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**Article — Published Version**

## Why Democracy is Essential to Monetary Stability

The European Journal

*Suggested Citation:* Homburg, Stefan (1997) : Why Democracy is Essential to Monetary Stability, The European Journal, ISSN 1351-6620, The European Foundation, pp. 13-

This Version is available at:

<https://hdl.handle.net/10419/93250>

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# Why Democracy is Essential to Monetary Stability – and why EMU will have neither

by Professor Stefan Homburg

THE INITIAL EXCITEMENT about the revaluation of the Bundesbank's reserves has now died down. However, the fact remains that the German government is forcing the Bundesbank to revalue its gold reserves, and to hand over the profits from that revaluation, if not in 1997 then later. There is no doubt that this means printing money, and that the Bundesbank will have to neutralise this monetary creation in order to keep its money supply target.

The coalition has justified its behaviour by referring to a banal but shocking truth: alongside the "independence of the Bundesbank" there is the "independence of the legislator". In other words, the Bundesbank is only as independent as the legislator allows it to be. It must therefore be concluded that the key to the successful monetary history of Germany over the last 50 years cannot lie in the fact that Germany has an independent central bank. Rather, one must explain why the legislator has accorded the Bundesbank such a wide-ranging autonomy.

Because of the currency reforms of 1923 and 1948, the Germans have an extreme aversion to inflation. Any government which wants to win an election must take this into account. If it undertakes policies which arouse doubt about the stability of the currency, it will be threatened by defeat at the hands of the electorate. Therefore, it is optimal for the government not to touch the independence of the central bank. It is only for this reason that governments take such care, and make such a performance, when changing the Bundesbank law. Even though such changes can be decided by a simple majority in the Bundestag, without even being approved by the Länder, federal governments typically behave as if they were amending the constitution.

The stability of a currency therefore does not depend on the letter of the law, but rather on the sanctions which governments and legislators have to fear when they make a change to that law which might weaken the currency. In this sense, the policies of the Bundesbank were thoroughly democratically legitimised: voters wanted the autonomy of the Bundesbank and monetary stability.

This conclusion shows that many reflections on the stability of the future euro are based on false methods. In recent years, Germany has studied Maastricht fervently, weighing up each dot and comma to see whether the treaty really does ensure monetary stability. But the question is in fact what incentives there will be to encourage political actors to change the

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treaty, for instance towards reducing the independence of the European Central Bank, once monetary union has been achieved.

Let us assume that the euro inflates at a rate of 20% a year. The citizens of Europe will no doubt be very irritated by this – but can they do anything about it? The Council of Ministers, which is composed of representatives of the governments of the member states, will decide the rules of the game in monetary policy. It has no democratic legitimacy, and it cannot be voted out of office. If the Council reduces the independence of the European Central Bank, it has no sanctions to fear.

The same is true for the national governments, especially if the desired political union is created in which decisions are mostly taken by qualified majority. Because the meetings of the Council are not public – Maastricht stipulates that they are secret – each national government will be able to maintain to its voters at home that it is not responsible for developments. And it would not be credible for voters to threaten to vote a national government out of office because of mistakes made at supranational level.

Because a weak euro brings no sanctions for those responsible for it, and while the winnings from inflation (known as seigniorage or inflation tax) provide such

an appetising way of quietly creating government revenue, the political actors will find a weak currency to be optimal. The resulting profits from the central bank will be divided up between 15 Leviathan governments, and no voter will be able to stop them. This analysis seems radical. It is radical in the sense that it studies the problems of monetary stability at their root, and does not rely on official declarations which are supposed to convince the citizens of Europe of the good intentions and boundless idealism of their political leaders.

After all, it is easy to understand why precisely a conservative finance minister risked insulting the Bundesbank, while his Social Democrat predecessors always regarded the Bundesbank as untouchable and sacred. The logic of this attitude lies in the fact that the independence of the Bundesbank and the stability of the Deutsche Mark have become unimportant. In the election year 1998 every voter will see that there is little sense in sticking to the German culture of stability, when the following year the D-Mark will have disappeared and the reputation of the Bundesbank will have been buried. Rather, it is totally in the German interest to be as "creative" in monetary and financial matters as its neighbours. The division in EMU between responsibility for monetary policy and democratic legitimacy is already throwing its long shadow before it.

Thus, the recent conflict between the government and the Bundesbank is the monetary writing on the wall: the single currency has been weighed in the balances and found wanting. In order to avoid further damage, the whole idea should be abandoned as quickly as possible.

*Stefan Homburg is professor of Public Finance at the University of Hannover and a member of the Council of Advisers to the German Federal Finance Minister. He has contributed a chapter to the recent book, The Future of the D-Mark ('Die Zukunft der D-Mark') edited by Professor Franz-Ulrich Willeke and published by Olzog Verlag. This article first appeared in the Handelsblatt on 5th June 1997.*