be a further disincentive for the Community to rein in its spending, and it would make the establishment of rationality in EC finances even more difficult than it already promises to be.

Apart from being detrimental to European public finance, a central bank would also be very damaging to the European financial system. For reasons already explained, the Community would be strongly tempted to finance its overspending at least in part by imposing reserve requirements and other regulations on the banking system. Taxing the banking system in this way is politically attractive, because such taxes would be relatively easy to disguise; and, in any case, banks are often an easy political target because they rarely get much public sympathy. Nor is there any reason to expect that the Community would subsequently refrain from further taxes on the banking system. The very factors that led the Community to intervene the first time will encourage it to do so again, and the burden on the banks will tend to increase over time, seriously eroding the efficiency and competitiveness of the European financial system.

There is also a very real danger that the Community's search for new ways of taxing the financial system could wipe out the Euromarket as well as undermine the relative freedom on which the prosperity of Europe's financial centers depends. London would be especially vulnerable in this regard. Another disturbing feature of these interventions is that the central bank would be most unlikely to justify them as taxes, because to do so would expose it and the Community to unnecessary criticism. Instead, the central bank would be likely to hide behind the smokescreen that the interventions were required for various "prudential" purposes: to "stabilize" the banking system, to "protect" widows and orphans, and so forth.[17]

[17]See Selgin (1988, 1989) and Dowd (1988, 1989a), who both argue that interventions to stabilize the banking system have usually had just the opposite effect. As for the "widows and orphans" argument, the single most important service the government could provide such people would be to protect the value of their investments by refraining from inflation, something that governments have singularly failed to do.

These excuses would establish the unfortunate precedent that the European central bank *ought* to be intervening for these purposes. The justifications for the earlier interventions would then encourage the bank to develop an active "prudential" role, and the financial system could find itself saddled with a variety of unnecessary regulations that undermined it even further.

Potentially most disturbing of all, however, is the danger that the EC's financial problems could lead it to inflate the European currency. Inflation would be a tempting option for the Community, not only because it generates substantial rewards, but also because the costs to the EC of inflation would be relatively low. Costs would be low because it would be difficult for the injured parties (that is, the public) to figure out who was responsible, and it would be relatively easy for the Commission to throw up a smokescreen that deflected the brunt of criticism.[18] Even if the Community could not avoid criticism over inflation, the costs would still be quite low, because the public lacks any easy means to penalize the EC or force it to pay attention to their concerns. There are also reasons to expect that inflation might rise over time. Taxes on the banks are likely to be politically less costly than inflation, and it would be in the Community's interest to exploit the politically less-damaging taxes first and only gradually increase its use of the inflation tax. In any case, there would come a point where it would become increasingly difficult to extract further resources from the financial system, and the EC would have to rely increasingly on inflation to finance its additional spending. So there is a very real possibility that Community's financial problems would not only lead to substantial inflation, but that they would also produce rising inflation as well.

U.S. Experience with the Federal Reserve System

Since the proposed European Federal Reserve system is modeled to some extent on the U.S. system, it makes sense to see what could be learned from the American experience. The Federal Reserve was established in 1914 to provide the U.S. banking system with protection against the periodic crises to which it was prone.[19] During

[18]Vaubel (1988) argued persuasively that one of the functions of the bureaucracy is to do the "dirty work" for elected politicians and take the blame for it. This would presumably be one of the functions of the new central bank. Such an arrangement makes sense from a public choice point of view, because it is more difficult for the public to penalize the bureaucrats than it is for them to penalize the politicians.

[19]There is considerable evidence that these crises were due to the inappropriate legal framework provided by the national banking system. For the destabilizing effects of these and other restrictions on the U.S. banking system, see Benston (1989), Dowd (1989a), and Selgin (1989).

the early 1930s, however, the Fed's failure to provide that protection escalated relatively minor banking problems into waves of bank failures that had catastrophic effects on economic activity. As Friedman and Schwartz concluded (1963, p. 391):

> The leadership which an independent central-banking system was supposed to give the market and the ability to withstand the pressures of politics and of profit alike and to act counter to the market as a whole, these—the justification for establishing a quasi-governmental institution with broad powers—were conspicuous by their absence.

Recent work on the Fed's performance supports this assessment. Gorton (1986) examined the impact of the Fed by carrying out a counterfactual experiment to predict what would have happened if the pre-Fed regime had continued after 1914. His results indicate that although a panic would have occurred in December 1929, the "failure and loss percentages would have been an order of magnitude lower" (p. 29) in the absence of the Fed. This result suggests that there would have been a downturn in the early 1930s, but not the major disaster that actually occurred. Studying the period up to 1940, Miron (1989, pp. 290–91) found that "the variance of both the rate of growth of output and of the inflation rate increased substantially, while the average rate of growth of output fell, and real stock prices became substantially more volatile." He suggested that these conclusions hold even if the period of the Great Depression is ignored. Miron's analysis also suggested that these changes were not merely coincidental with the founding of the Fed but can be directly attributed to it. The record of the Fed since the World War II has not been much better. Output variability does not appear to have decreased (Romer 1986), and prices have become much less stable than they were earlier. The postwar era was also the period when the Fed shook itself free of the discipline imposed by the gold standard, and it used its newfound freedom to create an inflation that is unprecedented in U.S. peacetime history and that still shows no sign of ending.

The way in which the Fed has evolved since its foundation is also disturbing. It started off as a system of 12 autonomous Federal Reserve banks, with a Federal Reserve Board as a kind of liaison committee—much like the European central bank proposed by Delors. Subsequently, however, it evolved into a system in which "the Board in Washington is all powerful and the Federal Reserve Banks not much more than administrative units" (Timberlake 1986, p. 759). In the process, the Fed turned into an institution

> whose every act is to enhance the power and prestige of itself and the government. Unless one can argue that what is good for the government is good for the general public, one cannot defend either the mutation of the Fed as it has occurred, or the Fed's continued existence as an all-powerful central bank. Its 70-year history as a bureaucratic institution confirms the inability of Congress to bring it to heel. Whenever its own powers are at stake, the Fed exercises an intellectual ascendancy over Congress that consistently results in an extension of Fed authority. This pattern reflects the dominance of bureaucratic expertise for which there is no solution as long as the [Fed] continues to exist [Timberlake 1986, p. 759].

Disturbing as this record is, several factors imply that a European Federal Reserve system would fare even worse. The U.S. Federal Reserve has generally had to deal with a federal government that was in reasonably sound fiscal shape, so the pressure to inflate for fiscal reasons was usually quite limited (a factor that has undoubtedly helped to keep American inflation lower than it would otherwise have been). As I discussed earlier, however, a European Federal Reserve would have to deal with a European Community whose financial position is anything but sound, and the fiscal pressure to inflate would be intense. A European Fed would also start off with no discipline against over-issue, such as that which the gold standard provided the U.S. Fed during its early days. This combination of fiscal pressure and the lack of any discipline against over-issue makes it all but certain that a European Fed would make the inflation record of its American counterpart look very good indeed.

Some Alternatives to a European Central Bank

Fortunately, there are superior alternatives to a European central bank. One is simply to persist with the EMS. The EMS is a currency bloc in which the member central banks agree to maintain the exchange rates of their currencies within relatively narrow bands. Should one country attempt a more expansionary monetary policy than the rest, then that country can maintain its exchange rate within the permitted bands only by running down its reserves of foreign exchange or by borrowing reserves from elsewhere. Its ability to maintain a more expansionary monetary policy is therefore necessarily limited, and the maintenance of its exchange rate in the long run requires that its monetary growth rate be compatible with the monetary growth rate pursued by its partners in the exchange rate system. Because the more conservative central banks can keep accumulating reserves at relatively little cost or inconvenience but the more expansionary ones would eventually run out of reserves and

cease to be able to maintain their exchange rates, the pressure to adjust tends to be concentrated on the expansionary central banks, which then have to curtail their monetary growth. This implies that the system's monetary policy is effectively determined by the most conservative central bank, which therefore sets the monetary growth rate and forces its partners to restrict their monetary growth to rates that are compatible with its own.

The most conservative central bank in the EMS is the Bundesbank, and much of its conservatism seems to stem from the combination of its mandate to secure the value of the currency and its independence from the German Federal Government.[20] The asymmetry of the reserve pressure between comparatively expansionary central banks and the Bundesbank "imparts a helpful anti-inflation bias into the EMS whereby central banks that have a tough anti-inflation stance can put pressure on other, less disciplined central banks" (Currie 1989, p. 21). Thus, the EMS mechanism allows the weaker central banks to piggyback on the Bundesbank's superior inflation record and "borrow" its credibility. Currie (1989, p. 21) found that the EMS contrasts "with the way in which a centralized, coordinated monetary policy can operate, say within a full monetary union [with a European central bank]. For then, monetary policy will be determined by committee, and the outcome will tend to reflect the average, not the best, anti-inflationary policy." It follows that if a central bank is to run European monetary policy, inflation would be lower with the Bundesbank in control than with a new central bank whose policies would be bound to reflect compromises between those who want higher inflation and those who do not.

Although the EMS still allows for occasional currency realignments, it will become increasingly difficult to accommodate realignments as remaining capital controls are lifted across the EC. If monetary policies are not consistent across the EMS countries, then markets will have no difficulty anticipating the direction of the prospective exchange rate change and market operators will discount the currency that is expected to be devalued. In order to maintain asset market equilibrium, interest rates will then rise sharply in the country whose currency is to be devalued, and interest rates will keep rising until the devaluation takes place. As controls are lifted and capital becomes more mobile, even greater interest rate movements will be required to maintain asset market equilibrium and the

[20]One might also add another factor: the memory of previous 20th-century inflations in Germany.

capital flows involved will become larger and more disruptive.[21] The relaxation of capital controls, therefore, will increase the pressure on the EMS to prevent exchange rate realignments altogether, and the other central banks will find their freedom of maneuver even more restricted than it already is. The present "soft" EMS would tend to evolve into a "hard" EMS in which exchange rates were fixed once and for all, and the Bundesbank's hegemony was even stronger than it already is.[22]

The drawback with this option is that we are still left with the avoidable monetary instability created by the Bundesbank itself. It is often overlooked that the Bundesbank's inflation record is good only in comparison with that of other central banks and that it is poor compared to what commodity standards have been able to achieve in the past. Perhaps the easiest way to eliminate the price instability created by the Bundesbank would be to tie one of the ERM member-currencies to a general price index.[23] The issuer of the currency would be legally compelled to buy and sell its currency for some redemption medium (e.g., shares) at an exchange rate determined by the general price index, and it would be impossible for the issuer to inflate the currency further. The new inflation-proof currency would then displace the D-mark as the "strong" currency in the EMS, and the Bundesbank would no longer determine EMS inflation. If they wished to maintain their EMS parities, the issuers of the remaining currencies would have to abandon their inflationary rates of monetary growth, and inflation would be eliminated throughout the EMS countries. The "hard" EMS would thus be transformed into a "super-hard," non-inflationary EMS that was free of the Bundesbank's own inflationary proclivities. Once the values of the EMS currencies had been tied down, the next logical, and highly desirable, step would be to remove any legal restrictions against the issue of currency and to abolish the existing central banks. The issue of "money" could

[21]These short-term interest fluctuations can be very considerable. See de Cecco and Giovannini (1989, p. 5). There is also empirical evidence that capital controls have helped to restrain interest rate fluctuations and capital movements (Giavazzi and Spaventa 1990).

[22]It seems that this German hegemony causes considerable resentment, especially in France. This resentment might help to explain why the French have been pushing for an international central bank in which German influence would be reduced. See Eltis (1989) and Goodhart (1989b).

[23]Dowd (1989b) elaborated on this proposal and suggested that the United Kingdom should introduce a monetary reform to stabilize prices and then announce the entry of the pound into the ERM.

then be left entirely to the free market, which is best able to look after it.[24]

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[24]See White (1984), Selgin (1988), Dowd (1988, 1989a), and Glasner (1989).

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A European Central Bank: Some Unanswered Questions

Anna J. Schwartz

Unsettled Issues

I am in substantial agreement with the views that Kevin Dowd expresses. In answer to the question of the paper's title, I agree that Europe definitely does not need a Federal Reserve System. Had I written the paper, however, I would have asked several other questions either at the start or at the conclusion. One question is: Is there any reason to believe that a single central bank will, in fact, be established in Western Europe? If so, when? Is the time framework under discussion a few years or a half century?

Another question is: Are there preconditions for the establishment of a single central bank? In most national states, political unification preceded the formation of a central bank. Is political unification of the 12 member countries a prerequisite for creating one central bank for all? If that is required, is there any indication that the governments of the 12 members are ready to pool their foreign exchange reserves and renounce their own monetary powers in favor of a single central bank?

The Federal Reserve System was an adaptation of the model of a European central bank to fit the regional and populist character of the United States. It was established in an existing nation. A Federal Reserve System of Europe would bear no genuine resemblance to its presumed prototype. The analogy to the United States would apply if the European Community were a federal government of Western European states comparable with the U.S. federal government.

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If one thinks of the powers of a central bank, the main one it enjoys is that it can engage in open-market operations. Open-market operations are usually conducted in risk-free government securities. Will these securities be the issues of a federal government of Western Europe? If not, which assets will the central bank acquire for its portfolio? What will happen to the portfolios of existing central banks? Will the monetary base the new central bank can create and destroy be a new currency, in that respect similar to the introduction of the Federal Reserve note? Enough of my questions, however. Let me turn to the content of the paper.

Approaches to European Monetary Union

Before assessing the arguments for a European central bank, Dowd first discusses the flaws in the proposal for a European monetary union that would substitute one new currency for existing individual national currencies. He examines the difference between a monetary union with distinguishable national currencies linked by fixed exchange rates and a monetary union with a common currency.

In the case of a monetary union with fixed exchange rates, the benefit it affords is the elimination of exchange rate risk. However, if the currencies that are linked are not all members of the same optimum currency area, there is a cost. Fixing European exchange rates in this view may not yield a net gain. Let me add that defining an optimum currency area is not a simple exercise.

In the opposite case of a monetary union with a common currency, a reduction in transactions costs, which Dowd estimates as equal to one-tenth of one percent of GNP, is the benefit. Human and mechanical costs would be imposed in adjusting accounts to a new currency unit—a more radical change in his view than Britain experienced in 1971 when it adopted decimalization. So adopting a common currency may also not yield a net gain.

Dowd's conclusion is that free competition among currencies should determine which form of monetary union should be chosen. He says that the resolution of the question would come either by pressure from the public on issuers to peg their currencies or else by a demonstration by the public of preference for one national currency among competing national currencies circulating in each country.

However, monetary union in the sense of pegged exchange rates does not require free competition among currencies. It is not obvious that first the snake and then the European Monetary System (EMS) were a response to public pressure to peg currencies any more than the Plaza Agreement or the Louvre Accord to coordinate official

intervention in foreign exchange markets was such a response. These were decisions by policymakers. I am not aware that the public's wishes were consulted.

On the other hand, a monetary union with a single currency that might emerge from a competition among 12 national currencies would impose huge information costs on the public in arriving at its final choice. I suggest that Dowd should first have dealt with the magnitude of information costs for money holders in choosing one from a dozen competing national monies. If adjustment to one new money imposes large human and mechanical costs, as Dowd argues, then surely the costs of adjustment to singling out one of multiple competing monies would be far greater.

In principle, I believe money holders should be free to choose to hold money denominated in different national units. But is this the royal road to achieve monetary union? Money holders seem to exhibit enormous attachment to the national money with which they customarily conduct transactions, even when that currency is far from stable. Barring hyperinflation, what is the evidence that money holders will readily shift to a currency other than their usual national one? Is this a reason that the ECU has not taken off as a private transactions money?

Price Stability under a European Central Bank

Dowd makes the important point that the object of monetary integration is to achieve stable monetary conditions. To quote him, "Price stability is the central issue, and monetary union per se is secondary in comparison."

He therefore asks: What is the prospect that a European central bank would, in fact, achieve stable monetary conditions and hence price stability? The proposal for a European central bank makes no provision for a rule binding the bank to provide steady, noninflationary money growth. Instead, monetary policy is directed to achieve additional objectives, other than price stability, that are not within the competence of any central bank and only distract it from the single objective of price stability that is within its competence. Moreover, the bank's independence is compromised by making it subservient to politicians in the Council of Ministers and the European Parliament.

Because the European Community does not exercise control over its expenditures, Dowd rightly argues that it will seek to increase its resources by drawing on the seignorage that money creation by a European central bank would give it. He estimates that if the Euro-

pean central bank passed on to the Community seignorage revenue equal to 0.2–0.3 percent of GDP, roughly the present level at member countries, Community resources would increase between 17 and 26 percent. But that is not the end of the story. The Community could also press the new central bank to raise reserve requirements, thus increasing the demand for monetary base and increasing Community resources by around 60 percent thanks to higher seignorage. Pressure on the central bank for a higher inflation rate would increase seignorage revenues further. In addition the Community could seek subsidized loans from the central bank—with the effect of permitting Community spending to proceed unchecked. So there is reason to be suspicious that monetary and price stability will be an overriding concern of a European central bank.

Dowd foresees incentives for the Community and the central bank to undermine the efficiency of the European financial system by taxes that would wipe out the offshore market in Europe and by unnecessary regulation. When it would become difficult to extract further resources from the financial system, the European Community might well rely increasingly on inflation to finance growth in its spending.

He then asks whether the record of Federal Reserve experience is reassuring and answers in the negative, on the basis of its deflationary actions in 1930–33 and its inflationary actions in the past quarter century. He concludes that a European central bank would fare even worse, on the ground that the fiscal position of the U.S. federal government until recently has been reasonably sound—this observation may be dubious—which is not true of the European Community. Therefore, the inflation record of the European central bank is likely to be worse than that of the Fed.

Monetary Policy under the EMS

Dowd suggests that continuation of the existing Exchange Rate Mechanism (ERM) under the EMS would produce a monetary policy that would outclass the monetary policy of a supposed European central bank. His reason is that the EMS's monetary policy is determined by the most conservative central bank—the Bundesbank. European monetary policy set by the Bundesbank, he concludes, would lead to lower inflation than if set by a new central bank compromising between those on its board who want higher inflation and those who do not.

Attributing the superior performance of the EMS to the German Dominance Hypothesis has been challenged in a recent article by

Michele Fratianni and Juergen von Hagen (1990). On the basis of empirical tests, the authors reject the interpretation of the EMS as dominated by the Bundesbank. They find that EMS countries responded to common shocks emanating from tighter U.S. monetary policy in the early 1980s and the decline in oil prices. Only Italy's monetary policy was responsive to Germany's. On the other hand, other EMS monetary policy impulses had no lasting effect on the Bundesbank's policy. German independence, they assert, is not the same as German dominance. Capital and exchange controls and realignments allow other EMS members to diverge from German monetary policy if they wish.

Dowd has countered the last point. He notes that as remaining capital controls are lifted, the arrangement will no longer be able to accommodate exchange rate realignments. Markets will anticipate the direction of a prospective exchange rate change if one country gets out of line. To maintain asset market equilibrium, interest rates will rise sharply in the country whose currency is to be devalued, and capital flows will become larger and more disruptive. To avoid this outcome, exchange rates in the EMS will then really become fixed, and Dowd anticipates that the Bundesbank's hegemony will, contrary to the theme of the Fratianni-von Hagen article, become even stronger.

The positive scenario that Dowd pictures assumes that financial liberalization will tie the hands of central banks. Central banks, however, have a long history of responding to undesired international capital flows by closing their financial markets and resisting exchange rate changes that the market may demand. So such an eventuality is not unthinkable.

An Inflation-Free Monetary Regime

Finally, Dowd discredits the inflation performance of the Bundesbank compared to what commodity standards achieved in the past. He proposes linking the ERM-member currencies to a general price index. The issuer would redeem the currency in some redemption medium, and the new inflation-proof currency would displace the D-mark as the strong currency in the EMS. Issuers of the remaining currencies would have to abandon inflationary monetary policy. The values of EMS currencies would thus also become inflation-proof.

The final step would be the removal of restrictions on the issue of currency by private firms and the abolition of existing central banks. Dowd's vision is certainly far beyond 1992.

In conclusion, I share Dowd's skepticism that establishing a European Federal Reserve System will contribute to the welfare of the European Community. My skepticism, however, also extends to the implicit assumption that in the foreseeable future such an institution will evolve.

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WHY DOES EUROPE WANT A FEDERAL RESERVE SYSTEM?

George A. Selgin

Unlike the authors of the Delors Report, Kevin Dowd does *not* think that Europe needs a Federal Reserve System. Those who know my work will not be surprised to see that I share Dowd's view. Indeed, I have argued at length (Selgin 1988) that the United States itself does not need a Federal Reserve System.

Rather than reiterate Dowd's arguments, I wish to address a question which Dowd only touches upon. That question is: Why does Europe *want* a Federal Reserve System? Economists, with few exceptions (Dowd among them), seem to take for granted that governments seek more centralized control over monetary affairs in order to achieve greater monetary stability. A European Federal Reserve System would, its proponents claim, help European governments stabilize prices and other nominal magnitudes by allowing them to "coordinate" their monetary policies.

To be blunt, this view of the "objective function" of European governments and their monetary authorities is extremely naive. It demonstrates an appalling neglect of the history of monetary centralization, while also turning a blind eye toward the insights—common sense, really—of public choice theory.

Proponents of a European central bank will deserve to have their arguments taken seriously only if they consider alternatives to the dubious premise that governments are primarily concerned with the maximization of social welfare. This is actually being generous to them in light of the fact that arguments for central banking are weak even granting the assumption of benevolent politicians and bureaucrats.[1]

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[1]See Dowd (1989), Selgin (1988, 1989), and White (1989).

A Political Economy of Monetary Centralization

A cursory review of monetary history shows that government control of money, and the growing institutionalization and centralization of that control, has always included among its objectives the furthering of governments' powers to extract revenue from the public through seignorage and inflation. By eliminating competitors in the market for currency, government monetary authorities reduced the elasticity of demand for their own currencies, thereby enhancing their bureaucratic powers as well as their revenues from money supply. In ancient times, as noted by Glasner (1989, p. 30), the control of coinage by governments "had little to do with [monetary efficiency] and everything to do with political power." Later on, identical motives encouraged governments to interfere with the banking industry. However, instead of nationalizing banks altogether, most governments were content to establish privileged private banks of issue, which the governments could then exploit as sources of revenue. This strategy was more efficient than nationalization insofar as banking, unlike minting, required "considerably more business acumen than governments typically possess" (Glasner, p. 33). At the same time it spared governments the trouble of having to collect and coordinate smaller loans from a number of independent, private banks of issue. The circumstances leading to the establishment of the Bank of England, as recounted by Macauley (quoted in Glasner, pp. 35–36), were typical:

> In old times when the Treasury was empty, when the taxes came in slowly, and when the pay of the soldiers and sailors was in arrear, it had been necessary for the Chancellor of the Exchequer to go hat in hand, up and down Cheapside and Crowhill, attended by the Lord Mayor and by the Alderman, and to make up a sum by borrowing a hundred pounds from this hosier, and two hundred pounds from that ironmonger. Those times were over. The government, instead of laboriously scooping up supplies from numerous petty sources, could now draw whatever it required from an immense reservoir, which all those petty sources kept constantly replenished.

Better still, from the government's point of view, was the fact that, through suspension of convertibility and inflation, it could now command resources well in excess of any it might have garnered without the benefit of monetization.

The Bank of England was only the earliest instance of a bank currency monopoly aimed at achieving *fiscal*—not monetary—ends.[2]

[2]Private (non-joint-stock) banks were at first allowed to issue notes, and the Bank of England did not compete with them outside of the vicinity of London. They had gradually to relinquish this privilege in consequence of the Bank Act of 1844.

The subsequent spread of central banking was based in part on identical objectives. The treatment of privileged banks of issue as institutions having unique *monetary* responsibilities emerged as an afterthought, partly in consequence of monetary instability brought about by the privileged institutions themselves. The fiscal objectives of central banking never subsided, however—a fact attested to by the performance of central banks throughout the present century, in Europe as well as elsewhere.

The Fed Is No Exception

The U.S. Federal Reserve System, which some view as a role model for Europe, is no exception to the rule of central banks being a by-product of governments' eager quest for funds. However, the connection in the United States between central banking and fiscal appetite was indirect. The Fed was in part a *direct* response to the failure of the prior national currency system, but the National Currency Acts of 1863 and 1864 were themselves products of wartime fiscal desperation. The 1863 act authorized the establishment of national banks, empowered to issue notes backed by Federal government bonds. The express purpose was to create a new market for Union government debt. In 1865 the government, disappointed by the demand for national bank charters, imposed a prohibitive 10 percent tax on notes issued by state chartered banks. The tax was meant to force more state banks into the national system, as a further boost to bond sales.

As an emergency fiscal measure, the National Currency Acts were a failure: The demand for national bank charters remained sluggish until the last year of the war (the 10 percent tax on state bank notes not having come into effect until mid-1866). But this failure was hardly the acts' worst shortcoming. Far more serious was their long-term monetary consequence, which was to link the currency stock to the stock of government debt instead of allowing it to adapt to the wants of the public. Throughout the 1880s and early 1890s, as government debt was retired, the stock of national bank notes shrank. This contraction of national bank notes made the economy increasingly vulnerable to seasonal shortages of currency and credit, which occurred with great severity in 1884, 1893, and 1907. The last panic especially supplied a rationale for the creation of the Federal Reserve System. Rather than having been a response to market failure, as is often claimed in textbooks and Federal Reserve publications, the Fed was largely a response to perverse consequences of previous government failure in its attempts to exploit the banking industry.

Moreover, the Fed was not even a good response to the problems of inelastic currency supply and panics. A far better solution would have been to abandon legal restrictions on note issue and on branch banking. This solution would have created a banking system similar to Canada's at the time, only on a much vaster scale. This deregulatory solution was, unfortunately, precluded by a powerful anti–branch banking lobby. It was, furthermore, incompatible with the government's fiscal motives, including its desire to retain a captive market for federal bonds. Finally, it was contrary to the thinking of interested experts who viewed European central banks—especially the Bank of England and the Reischbank—as the acme of "scientific" monetary management. So the United States headed down the road to currency centralization, head-on into its most disastrous banking crisis (which Canada neatly avoided).

A Wheel Turned Full Circle

The wheel has now come full circle. In 1913 the United States looked to Europe for a "model" banking system when it might have looked to its northern neighbor for a superior, deregulated currency system. Today Europe is looking toward the United States, when it ought to be thinking of deregulation and free trade in currency as the sole reliable means for achieving monetary stability and unity. Why such persistent error? The reason, I believe, is governments' desire to extend—and never to relinquish—their monetary powers and perquisites, not in order to secure monetary stability, but to enhance the power of politicians and bureaucrats and to serve their fiscal ends. Power, in other words, overshadows stability as an objective of monetary control. As De Jouvenel has observed (1962, p. 4), "the struggle to magnify itself is Power's essense."

In making these obvious points I do not pretend to offer any precise, alternative specification of monetary authorities' objective function. I merely wish to cast doubt on the simplistic expectation that a European central bank would "maximize a weighted average of the social welfare function of all individual countries" (Canova and Diaz 1989, p. 91). Although the history of monetary centralization offers no precise, alternative specification—central banks do not always maximize seignorage, either—it suggests strongly that a European "Fed" would serve, not to discipline irresponsible national monetary authorities, but rather to force more responsible nations to abandon their relatively conservative monetary policies in favor of a policy of uniform inflation for all Europe. As Dowd correctly points out, a European central bank would eliminate competitive constraints

against inflation (e.g., the loss of foreign exchange reserves by relatively inflationary central banks to relatively conservative ones). A European bank could, in principle at least, operate as a revenue-maximizing monopoly, enjoying a highly inelastic demand for its currency and unconstrained by inter-European reserve losses.

Public Welfare or Public Choice?

Which (extreme) view of the likely consequences of European monetary cooperation gets closest to the truth? Is it the pessimistic public choice view or the optimistic public welfare view? Do European officials want their own "Fed" to prevent inflation or to enable themselves to profit from more of it? If the former, then why is it that Germany rather than Greece or Italy is most frequently criticized for refusing to coordinate its monetary policy with the policies of other EMS members? Is it because Germany's currency is not stable enough? Hardly. Germany is criticized precisely because its currency is too stable—because the policies of the Bundesbank too often interfere with other European central banks' ability to inflate their currencies with impunity and without losing foreign-exchange reserves. Why should we expect the very authorities who are presently Germany's strongest critics to plead for monetary stability and conservatism once they are appointed members of the Board of Governors of a European Fed?

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