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Democratic accountability and the exchange-rate policy of the euro area[1]

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ABSTRACT

This article examines the consequences of the political 'incompleteness' of the monetary union for the democratic accountability of its external monetary policy, comparing the euro area to the United States. In most countries, exchange-rate policymaking is substantially delegated to the finance ministry and central bank; oversight by other domestic actors is relatively weak. While this is true of the United States, the role of the Congress provides the possibility for 'democratic override' when policy diverges substantially from the preferences of a broad set of private sector interests. Europe's monetary union, by contrast, lacks such a mechanism; no institution can provide an effective check on the policies pursued by the core actors, the ECB and Eurogroup. A comparison of the postures of the United States and euro area toward Chinese exchange rate policy suggests that these institutional differences affect policy outcomes.

KEYWORDS

The euro; exchange-rate policy; accountability; interest groups; China; euro governance.

INTRODUCTION

Several authors have examined the political 'incompleteness' of the monetary union. Operating a monetary union within a political structure that falls well short of a political union or cohesive state has consequences for a number of issue areas, including internal monetary policy, fiscal policy, financial regulation and supervision, and exchange rate policy. The gap between monetary integration and political integration also gives rise to questions about the democratic accountability and legitimacy of the euro area, a subset of the debate over the democratic governance of the European

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Union as a whole (Berman and McNamara, 1999; Caporaso, 2000; Dyson, 2000; Hodson and Maher, 2002; Jones, 2002; Verdun, 1998; Verdun and Christiansen, 2000).

This article examines the accountability of the euro area's external policy. Much has been written about democratic accountability and the independence of the European Central Bank. Several works have addressed the external monetary policy of the euro area (see, among others, Bergsten, 1997; Cœuré and Pisani-Ferry, 2003; Cohen, 2003; Eichengreen and Ghironi, 1998; Henning, 1997, 2006; Henning and Padoan, 2000; Kenen, 1995; McNamara and Meunier, 2002). But no study known to this author has yet addressed issues of representation and accountability for the exchange rate policy of the euro area.

One possible reason for this omission from the literature is that exchange rate policy is usually a closed affair. In almost all countries, policymaking in this realm is extensively delegated to finance ministries and central banks and oversight by outsiders is relatively weak. Although the rationale for extensive delegation is compelling, however, this does not mean that oversight and accountability are not desirable or feasible. As a normative matter, review and assessment by outsiders, especially the legislature, is appropriate in democratic systems. As a positive matter, democratic accountability of exchange rate policy is important to maintaining political support for economic openness.

This article compares the democratic accountability of exchange rate policymaking in the United States and Europe's monetary union and examines the impact of the differences on policy outcomes. In short, in the United States, the Congress plays an important role in oversight and accountability in exchange rate policy. Although the Treasury Department and Federal Reserve dominate policymaking and accountability is not perfect, the Congress has weighed in at critical junctures, asserting a 'democratic override' when policy deviates substantially from the preferences of broad coalitions of private sector groups. Owing primarily to the different institutional framework of the European Union, however, the euro area lacks an effective counterpart to the Congress in this role. The ECB and Eurogroup together operate virtually without effective external review or potential sanctions for departing even in the extreme from the preferences of a broad set of interest groups within the monetary union. These institutional differences affect policy outcomes when exchange rates become problematic, as illustrated by contrasting responses to Chinese foreign exchange intervention of unprecedented magnitudes during 2002–2006.

This article does not assess the democratic legitimacy of the exchange rate policy of the euro area. Assessing the legitimacy of the monetary union, a more subjective concept than accountability, is a complex undertaking left for other studies. Nonetheless, the argument advanced here contains a warning for the legitimacy of the euro area: if authorities' policy diverges from the preferences of a broad coalition of interests, weaker mechanisms of accountability leave the euro area at risk for an erosion of legitimacy over time.

The article defines the term 'accountability' and describes its different types in the next (second) section. The third section compares the United States and the euro area along this dimension. The fourth section examines US and euro-area policymaking with respect to the controversial case of the Chinese renminbi. The final section draws conclusions from this analysis.

DELEGATION, ACCOUNTABILITY AND DEMOCRACY

'Accountability', as Grant and Keohane (2005: 29) define the term, 'implies that some actors have the right to hold other actors to a set of standards, to judge whether they have fulfilled their responsibilities in light of these standards, and to impose sanctions if they determine that these responsibilities have not been met'. It presupposes 'general recognition of the legitimacy of (1) the operative standards for accountability and (2) the authority of the parties to the relationship (one to exercise particular powers and the other to hold them to account)' (see also Oakerson, 1989). Accountability also requires sufficient transparency and information to assess whether standards have been fulfilled.[2]

Borrowing from other theorists, Grant and Keohane (2005) identify two models of accountability, a 'participation' model and a 'delegation' model. Under the participation model, the performance of policymakers is evaluated by the actors that are affected by policies; under the delegation model, performance is evaluated by the actors that grant them policymaking authority. The delegation model, in turn, contains two variants: a principal-agent model, in which power-wielders reflect the preferences of principals, and a trustee model, in which power-wielders might deviate from principals' preference so long as they serve the purposes for which they are authorized to act. Independent central banks would approximate the trustee model, for example, and we return to these distinctions below.

Legitimacy of the standards of accountability and the authority of one actor to hold another to account deserves emphasis because it differentiates open democratic accountability from raw political influence. Selected interest groups can have privileged access to officials within a closed policymaking system and thus an ability to induce them to adopt or change particular policies. But susceptibility to interest group pressure alone does not constitute accountability. Democratic accountability occurs through the legitimately recognized bodies of government and policy processes, such as the legislature and legislative oversight conducted by elected representatives. Open accountability gives voice to a broad set of actors and is sufficiently transparent to allow those outside the closed circle, such as the legislature, to evaluate policy. A policy that responds to the preferences of a requisite majority of members of the legislature, pursuant to legislation, and subject to legislative oversight in public hearings is thus openly and democratically accountable. By contrast, a policy that is the product of a back room deal or a telephone call from the chief executive officer of a country's largest automobile manufacturer to the finance minister or prime minister is not democratically accountable. Open democratic accountability does not guarantee that policy reflects the 'national interest' or cannot be captured by particularistic groups, but it helps to render policy more consistent with broadly held preferences than a closed, insider system. This distinction between responsiveness to interest group pressure and democratic accountability relates to the comparison between the United States and euro area below.

'Legitimacy' refers to the normative acceptance by the governed of the authority and behavior of policymakers. Dyson (2000: 212–3, 243, 248) analyzes the legitimacy of the euro area, concluding that '[t]he ECB finds itself in uncharted and problematic political territory for a central bank' (see also Caporaso, 2000; Jones, 2002; McNamara and Berman, 1999; Verdun, 1998, and, on the distinction between input- and output-oriented legitimacy, Scharpf, 1999). However, arguments about the legitimacy of the monetary union and exchange rate policy *per se*, though related, go beyond the scope of the present article, which focuses on the more narrow but concrete concept of accountability. Legitimacy enters in here to the extent that it pertains specifically to standards of accountability and authority in exchange rate policymaking.

In issue areas characterized by extensive delegation to executive agencies, of which exchange rate policy is typically one, legislatures can provide political accountability through oversight. As Oakerson (1989: 123) describes it, 'Oversight consists of monitoring by committees charged with writing the legislation that pertains to agencies' authority and annual appropriations. Control over appropriations and authority gives committees leverage over agency discretion beyond the requirements of law'. In the United States, as shown below, the Congress has an additional tool of leverage: powers over legislation in areas functionally linked to exchange rate policy.

A normative debate exists over the appropriate degree of 'democratization' of exchange rate policy, arising principally from different conclusions drawn from US exchange rate policymaking during the 1980s. Destler and Henning (1989) interpret the shift in exchange rate policy of the Reagan administration during 1985 as the result, in substantial measure, of the constructive role of the Congress in intermediating between private-sector activism and executive neglect. We recommended broadening intra-executive deliberations over the exchange rate, strengthening the role of Congress in setting broad international economic objectives, and institutionalizing and legitimating private-sector advice to the Treasury.

Dominguez and Frankel (1993: 50–3; 137–8), while advocating broader consultation within the executive, oppose a broader role for the Congress and private-sector advisory committees and more generally a 'democratized' exchange rate policy. A broadening of the exchange-rate policy process, they fear, could someday induce policymakers to push the exchange rate away from equilibrium rather than toward it. To some extent, this disagreement may reflect differences between the preoccupation of economists with policy optimization, and sometimes a professional preference for technocratic management, and the preoccupation of political scientists with connections between electorates, legislatures and officials.[3] This debate serves as a backdrop for analysis of democratic control and accountability of the exchange rate policy of the euro area.

ACCOUNTABILITY AND EXCHANGE RATE POLICY

Exchange rate policymaking is highly delegated and relatively closed, dominated by the central bank and finance ministry, in most countries. The balance between these two institutions varies from country to country (see Henning, 1994, 2007), but together they dominate the lion's share of external monetary policymaking in virtually all countries. While delegation does not necessarily imply lack of accountability, in principle, policymaking in the exchange-rate field also typically ranks low on measures of democratic accountability.

Exchange rates are affected by many factors, including monetary, fiscal, and financial policies, and exchange rate economics is a contentious academic field. Exchange rate policymaking is thus technical, if not arcane, and must sometimes adjust with alacrity to fast-changing market conditions. Policy in this field cannot be legislated practically and legislatures wisely delegate substantial discretion to finance ministries and central banks.

As a general matter, though, that delegation is more often vague and ambiguous than clear and precise. National legislation specifying the responsibilities of these bureaucracies focuses largely on their domestic tasks and often leaves their roles in exchange-rate policy incompletely defined. So, the authority to make decisions, conduct operations and issue declarations about exchange rates is often instead established by patterns of practice and precedent, as well as non-legal understandings between central banks and finance ministries that are negotiated and renegotiated over time and largely opaque to outsiders.

Thus, delegation is often implied and implicit rather than explicit and formally structured. The role of the legislature in overseeing the finance ministry-central bank nexus is often unclear. Standards by which the performance of these bureaucracies is to be judged are also often vague. Policymaking is removed from public purview and reporting by the bureaucracies is selective and incomplete, if it occurs at all. The effectiveness of interest group pressure varies across states; the preferences of sectoral interests are reflected in policy outcomes in many countries. But in most countries democratic accountability is weak relative to other areas of economic policy.

Nonetheless, when exchange rate policy diverges from preferences of the electorate and/or a broad set of organized interest groups, tools by which such a coalition can reclaim a degree of control over the finance ministry–central bank nexus exist in some countries, the United States in particular, and are at times critically important. Compare the United States and the euro area below.

THE UNITED STATES

The Treasury Department and the Federal Reserve sit at the heart of the closed system in the United States. They naturally prefer to retain complete discretion in declarations, negotiations and interventions. Usually, they are quite successful in keeping the exchange rate 'act' to themselves. However, US institutional arrangements provide for a 'democratic override' when policy strays so seriously from electorate and interest group preferences that the Congress becomes engaged. Such periods have usually coincided with neglect of an overvalued dollar coupled with an import surge and large current account deficits. In the early 1970s, mid-1980s, and presently, Congress has become engaged in this way (Destler, 2005: 57–61; Destler and Henning, 1989).

The United States Constitution gives Congress the power 'To coin money, regulate the value thereof, and of foreign coin ... ' (Article I, section 8). So, the authorities of both the Federal Reserve and the Treasury on monetary and exchange rate policy are delegated by Congress and both bureaucracies are formally accountable to the Congress across the full range of their responsibilities. Most of the time, the exchange rate is not an issue for members of Congress. At particular moments in recent history, however, Congress has been quite extensively engaged in this issue domain. When so aroused, the US legislature has several tools.

First, by virtue of its oversight responsibilities, key committees receive reports from the Treasury and Federal Reserve and can secure testimony from officials within these agencies at public hearings on exchange rate policy. Treasury reports on the use of its Exchange Stabilization Fund, its principal vehicle for foreign exchange intervention, on a monthly, quarterly and an annual basis (Henning, 1999: 45–8). Congress's oversight powers are strongly reinforced by its control over grants of authority, appropriations, and appointments to key posts in these agencies. The Omnibus Trade and Competitiveness Act of 1988 required the Treasury to submit semi-annual reports to the banking committees of both houses. The Act required Treasury to determine, among other things, whether foreign governments 'manipulate' the value of their currencies to achieve competitive advantage and, if so, to pursue corrective negotiations with the country concerned. The legislation thus attempted to define a standard – manipulation – around which Treasury was to focus part of its efforts. Although oversight remained incomplete after 1988, the act strengthened accountability compared to previous arrangements and compared to other key currency countries.

Second, Congress can in principle legislate directly on exchange rate policy. Although usually impractical, the threat of such legislation can get the attention of a distracted administration, as it did in 1985, and reinforce Congress's determination to shift the course of policy. In practice, such proposals are usually de-fanged and re-channeled toward reinforcing oversight.

Third, Congress can legislate indirectly in fields in which it has more practical influence. Trade policy, foreign aid, and support for international financial institutions such as the International Monetary Fund and the World Bank can and have been linked by Congress to its being satisfied by the administration on exchange rates. The outstanding example, but by no means the only example, was Congress's threat in 1985 to pass protectionist legislation unless the second Reagan administration secured a substantial depreciation of the dollar – to which Treasury Secretary James A. Baker III responded with alacrity (Destler and Henning, 1989). Under specific circumstances, such linkages can thus be credible and effective threats.

Treasury's 'manipulation report' has also periodically affected the substance and tactics of US exchange rate policy. When the central banks of Taiwan, South Korea, and China restrained the rise of their currencies after the Japanese yen appreciated in the mid-1980s, US officials began to scrutinize their exchange-rate policies more carefully. These three countries were cited in the late 1980s in Treasury's reports for manipulating their currencies to achieve unfair competitive advantage (see, for example, US Department of the Treasury, 1988). Their currency policies were publicly reviewed in hearings before the banking committees of the US Congress at which members forcefully and publicly advocated appreciation. The reporting process thus underpinned a 'good cop, bad cop' routine that contributed to securing the subsequent currency adjustments by these governments.

The United States, therefore, has exchange rate policymaking arrangements that, while still dominated by the Treasury/Federal Reserve nexus and imperfect with respect to accountability, are subject to a significant extent to legislative scrutiny and influence. Checks on the otherwise closed system have affected policy outcomes at several points over the last four decades, points where US trade policy could have become considerably more protectionist for years to come in the absence of exchange-rate accommodation. Such checks, a 'democratic override', have therefore been quite useful in maintaining domestic political support for international economic openness in the United States.

The role of Congress is also important as an arbitrator of conflicts between the Treasury and Federal Reserve over exchange rate policy and their respective prerogatives. On several occasions during the 1970s, for example, members of Congress threatened to intervene to settle differences between these bureaucracies over foreign exchange intervention. Mutual interest in preventing such intervention has been a powerful incentive for the Treasury and Federal Reserve to resolve differences quietly (Destler and Henning, 1989: 89–90). If irresolvable differences arise in the future, though, Congress would be the ultimate adjudicator.

THE EURO AREA

The euro area lacks any significant 'democratic override' of exchange rate policies that might lie considerably beyond the range of preferences of the electorate and interest groups of the monetary union. Accountability on exchange rate policy is less open and more attenuated than accountability in the United States. Consider in this section, first, the institutional arrangements for external monetary policy in the euro area and, second, the ability of the European Parliament and European Commission, the key 'outside' institutions, to hold the core actors to account.

Authority over external monetary policy is distributed by the Treaty on European Union (Maastricht treaty) to the European Central Bank and the Council of the European Union. The European Central Bank and the national central banks of member states that have adopted the euro can be called the 'Eurosystem', in keeping with the nomenclature of the bank itself. The finance ministers of the member states within the euro area meet in a configuration of the Council dubbed the 'Eurogroup', a subunit of the Ecofin Council.

Under the Maastricht treaty, the objective of both monetary and exchange rate policy was 'to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Community' (European Union, 2002: Article 4, originally Article 3). Formal exchange rate agreements, which must respect internal price stability, are the province of the Council (European Union, 2002: Article 4, originally Article 3). In the absence of a formal agreement, the Council can issue 'general orientations' to the ECB with respect to exchange rates, although these too must respect domestic price stability (*ibid*, Article 111, paragraph 2). The Council decides the external representation and arrangements for negotiating external monetary accords as well as the position adopted within such negotiations by qualified majority (*ibid*, Article 111, paragraphs 3 and 4).[4] Under each of these procedures, the Council acts on the initiative of the Commission, or on the initiative of the ECB in the case of formal agreements, and must consult the ECB (for analysis of these provisions, see European Commission, 1997; Hahn, 2000; Henning, 1997, 2000; Kenen, 1995; Kutos, 2001; Smits, 1997: 367–453; see also Padoa-Schioppa, 1999, 2004).

For its part, the Eurosystem was specifically empowered to hold and manage foreign exchange reserves and conduct foreign exchange operations. Although a substantial fraction of foreign reserves was not pooled, the Eurosystem ensures that those reserves remaining in the hands of national central banks do not interfere with exchange rate policy (European Central Bank, 2003: articles 3, 6, 23, 30).

However, the treaty did not define the institutional division of labor for making public statements, negotiating with external partners and deciding on foreign exchange interventions under a regime of managed floating. Shortly after the introduction of the euro, currency movements forced euro area authorities to define these arrangements more explicitly. The Eurogroup, full Ecofin and Eurosystem reached a partial understanding on these questions during meetings in Turku, Finland, in September 1999 and Luxembourg in June 2000. Under the Turku agreement, the Eurosystem was recognized as being 'solely competent' for deciding intervention but would do so on the basis of an understanding with the Eurogroup about the strategic direction of policy and an agreement that key officials would consult and coordinate their public statements. The resulting institutional framework, for the time being, approximates the relationship between the German finance ministry and the Bundesbank prior to the monetary union – the 'German model' (the inter-institutional understanding is described in Henning, 2007).

These documents – the Maastricht treaty, Turku understanding, Eurogroup and Eurosystem statements – are virtually silent with respect to democratic accountability on external monetary policy. Beyond consistency with price stability, they enunciate no standards by why which policy is to be assessed. They mandate no disclosure of information to the public or systematic reports between institutions; neither the ECB nor the Eurogroup are transparent.[5] No process of review and/or assessment is established. Accountability was an 'oversight', in a different sense of the term, of the officials of member states and the European Union when grappling with other, hard-fought political and institutional questions in the negotiations that led to the Maastricht treaty.

The Council must consult the European Parliament when concluding formal agreements on the euro's participation in an exchange rate system (Paragraph 1, Article 111). The Parliament can hold hearings on exchange rate matters and solicit the testimony of expert witnesses. In this way, the Parliament, like the Congress, can in principle raise public consciousness of currency misalignments and build a case for policy action. Exchange rate questions are sometimes posed to ECB officials at quarterly hearings on monetary policy and at hearings to question nominees to the bank's

Executive Board (on the accountability of the ECB on monetary policy, see Berman and McNamara, 1999; Buiter, 1999; Jabko, 2003). Members of Parliament can also highlight exchange rate issues in hearings and reports on trade and broader economic issues.

The Parliament's role in this domain is nonetheless very much constrained. ECB officials consent to appear before parliamentary committees, but are not compelled to do so; thus the word 'testify' is not used to describe their presentation. Parliament does not approve appointments to the ECB. It has no budgetary or grant-of-authority powers over the ECB – and certainly has no such authorities over the Eurogroup and its constituent finance ministers. Symptomatic of the allocation of competence among EU institutions in general, the European Parliament lacks the powers that give muscle to congressional oversight in the United States. The Parliament's role in trade policy is weaker and more tenuous than that of the Congress and it cannot of course formally initiate legislation. It cannot therefore effectively link trade actions to satisfaction on exchange rate policy.

Could the European Commission provide democratic accountability? The Commission has a window onto the exchange rate policy process: its officials attend Eurogroup and ECB meetings, among others. By its power of legislative initiative, the Commission can propose measures on exchange rates and other international monetary issues of concern to the Eurogroup and the ECB. However, it is difficult to see how the Commission could use these tools to hold the central players to account, stimulate a shift of errant policy, or otherwise provide democratic accountability. The Commission's own democratic credentials are, after all, indirect at best.

What of the normative theory that euro-area authorities are accountable to electorates through the elected governments of member states? Moravcsik (2002), for example, argues that member states have devolved issues to the EU that their electorates are content to have delegated and that the European Union in general is as democratic as the national political systems within it. With respect to the monetary union, similarly, one might observe that national governments' finance ministers sit in the Eurogroup, their heads of government sit in the European Council, and the European Council in turn appoints the top officials of the Eurosystem. The Eurogroup could issue general orientations on exchange-rate policy for the ECB under Article 111. However, as a committee, the Eurogroup (a) is inherently less coherent than a single minister or secretary and its ability to adopt a coherent position and bargain with the ECB is correspondingly limited and (b) has limited influence over the ECB owing to the central bank's independence under the treaties. Moreover, the finance ministers themselves are part of the closed system that would be held to account with a democratic override.

An advocate for the monetary union might also be tempted to argue that, although the United States and euro area have different systems, their accountability is equivalent. Within the United States, Congress delegates authority to the Fed and Treasury and interest-group participation through the Congress can help to keep the closed circle 'honest' – a mix of Grant and Keohane's (2005) delegation and participation models. This argument might assert that the euro area's exchange rate policy approximates the trustee model, in which officials have great discretion as long as they serve the purposes for which they are appointed.

However, on close scrutiny, the structure of the external monetary policy process in the euro area does not actually lend itself to either model of accountability. First, a substantial share of the ECB's authority in the exchange-rate area is granted by the member states through the Maastricht treaty. While the treaty-ratification process was reasonably democratic, the ECB's exercise of those powers is neither transparent, sanctionable nor effectively revocable. Second, to the extent that the Eurogroup has devolved further discretion over exchange rate policy to the ECB, by default or design, oversight by a group with diverse preferences implies considerable room-for-maneuver for the central bank. More fundamentally, the preconditions for accountability – transparency and general recognition of operative standards and authorities with respect to accountability – are nearly absent.

Could it be unfair to compare the euro area to the United States and to hold the monetary union to the same standard of democratic accountability as nation states? Euro area authorities might rely on the Grant–Keohane defense of international organizations, namely that such organizations are in fact often accountable but by means (such as markets, peer pressure and public reputation) that are not recognizable through the lens of domestic models of democratic governance. That the euro area has taken on responsibility for administering a common exchange rate policy creates a problem for this argument, however. In all aspects of monetary policy, sovereignty has been transferred completely from member states to the union. The standards by which its democratic accountability should be judged are thus closer to those of nation states than international organizations.

In sum, the euro area lacks a mechanism to effectively hold core policymakers at the ECB and Eurogroup to account on exchange rate policy or to override them if exchange rate policy deviates substantially from broadly held preferences. Accordingly, it lacks a mechanism to pressure the key actors to redress inequities in the international monetary system, such as misaligned currencies, when the Eurogroup and ECB might be reluctant to do so. By contrast, institutional arrangements in the United States have sometimes served to focus political backlash from currency misalignment on exchange rate policy solutions, defusing pressure for trade protection. Euro-area arrangements run the danger that the political response to currency misalignment will not have an outlet in exchange rate policy, but will be focused instead on trade policy and market closure.

To be clear, this article has not argued that private interests and representative associations do not matter in the determination of European exchange rate policy. Private-sector interests mattered before the creation of the monetary union, especially the industrial and banking sectors (see, for example, Broz and Frieden, 2004; Henning, 1994; Walsh, 2000), and continue to influence the posture of member-state governments, the finance ministers in particular, on exchange rate policy. However, the shift to the monetary union also shifted the institutional framework that mediates the influence of interest-group preferences on policy. Finance ministers must now vie with one another to set a common policy and they have less collective influence *vis-à-vis* the central bank than most of them wielded individually prior to the creation of the euro. As a consequence, the transmission of interest-group preferences into policy outcomes is far less direct within the monetary union now compared to within the member states prior to the advent to the euro. Even when interest groups might have back-channel influence, moreover, euro-area exchange rate policy is not democratically accountable through transparent policy review by legitimate official bodies.

We would expect access to the policymaking process, or lack of it, to affect the character and intensity of private-sector attempts to influence policy. Where the structure of official institutions and the division of authority among them create barriers to successful lobbying, injured groups are likely to be discouraged from seeking redress on exchange rate policy. To a significant degree, in other words, private lobbying is likely to be endogenous to policymaking institutions and their responsiveness to interest group pressure. Given differences in institutional design and accountability, we would not expect to observe as much exchange rate lobbying within the euro area as within the United States under similar economic circumstances.

RESPONSES TO CHINESE EXCHANGE RATE POLICY, 2002±2006

The responses of the United States and the euro area to the exchange rate policy of China during 2002–2006 demonstrate the differences in institutional design and accountability within each system and their consequences for policy outcomes. This case cannot be a definitive test because interest group opposition to exchange rate policy has not been as broad as in some earlier cases, yet, and this policy conflict remains ongoing. Nonetheless, comparing US and euro area policy *vis-à-vis* China is useful for two reasons. First, exchange rate politics on the two sides of the Atlantic are considerably more independent in third-country cases than in cases focused on the dollar-euro exchange rate.[6] Second, the renminbi is by far the most undervalued of the major currencies in the international monetary system and the most important case of undervaluation since the creation of Europe's monetary union. The case thus provides a highly instructive illustration of the argument presented here.

This section describes Chinese exchange rate policy, highlights the role it plays in the global adjustment problem, compares the US and European responses to this problem with particular focus on private lobbying patterns and accountability mechanisms, and considers some alternative explanations for the different responses.

Chinese adjustment problem

During 1994–2005, the Chinese government pegged its currency, the renminbi, to the US dollar. As the dollar rose and fell over this period, the renminbi similarly rose and fell against the non-dollar currencies. As China's international trade rose dramatically, other Asian countries felt increasing competition from China and looked to China when setting their exchange rate policies. Neighbors shadowed the dollar under regimes of managed floating in order to prevent their currencies from appreciating against the renminbi when the region stabilized after the financial crises of 1997–1998. China's currency peg to the dollar therefore became something of a proxy for currency policies of the region as a whole.

During 2000–2005, however, China ran increasingly large surpluses on both its current and capital accounts. Its current account surplus alone rose to $159 billion in 2005, nearly 7 percent of China's GDP. Maintaining the exchange-rate peg therefore required increasingly large purchases of dollars by Chinese authorities, purchases that became unprecedented in magnitude. As a consequence, China became the world's largest holder of foreign exchange reserves, which breached the $1 *trillion* mark in 2006 – an all-time record for *any* country. For these reasons, Goldstein (2005) and Goldstein and Lardy (2004, 2005), for example, argued persuasively that the renminbi was substantially undervalued and should be revalued on the order of 25 percent.[7] Because other countries in the region were reluctant to allow their currencies to appreciate against China's, renminbi appreciation against the dollar became the key to East Asia's contribution to global current account adjustment.

In July 2005, Chinese authorities announced a 2 percent revaluation of the renminbi against the dollar and a shift in the regime: thereafter, the renminbi's value would supposedly be allowed to change as much as 0.3 percent per day against an undisclosed basket of currencies (People's Bank of China, 2005: 16–9). Nonetheless, subsequent exchange rate changes were quite modest: by December 2006 the renminbi had appreciated only 5.4 percent against the dollar and remained close to the 10 yuan/euro level that prevailed prior to the mid-2005 announcement, having appreciated slightly and then depreciated against the European currency in the meantime.

Table 1 Imports from China: Comparison of the Euro Area, European Union, and the United States, 2000–2005[1] (In billions of dollars)

	2000	2001	2002	2003	2004	2005
Eurozone						
Total imports from China	48.8	51.1	58.4	84.3	115.7	146.4
Total imports from China (percent of total imports)	5.2	5.6	6.3	7.5	8.6	9.7
EU-25						
Total imports from China	68.7	73.1	84.7	119.3	158.5	196.5
Total imports from China (percent of total imports)	7.5	8.3	9.5	11.2	12.3	14.8
USA						
Total imports from China	100.0	102.3	125.2	152.4	196.7	243.5
Total imports from China (percent of total imports)	6.9	7.5	9.0	10.0	11.1	12.2

[1] *Sources:* Eurostat database and U.S. Census Bureau, Foreign Trade Division.

Given China's rapidly expanding current account surplus, amounting to roughly nine percent of GDP in 2006, such a modest appreciation would not provide needed adjustment.

The interest of the United States, European Union and euro area in Chinese exchange rate policy is broadly equivalent, even if the absolute value of US imports from China exceeds those of the euro area. Table 1 compares US, EU and euro area trade with China. In 2005, US imports were $244 billion while EU imports were $197 billion, which amounted to 12.2 and 14.8 percent of total imports, respectively. The euro area's imports were $146 billion, 9.7 percent of total euro area imports. All three areas' imports

Table 2 Exports to China: Comparison of the Euro Area, European Union, and the United States, 2000–2005[1] (In billions of dollars)

	2000	2001	2002	2003	2004	2005
Eurozone						
Total exports to China	19.1	22.5	28.2	39.6	50.6	54.1
Total exports to China (percent of total exports)	2.1	2.4	2.8	3.3	3.5	3.5
EU-25						
Total exports to China	23.8	27.4	33.0	46.6	59.9	64.4
Total exports to China (percent of total exports)	2.6	3.1	3.7	4.4	4.7	4.8
USA						
Total exports to China	16.2	19.2	22.1	28.4	34.7	41.8
Total exports to China (percent of total exports)	1.5	1.9	2.3	2.8	3.0	3.3

[1] *Sources:* Eurostat database and U.S. Census Bureau, Foreign Trade Division.

from China grew rapidly during 2000–2005, increasing by more than two-and-a-half times in absolute value and almost doubling as a share of total imports. These increases placed particularly strong pressure on import competing firms and workers in particular sectors, such as textiles and apparel. US, EU and euro area exports to China were comparably small relative to imports (Table 2). Public opinion surveys in the United States and key member states of the euro area showed an equally widespread concern, of 59 percent of respondents, with the Chinese economic 'threat' (German Marshall Fund, 2006: 17–8).

US response

In the United States, the issue of the Chinese exchange rate produced differentiated responses on the part of the Treasury and Federal Reserve, on the one hand, and other executive agencies and the Congress, on the other hand. In short, import pressure spawned activism on the part of affected groups and sectors to which the Congress was responsive. The Treasury, by contrast, while using moral suasion to induce China to revalue renminbi, was very reluctant to threaten China for intransigence. For three years, the Treasury and Congress played 'good cop, bad cop' with China on the currency problem. With some significant differences, this pattern is reminiscent of the relationship between Congress and the Treasury on the exchange-rate issue in the mid-1980s.

Private sector lobbying on the Chinese exchange rate issue has been vigorous and contested. A succession of alliances pressed Congress and the Bush administration to secure an appreciation of the renminbi: first the Coalition for a Sound Dollar, then the Fair Currency Alliance, and finally the China Currency Coalition (CCC). Private activity manifested a cleavage between large, multinational firms with investments and facilities in China, on the one hand, and domestic manufacturers, on the other hand. The former group, represented in part by the Business Roundtable, generally advocated a moderate position on Chinese trade and currency issues. The Domestic Manufacturers Group, on the other hand, advocated far more aggressive prosecution of trade cases and correction of currency undervaluation. These differences split the National Association of Manufacturers on both China trade issues and the Chinese currency issue (see, for example, Hufbauer *et al.*, 2006; McCormack, 2006; Stokes, 2006) The CCC nonetheless gathered together 45 associations representing a broad array of potentially influential domestic manufacturers and labor unions.[8]

In this atmosphere, Treasury's 'manipulation reports' under the 1988 trade act became a semi-annual drama, with Congress, the financial markets and foreign governments waiting in anticipation for release of the document. The banking committees of both houses of Congress followed up on these reports with hearings at which senior Treasury officials testified. Arguably at variance with the purposes of the 1988 act, however, Treasury, bent over backwards to avoid citing China as a 'manipulator', which would have triggered requests for formal negotiations over the matter (see, for example, US Treasury, 2005).

Caught between private pressure groups and a reticent Treasury, members of Congress submitted a series of legislative measures that, if passed, would have mandated Treasury action or would have imposed trade barriers against China. During the 109th Congress alone (2005–2006), more than fifteen bills targeting renminbi valuation were submitted by members.[9] Senators Charles Schumer (D, NY) and Lindsey Graham (R, SC) co-sponsored a bill that would have imposed a tariff of 27.5 percent – their guess as to the extent of the undervaluation of the renminbi – on all Chinese imports in the absence of a substantial Chinese revaluation (Senate bill 295, 109th Congress, 1st session, submitted February 3, 2005). When this bill received 67 votes in the Senate on a procedural motion in late March 2005, the administration began taking congressional threats on China trade more seriously. Senators Schumer and Graham agreed to defer a final vote on their bill in exchange for assurances from the Treasury Department that Chinese authorities would act. Meanwhile, in an effort to provide an alternative to the Schumer-Graham proposal that would not violate US obligations in the WTO, then Senate Finance Committee Chairman Charles Grassley (R, IA) and then ranking minority member Senator Max Baucus (D, MT) co-sponsored a measure that would sharpen and enhance Treasury's reporting requirement under the 1988 trade act. Their bill also mandated sanctions for countries that maintain undervalued currencies (Senate bill 2467, 109th Congress, 2nd session, introduced March 28, 2006). These and other bills could be consolidated into compromise legislation during the Democrat-led 110th Congress.

The United States imposed trade barriers against China in specific product areas. As of Spring 2006, the United States had restricted imports of apparel, color television sets, semiconductors, shrimp, textiles and wood furniture – all under WTO-consistent provisions or negotiated with Chinese authorities. The Bush administration also began trade action on auto parts and, among other things, prepared action on violations of intellectual property rights (Hufbauer *et al.*, 2006; *Inside U.S. Trade,* various issues, Spring 2006). But such relief to US producers did not eliminate the broader coalition targeting the exchange rate and, in this respect, stands in contrast to the experience within the euro area.

The role and authority of the Congress had a substantial impact on the content and tactics of US policy *vis-à-vis* the Chinese currency. Oversight and accountability mechanisms, though incomplete, have been important instruments of congressional influence over the Treasury. In the absence of congressional pressure, Treasury could well have shied away from warning

China in May 2005 that it would be cited as a 'manipulator' in Treasury's subsequent report in the absence of action. China could well have declined to revalue its currency in July 2005 in the absence of this political pressure. Although appreciation of the renminbi against the dollar has been relatively modest as of this writing, these measures could well prove to be early steps in a long incremental process in which congressional pressure remains important.

Euro-area response

Europe faced pressures similar to those faced by the United States and imposed similar trade restrictions. The European Union imposed safeguards actions on textiles and apparel, as has the United States, and leather shoes.[10] The United States and European Union together brought action in the WTO against China on auto parts (*Washington Post* March 28, 2006). However, by contrast, euro area policy with respect to the renminbi exchange rate was relatively complacent.

European policymakers did not form any particularly clear or coherent policy toward the Chinese currency during 2003–2005, and European officials stressed different priorities when speaking with Chinese counterparts. Moreover, European officials were explicitly critical of the US approach to China on this matter as unilateral, coercive, and consequently likely to be counterproductive (not-for-attribution interviews with European officials, Frankfurt and Brussels, May 2005). The European members of the finance G-7 advocated greater 'flexibility' for 'major countries or economic areas' with the US Treasury at Boca Raton, Florida, in February 2004[11] and agreed to mention China specifically in this context at the G-7 meeting in April 2006 (G-7 Finance Ministers and Central Bank Governors, 2006; Taylor, 2007: 294–300). However, 'flexibility' is substantially different from 'revaluation' and the Eurogroup stressed the importance of gradualism when meeting with Asian finance ministers in Vienna in April 2006 – a stance that was quite consistent with China's own rhetorical commitment to flexibility in the very long run, unmatched by serious action during 2002–2005, and in contradistinction to the position of the US Treasury (*Agence France Presse*, 2006; *AFX International Focus*, 2006; ASEM Finance Ministers, 2006). During state visits in 2006, neither German Chancellor Angela Merkel, French President Jacques Chirac, nor Italian Prime Minister Romano Prodi pressed their Chinese counterpart to raise the value of the renminbi with anywhere near the intensity of President Bush (*Financial Times,* 10 April, 19 and 24 May, 15 September 2006; *International Herald Tribune*, 26 October 2006).

In the euro area, there are relatively few reports issued by European authorities that raise Chinese exchange rate matters and no formal oversight of the exchange rate policy of the ECB and Eurogroup. Although exchange rate matters can in principle be raised in hearings with ECB officials at the European Parliament, and occasionally in other forums, these discussions are sparse compared to the relatively intense focus on the Chinese currency in the Congress. There is only sporadic mention of the Chinese exchange rate issue in on-line documents of the European Parliament and European Commission for the period 2003–2005. During the same period, there were nine hearings in the US Congress in which the exchange rate was a central theme, nine hearings in which it was a significant theme, and a large number at which it was mentioned several times.[12] The *European Competitiveness Report 2004*, written by the Commission, contains a substantial chapter on China but not a single mention of the exchange rate within it (European Commission, 2004). The Commission omitted renminbi appreciation from its 'priorities for action' in its 2006 China strategy paper (European Commission, 2006a,b). In short, there is little public evidence of serious review of the euro area's exchange rate policy *vis-à-vis* China by the European Parliament and European Commission or discussion between these institutions and those principally responsible for exchange rate policy, the ECB and Eurogroup.

The relative lack of attention to renminbi valuation among euro area authorities compared to those in the United States is not due to a lack of competitive pressure on traded goods producers or workers. The tripling of Chinese imports during 2000–2005 particularly impacted firms and workers in low-skill intensive industries, many of which have sought remedies. The Italian business association Confindustria, for example, warned repeatedly about competition from China in global markets, describing the renminbi as 'strongly undervalued' and citing others' estimates of the undervaluation at 20–40 percent.[13]

However, private sector lobbying on this issue was fragmented by two institutional features of the euro area. First, the different trade structures of member states conferred differentiated interests with respect to Chinese trade and exchange rate issues upon European countries (Betschart *et al.*, 2005; Larch, 2005; Oxford Economic Forecasting, 2006). Germany's trade structure is complementary with China's while that of Italy and Spain is considerably more competitive. The technology intensity of Italian and Spanish exports is substantially lower than those of German exports, for example, making them more sensitive to the competitive effects of renminbi valuation (Betschart *et al.*, 2005; Pisani-Ferry and Sapir, 2005). Even when domestic firms in low-skill-intensive industries might prevail upon their national officials, those officials face apathy or opposition from fellow ministers within the Eurogroup.

Second, the division of interests between large multinational firms and domestic manufacturers manifests differently in the European institutional setting. The companies that dominate the pan-European business associations are multinational firms that are far more likely to source from and invest in China than the domestic manufacturers. The voice of manufacturers with primarily domestic operations is thus muted at the European level – an example of the endogeneity of lobbying to institutional design. While the EU-level association of European business groups, UNICE, pressed the European Commission to 'adopt a more resolute and coordinated strategy vis-à-vis China' that included 'adjustment of the Chinese currency (yuan) to market forces', the exchange rate was only one out of 11 agenda items for EU–China economic relations.[14] As of this writing, nothing similar to the China Currency Coalition in the United States has emerged in Europe.

Accordingly, there are no serious threats within the euro area to restrict trade with China in order to secure a change of exchange rate policy. While the European Union invoked safeguards against Chinese textile imports, these measures and measures similar to them have not been linked to the exchange rate and would arguably have been invoked irrespective of exchange rate policy, as a result of the phase-out of the Multi-fiber Arrangement. There is no European equivalent of the Schumer-Graham bill of 2005, in other words, or of congressional threats to restrict trade in the mid-1980s.

Given the institutional arrangements of the European Union, in fact, several obstacles impede such linkages in practice. The first obstacle is the disconnect between trade policymaking, an apparatus of the European Union, and exchange-rate policymaking, an apparatus of the euro area. Member states outside the euro area may not wish to use EU trade policy as a lever for adjustment in the euro's exchange rate. The second obstacle is again the differentiation of competitive pressures from China across member states of the euro area that creates divergent preferences within the Eurogroup and Ecofin and blocks consensus in these bodies. The third obstacle is the inability of the European Parliament to make the linkage. Although it might have some influence over trade policy, the Parliament does not have legislative authority on exchange rate policy and little desire to risk its tenuous standing on trade policy by linking it to changes on external monetary policy.

Owing to the weak institutional standing of the European Parliament, groups and sectors seeking relief from import competition are more likely to access trade measures through their member-state governments and the European Commission than to press for an exchange-rate adjustment. The configuration of euro area policymaking institutions makes such an effort impractical. By contrast, the Commission can alone impose preliminary antidumping duties and its definitive duties are implemented unless there is a negative vote within the Council by simple majority (Woolcock, 2005: 387). Groups can therefore obtain relief more easily in the form of antidumping duties, for example, than in the form of a change in exchange rate policy.

Differences in the economic circumstances of the United States and euro area, such as their foreign direct investment positions in China and their overall current account positions, are sometimes offered as alternative sources of their different responses. The use of China as a low-wage production platform would certainly confer an interest in low valuation of the renminbi upon European multinational corporations. However, the amounts of US and euro area FDI in China are roughly comparable.[15] When lobbying on trade and currency issues, moreover, both American and European multinational companies tend to give priority to securing and expanding their investment position in China's rapidly growing market for the future. Foreign direct investment and the engagement of multinational companies in China thus do not seem to explain the difference in responses.

Similarly, with respect to the current account imbalances, some European observers hope that because the euro area's deficit is relatively small, Europe can remain removed from the global adjustment process. The United States and East Asia are the main areas of savings shortage and savings surplus in the world economy, in this view, and the burden of adjustment should therefore fall mainly upon them.[16] This line of argument concludes that European officials need not become as exercised as US policymakers over Chinese exchange rate policy.

However, the more favorable current account balance of the euro area does not by any means suggest that Chinese exchange rate policy has a lesser impact on Europe. To the contrary, the euro area's interest in renminbi revaluation is arguably greater than that of the United States, for three reasons. First, owing to the greater share of manufactures in the European economy and the euro area's lesser economic flexibility, China's emergence generally represents a greater challenge for Europe than for the United States (Pisani-Ferry and Sapir, 2005). Second, if the dollar depreciates against the euro as part of the adjustment process and China does not allow a substantial appreciation, the renminbi will depreciate against the euro as well – further displacing low-skilled workers and low-technology firms (see, for example, Ahearne and von Hagen, 2005). Third, unprecedented accumulation of dollar reserves in Asia creates compelling incentives for central banks to diversify those reserves into euros to prevent capital losses on dollar depreciation – diversification that would put further upward pressure on the exchange value of the euro. On the basis of these considerations, we would expect more lobbying on the exchange rate and more attention to Chinese currency policy on the part of officials in the euro area compared to the United States; instead, we observe less.

These alternative arguments therefore do not displace the explanation presented here. While institutional structure and democratic accountability are not the only factors differentiating the US and euro area responses to Chinese exchange rate policy, they deserve a prominent place as leading causes of the difference in both the level of private activity and the policy outcomes. Moreover, we can expect them to manifest in other cases of exchange rate conflict in the future.

CONCLUSIONS

This paper has reviewed the policies and institutions by which exchange rate policy is made in the United States and the euro area with special focus on democratic accountability. It argues that, while accountability on exchange rate policy is fairly weak compared to other policy areas in almost all countries, institutional arrangements in the United States provide for the possibility of a 'democratic override' when policy diverges sharply from the preferences of the electorate or broad coalitions of private sector interests. Such a democratic override does not exist in the euro area – a manifestation of the political incompleteness of the monetary union and European Union. Differences in institutional design and accountability account in large measure for the contrasting responses of the United States and euro area to the exchange-rate policy of the Chinese government during 2002–2006. The weakness of accountability on exchange rate policy within the euro area has two negative potential effects. First, it tends to bias remedies for undervaluation of others' currencies toward trade measures and away from exchange-rate measures and could thereby erode political support for economic openness more broadly. Second, if exchange rate policy deviates repeatedly from the preferences of broad private-sector coalitions, the weakness of accountability could allow an erosion of legitimacy over time.

These findings provide further normative support for completion of the political project of the European Union in order to align policy competence with democratic accountability. Because the democratic development of EU institutions is at best a long-term prospect, however, the core institutions should employ interim measures to compensate for weakness of accountability mechanisms. The ECB and the Eurogroup should provide transparency above and beyond that strictly required by the treaties. These institutions should be clear with the public concerning the division of labor between them and the exchange rate policymaking process as well as clear concerning to the objectives of policy – beyond the inadequate language of the treaties. Officials of the ECB and Eurogroup should openly solicit the views of private-sector representative associations, the Parliament and the Commission on external monetary policy and develop a more robust interinstituional dialogue. Finally, the absence of any reliable mechanism for adjudicating interinstitutional conflict places an extraordinary burden on the ECB and Eurogroup to develop, formally or informally, a consensus on exchange rate policy and act accordingly. Although such measures might not provide a 'democratic override' such as that in the United States, they can help to ameliorate the euro area's accountability gap in this policy domain.

NOTES

1 Prepared for the project on 'Legitimacy and Efficiency: Revitalizing EMU ahead of enlargement, organized by Erik Jones, Tal Sadeh and Amy Verdun. The author would like to thank Jacqueline Best, Daniel Daco, Andreas Falke, Kathleen McNamara, Jonathan Kirshner, Georges Pineau, Jens van Scherpenberg and two anonymous reviewers for comments on previous versions, as well as the editors and other authors and participants at the project meeting at SAIS Bologna in December 2005. He also wishes to acknowledge the valuable research assistance of Alina Milasiute and Bella Nestorova.

2 This framework thus adopts a concept of accountability that is procedural, institutional and rationalist. A normative concept, grounded in constructed norms and rights, represents an alternative that is certainly worth pursuing in scholarship on the accountability of policy within the euro area and European Union. Without intending to foreclose these alternative approaches, however, this article adopts the more institutional concept because it can be applied directly to the exchange-rate policymaking apparatus of the euro area, has been neglected in previous articles, and is particularly suitable for a comparison of accountability in the United States and euro area.

3 See also Freeman 2002, which evaluates the applicability of the concept of 'expert democracy' to monetary policy.

4 The Nice treaty changed the decision rule for external representation from unanimity to qualified majority.

5 The IMF staff drew attention to lack of transparency of the exchange-rate policymaking process in its 2001 report on the euro area, IMF 2001.

6 The latter is examined in Henning (2006).

7 These are critical contributions to a debate over global current account adjustment that is broad ranging. This paper does not hinge on the normative questions in this debate – such as the sustainability of the imbalances and the responsibility of the United States, euro area and East Asia, among other actors, for reducing them – interesting as such questions are. The argument developed here hinges instead on the impact of China's exchange rate policy on the economies of the United States and euro area and the responses of the two authorities.

8 See http://www.chinacurrencycoalition.org/members.html. Accessed December 11, 2006.

9 Search conducted on http://thomas.loc.gov/home/c109query.html in December 2006. Hufbauer *et al.* (2006) count 23 such bills between February 2003 and March 2006.

10 European Commission, 'Bilateral Trade Relations with China', accessed June 22, 2006 at http://ec.europa.eu/comm/trade/issues/bilateral/countries/china/index_en.htm.

11 'We continue to monitor exchange markets closely and cooperate as appropriate. In this context, we emphasize that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms'. Statement of G-7 Finance Ministers and Central Bank Governors (2004).

12 A search on congressional hearings during 2003–2005 mentioning the 'exchange rate' generated 7 at which the phrase was mentioned more than 30 times, 2 at which the phrase was mentioned 20–29 times, 9 at which it was mentioned 10–19 times, and more than 100 at which it was mentioned 1–9 times. Thirty-two hearings addressed China specifically. Conducted in April 2006 at http://www.gpoaccess.gov/chearings/search.html.

13 Confindustria, *Economic Outlook*, September 2003 (especially p. 10) and December 2005, as well as its *Report on Italian Industry*, October 2004. Available at http://www.confindustria.it.

14 UNICE, 'UNICE Position Paper on EU-China Relations', Brussels, May 8, 2006, available at www.unice.org. Interestingly, Confindustria argued that renminbi undervaluation should be addressed within the International Monetary Fund, rather than through EU or euro area machinery. Confindustria, *Economic Outlook*, December 2003: 10

15 To the extent that the available data allow a comparison. See Eurostat database, Foreign Direct Investment, available at http://epp.eurostat.ec.europea.eu.

16 While applauding China's modest revaluation in mid-2005, Weber (2005) and Issing (2005) take this essential position. Ahearne and von Hagen (2005) and Pisani-Ferry and Sapir (2005) inveigh against European complacency with respect to the renminbi, which they also describe as pervasive.

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