



Hochschule für  
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**THE ECB AND ITS MONETARY POLICY –  
BETWEEN NOSTALGIA AND ANTI-GROWTH  
AGENDA**

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**Paper for the 15<sup>th</sup> FMM conference *From crisis to  
growth? The challenge of imbalances, debt, and  
limited resources***

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## 1. Introduction

In 1923, Gustav Stresemann, the former Chancellor and Foreign Minister of Germany, had already posed the question of whether there should be a European currency. During a plenary meeting of the League of Nations he asked: “Où sont la monnaie européenne, [...] qu'il nous faudrait?” (Stresemann 1929, p.70) and thus launched the idea of what we nowadays call the European Economic and Monetary Union (EMU). But it was not until the 1970s, triggered by the end of the Bretton Woods system, that European leaders such as Helmut Schmidt and Valéry Giscard d'Estaing started re-thinking about a further economic integration in Europe. Some ideas, such as the Werner plan or the so-called *currency snake*, could not fulfil the hopes of the political elites; it was with the breakdown of the iron curtain in Europe and with the constantly deepening European Integration that the way for a single European currency was finally cleared. So, in 1988 a committee under the leadership of Commissions' president Jacques Delors proposed a roadmap including three stages for reaching the aim of a Monetary Union with a single currency: the hour of birth for the European System of Central Banks (hereafter ECB).

From 1999 onwards, monetary policy is set on a European level by the highly independent ECB, whereas fiscal policies are still part of the national remits. Launching the EMU and finally introducing the euro as the common currency not only meant a success for the integration process in Europe, but also set the seal on the asymmetrical<sup>1</sup> economic integration. This particular asymmetry in economic integration has led to several inner-European imbalances.

Against this background, the following paper will answer the question whether the ECB, its targets and its decision-making structures are really suitable for achieving an adequate growth rate in the euro area or if the ECB's strategy rather jeopardizes the future of the European Union (EU).

Starting with a short overview on the monetary policy strategy of the ECB, explaining its theoretical background (i.e. the quantity theory of money), the ECB's

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<sup>1</sup> As the EU indeed has got a common monetary policy, set up by the ECB, but neither a common fiscal nor social policy, the European Integration process has been widely described as being *asymmetrical*. In this context, it has been argued that the lack of an economic government, a mechanism for financial redistribution, common social security systems and a coordination mechanism for wage policy has led to decisive inner-European imbalances (Busch 2010).

targets will be critically reviewed. What is also striking in this context is the question of whether the European monetary policy has been successful in recent years. The ECB's performance will therefore, be investigated, taking into account both the inflation and growth rate in Euroland. Finally, the circle will be completed by looking more closely at the ECB's decisions within the most recent *Greek crisis*.

## **2. Nostalgia *par excellence*: the ECB and the Quantity Theory of Money**

Before starting to describe the targets and strategies of the ECB, it is indispensable to have a closer look at the theoretical background of monetary policy in general. It is no coincidence that the ECB acts in its fairly special way; in fact its behaviour is closely linked to what is generally known as the classical Quantity Theory of Money (hereafter: quantity theory). It is worth it going into more depth concerning this theory:

Although emerging as early as in Mediaeval Europe, the quantity theory received, for the first time, quite a high academic significance when in his book *Réponse aux paradoxes de Monsieur de Malestroict touchant l'enchérissement de toutes choses* (1566) Bodin pointed out that there is a link between the shipments of bullions from America to Europe and the so-called "Price Revolution" (Graff 2008, p.12). Some 300 years later, Mill clarified Bodin's idea by stating that if "the whole money in circulation was doubled, prices would be doubled [and] if it was only increased one-fourth, prices would rise one-fourth" (Mill 1848, p.15). Unfortunately, neither Bodin nor Mill witnessed the ennoblement of the quantity theory to broad academic consensus which started in the 1970s. In a time when unemployment was high and inflation rates were still increasing, the standard Keynesian ideas of economics could supposedly not explain the dilemma of stagflation. Simultaneously with these crises, the Bretton Woods system broke down; with the lack of fixed exchange rates, monetary policy became even more important. Against this historical background, Friedman and his ideas on how successful monetary policy should look became – at least for a decade – widely accepted in the scientific discussion. For monetary policy, only an auxiliary role was left, indirectly bolstering the economy (Graff 2008, p.14). Friedman specified the quantity theory by distinguishing between short-term and long-term effects of active monetary policy. In this context he stresses that "there is always a temporary trade-off between inflation and unemployment; there is no

permanent trade-off” (Milton 1968, p.11). Consequently, a change in the money supply can completely affect variables such as output or employment in the short-term, whereas in the long-term a change in the money supply affects only prices. Taking this for granted means that expansive monetary policy as an instrument for giving incentives for higher investments, for instance during a crisis, would be absolutely useless, or even counter-productive, due to the assumed higher prices. Relating to these ideas, Milton deduces that “monetary policy can [nonetheless] prevent money itself from being a major source of economic disturbance” (ibid., p.12). This destructive element of monetary policy can only be tamed if the central bank fixes a rate of money supply; Milton recommends a “3 to 5 per year rate of growth in currency plus all commercial bank deposits” (ibid., p.16) and thus approximates quite well the targeted money supply rate of the ECB: 4,5 %.

Before having a closer look at the ECB, some basic assumptions of Milton’s theory have to be generally criticized. Assuming that an increase in the money supply automatically causes a similar increase in the price level leads to the idea of an economy, being at, or close to full employment. In this context, Milton additionally ascertains that the central bank can directly control the supply of money and that the velocity of circulation is constant. Having a closer look at these assumptions one can argue that the central bank can only control the money supply indirectly by setting its interest rates and that the velocity of money is not constant at all (Goodwin et al. 2006, chapter VI., pp.31ff.). Another fairly crucial aspect in this context is the fact that the quantity theory neglects money’s function as a store of value and eagerly prioritizes money’s function as a medium of circulation. Although there are these obvious deficiencies of the quantity theory, Milton’s ideas obviously played an immense role when the targets of the ECB were defined.

## **2.1 The strategy of the ECB: price stability first!**

Apart from the targeted money supply rate, which will later be discussed, the Treaty of the European Union defines the key objective<sup>2</sup> of the ECB as follows: “The primary objective of the ECB shall be to maintain price stability” (Art 105, EC).

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<sup>2</sup> Apart from the objective to maintain price stability, the ECB’s monetary policy follows another, more general objective. It is stated that “without prejudice to the objective of price stability”, the ECB also “support[s] the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community” (Art. 105, EC). The combination of the two objectives is known as the *two pillar strategy* of the ECB.

There is no further information provided about the final arrangement of the desired inflation rate being necessary in order to achieve price stability. Due to this lack of precise definition, the ECB exercises its discretion and defines price stability as an inflation rate of less but close to 2 per cent over the medium term (Fitoussi 2002, p.20). In accordance with this target, the ECB additionally announced that there will be a reference value of the money supply rate guiding the ECB's monetary policy. As short-term fluctuations in money supply do not usually have any significant implications for the price level, the ECB decided to regularly contemplate the broad aggregate M3, possessing long-run stability properties (Issing 2002, p.82). Against this background, the ECB stated that "the reference value for M3 is set at 4.5 per cent" (ibid., p.86) without specifying this target by declaring – for instance – an explicit time horizon. Looking more closely at the development of M3 in Euroland, it becomes quite obvious why, in 2003, the ECB decided "to no longer conduct a review of the reference value on an annual basis" (Graff 2008, p.1).

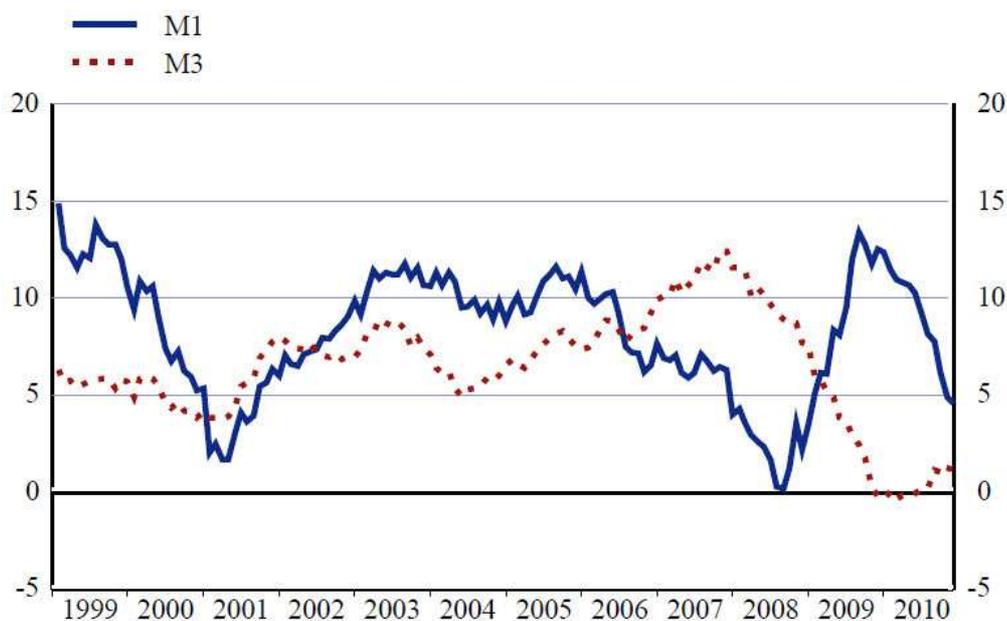


Figure 1: Monetary aggregates M1 and M3 in the Eurozone (<http://sdw.ecb.europa.eu>)

Figure 1 clearly demonstrates that the monetary aggregate M3 was frequently at a higher level than the declared target of 4.5 per cent.

To sum up, one can argue that the ECB uses its goal independency, deriving from the missing definition of price stability, quite incomprehensively. Sharpening this statement, one may say that "in Euroland, the macroeconomic policy-mix at any time

is not a deliberate but random outcome” (Bibow 2005b, p.11). But why is that then the case?

## **2.2 The ECB – Legacy of the German Bundesbank?**

At this point, the role of Germany throughout the whole negotiation process concerning the design of the EMU must be mentioned. After World War II, the Deutschmark became a hard and strong currency in Europe. Its strong independence from political decision-making processes was one of the main characteristics of the German central bank. Worth mentioning in this context is the fact that there has been at least a minimum political influence on the Bundesbank’s decisions through the German Bundestag. This idea has been transformed to the ECB; unfortunately to such an extent that Bibow defines the ECB as a “benevolent dictator enjoying unbounded discretion” (Bibow 2005b, p.8). Here, he makes a point on the fact that for the ECB, there is no political accountability at all.

Looking at economic history, one can see that in a system of fixed nominal exchange rates – especially under Bretton Woods – Germany succeeded in keeping its inflation rate below the rates of other members of the EU (Bibow 2007, p.306). Henceforth, there has been a depreciation of the Deutschmark, as well as export-driven upswing in German industry. The Bundesbank’s wisdom worked quite well in a Europe with different currencies and included the possibility of national appreciation or depreciation; potential economic imbalances between the member states could be alleviated by active national monetary policy of the central banks. But, to put it bluntly, the attempt to export the German central bank model of the European level failed. Bibow illustrates this by arguing that “Germany[‘s] abstinence from deliberate demand management was dependent upon its partners behaving differently – not alike” (ibid., p.307).

But to what extent did the German model of central banking really fail? And to what extent did the growth rate in Euroland suffer from this malperformance?

## **3. Looking back: the ECB’s performance from 1999 to 2009**

When, in 2000, the dot-com bubble burst, the global economy faced a serious economic crisis. Both Europe and the US were affected by this event. Curiously, at the beginning of 2002, the US markets continuously re-gained strength whereas the

members of the EMU still suffered from low growth rates. Bibow et al. stress in this context that the main reason for this unequal economic recovery can be found when looking at the monetary policy of the ECB.

After analyzing the historical roots of the ECB and generally criticizing the strict adherence of the price stability goal for Europe, the theory will now be put into practice. The performance of the ECB throughout the years 1999 to 2009 will therefore be examined, starting with the years 1999 to 2004 where the ECB key policy rate has been frequently out of touch with the GDP growth (figure 2). As in 2004, the two curves slowly converged (figure 4), this year will be the initial point for the further investigation, answering the question whether the ECB learnt from its malperformance or not.

### 3.1. From 1999 to 2004

The first year of the ECB's monetary policy was shaped by the economic troubles in Asia and the US. Fitoussi et al. argue that in this period the ECB fully succeeded in confounding "its critics who had feared that [the ECB's] asymmetric inflation target would lead to deflationary bias in European monetary policy" (Fitoussi/Creel 2002, p.20). This rather positive assessment does not refer to the fact that Euroland, in comparison to the US, did not participate in the global economic upswing. In an economic climate highly affected by a growth enthusiasm, the outlook of the ECB's policy is quite poor (Bibow 2007, p.310). One key argument usually states that the key interest rate in Europe, indirectly set by the central banks, was frequently set too high and thus usually out of touch with markets and economy; figure two provides evidence for this assumption:

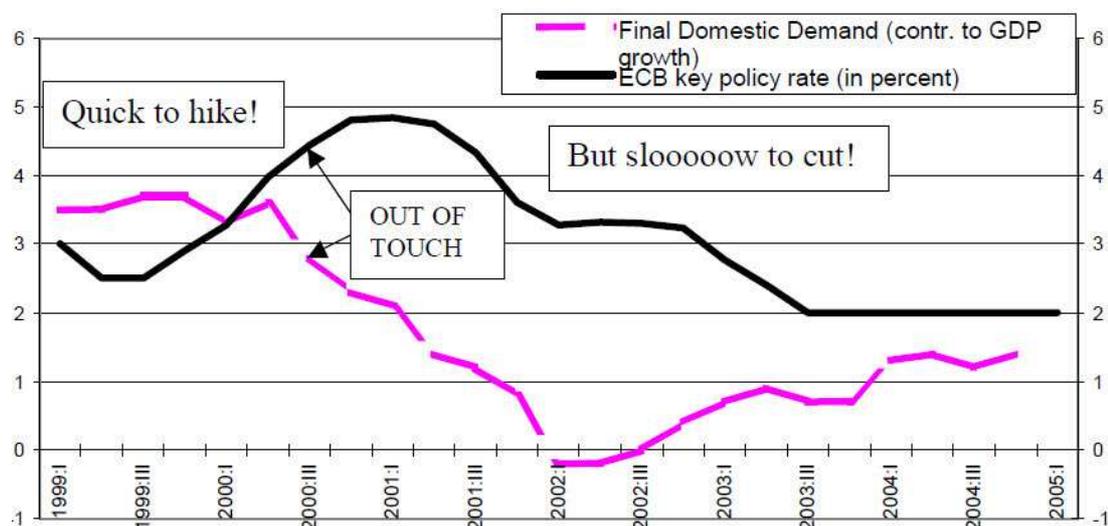


Figure 2: Quick to hike but slow to cut (Bibow 2007)

Looking back at 1999 and 2000, one can easily see that this scenario began exactly when the ECB started setting higher interest rates. Final domestic demand and the ECB key policy rate were simply no longer in touch. Which economic consequences can be expected from this particular mismatching? Putting it simply, the higher the key interest rate, the less money will be borrowed from banks to companies; this eventually leads to less investment<sup>3</sup> and thus to a lower growth rate of the economy. Accordingly, the performance of the ECB in the first two years is a rather poor one. Relatively high interest rates combined with fairly low growth rates – compared with the US growth enthusiasm – draw a disillusioning picture of what was expected from the ECB.

But how does the outcome for the target of maintaining price stability looks like?

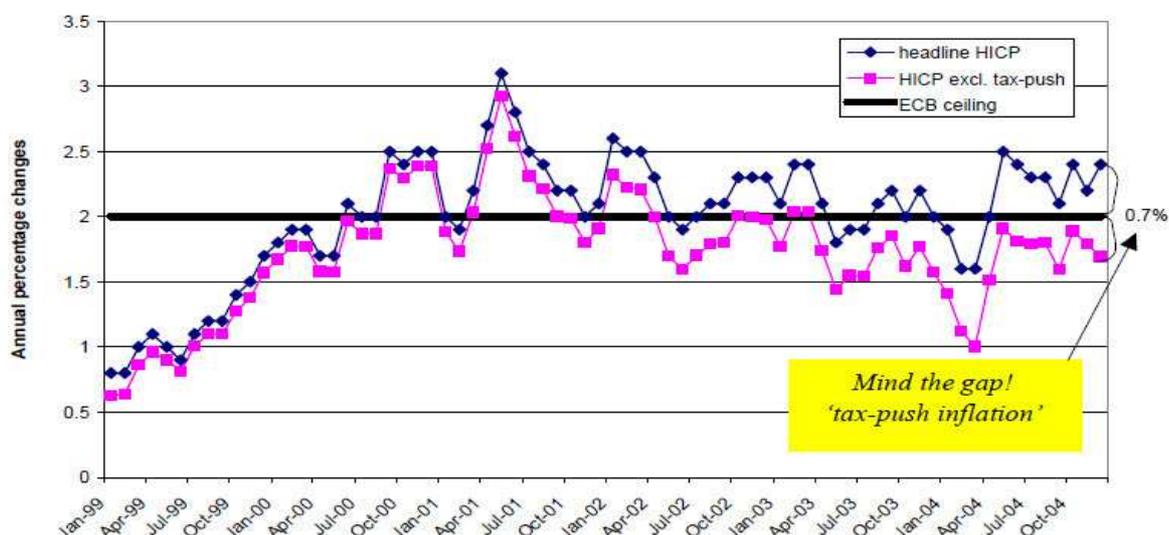


Figure 3: HICP both including and excluding tax-push inflation (Bibow 2005a)

At first glance, the ECB did quite well in achieving its goal of an inflation rate near but below 2% in the last years. Going into more detail regarding this figure, one can argue that without what is here called the tax-push inflation, the ECB's target would have been perfectly matched in 2004. The tax-push inflation occurs arguably due to the restrictions of the Stability and Growth Pact<sup>4</sup> (SGP), which force national governments either to cut spending or to higher taxes in order to fulfil the Maastricht

<sup>3</sup> Far more factors influence the borrowing process of money between the banks and the customers (i.e. uncertainty).

<sup>4</sup> *The Stability and Growth Pact* has been adopted by all EMU members and forces them to limit their fiscal deficit to maximal 3 per cent of GDP. In addition the national debt shall be lower than 60 per cent of GDP. Many scientists argue that these criteria are not beneficial at all for the economic development of the EMU (i.e. Fitoussi 2002, pp.54ff., Bibow 2009, pp.6ff.).

criteria. This is definitely not something of which the ECB could directly be accused; but there is an obvious link between the ECB, its monetary policy and the SGP being part of the European “stability-oriented vicious circle” (Bibow 2007, p.316).

### 3.2 From 2004 to 2009

It was not until late 2004 that the situation in Euroland began to change slightly. As Figure 4 illustrates, the ECB key policy rate was more or less in touch with the growth rate of domestic demand until the beginning of 2007. In a time of highly favourable economic conditions, Euroland finally seemed to have recovered from the years of slow growth and high unemployment.

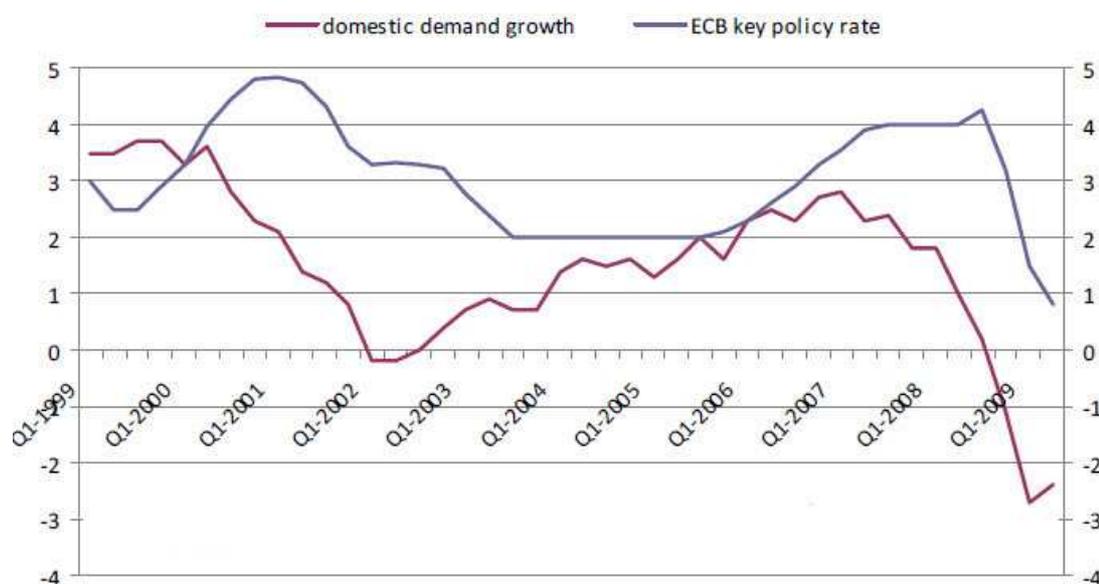


Figure 4: Quick to hike and slow to cut volume 2 (Bibow 2009)

Industries, such as the highly export-dependent German one, profited particularly from this world-wide economic upswing. During this time, the ECB hardly changed anything with respect to its key policy rate. For an institution which recently decelerated promising economic conditions, this is a rather positive outcome. But to be clear, by lowering the key interest rates appropriately, the FED in the US reacted faster and more firmly than the ECB did. Accordingly, one can state that from 2004 to 2007 the ECB did not directly slow down the economic growth potential of the Euroland, as it did before, but nevertheless, the ECB’s policy strategy is still far from being sound. With the beginning of the economic crisis<sup>5</sup> in 2007, a period of

<sup>5</sup> The term *economic crisis* refers in this paper to the most recent world economic and financial crisis beginning in 2007 in the US.

degrowth in domestic demand in the Euroland commenced. Simultaneously, the ECB again started hiking its key policy rate (Figure 4) without having any clear evidence that the crisis would soon be over. Since higher interest rates usually make it more difficult for companies to get credits and thus invest in the economy, many scientists eagerly criticized the ECB for this policy in times of an emerging financial crisis. Comparing this again with the FED one can clearly see that the ECB reacted very slowly and even bet on the wrong horse by hiking the key interest rate.

As a quintessence for this chapter, one can assess the ECB policy strategy as being rather insufficient and counter-productive.

#### **4. Excursus: The ECB's monetary policy and the Greek crisis**

As the previous chapter clearly demonstrates, the ECB's monetary policy can be criticised in different ways. At this point of the investigation, it is worth it to elaborate on the particular role of the ECB within the European sovereign debt crises. Against this background, the question arises as to whether the ECB with its strict monetary policy further sharpened the existing asymmetry within the EMU in the pre-crisis years. Hereupon, the ECB's reaction to the Greek crisis will be investigated; it is hypothesised, in this context, that the ECB acted too reluctantly in the beginning of the crisis and thus aggravated the situation for the Greek economy.

##### **4.1 Monetary policy in the pre-crisis years – sharpening asymmetry?**

Analysing the primary target of the ECB, which is defined as “to maintain price stability” (Art.105, EC), one can easily see that the German Bundesbank with its former guideline, strongly influenced the outlook of the ECB's scope of duties. The ECB thus eagerly prioritises the central banks function as a guardian of low inflation rates, but neglects its duty to encourage favourable economic conditions and high employment rates (Richter/Wahl 2011, p.7). Apart from this argument, the one-fits-all key interest rate of the ECB for the EMU members must be seen as being eminently problematic. Figure 5 provides evidence for this thesis:

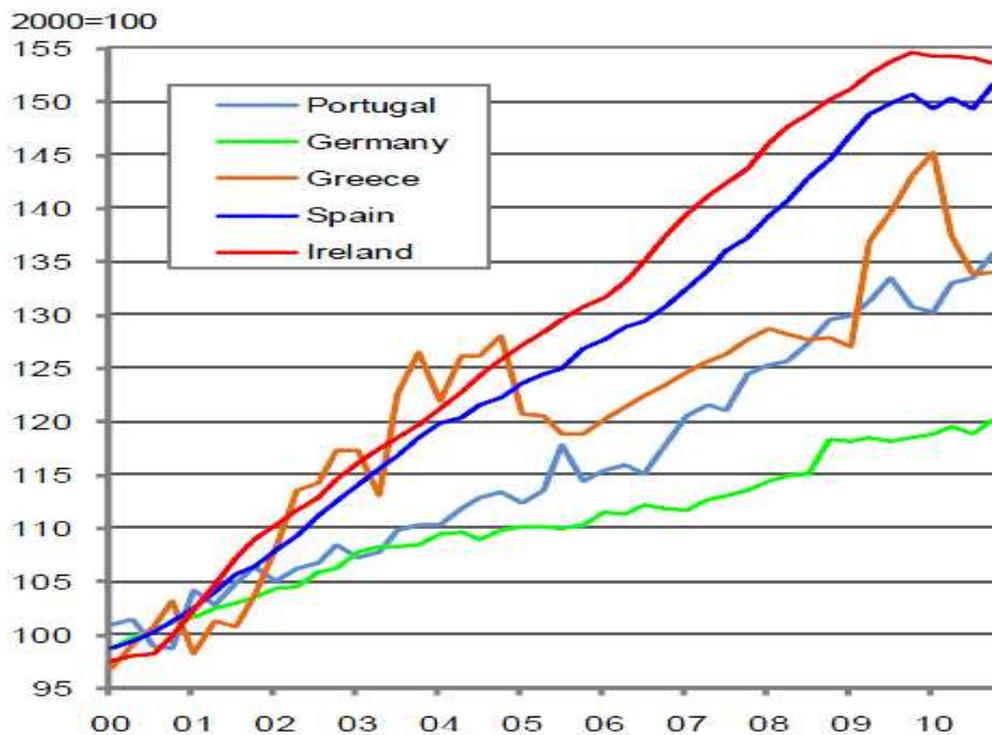


Figure 5: Labour costs in selected EMU countries (Bundesbank 2011)

With the abolition of the monetary mechanisms of appreciation or depreciation for national central banks, labour costs slowly became the overall indicator for competitiveness in Europe. In the years 2000 to 2010, wages in Germany only moderately increased, the German productivity, however, steadily grew; hence, the existing gap between productivity and wage level rose which led to shrinking labour costs in Germany. This would not be such a major problem for the other EMU members if they behave alike and also strongly limit the wage increases in their economies. Though, Figure 5 proves that Portugal, Greece, Spain and Ireland behaved differently; their labour costs increased in accordance with their productivity. In such a case of artificial competitiveness advantages for Germany, the other European countries would normally strongly depreciate their currencies; so that a *level playing field* is re-gained. In the situation with only one central bank and no further economic cooperation, such an intervention of the national governments is, however, no longer possible. What the case of the development of labour costs in Europe illustrates is that the ECB – embedded in the post-Maastricht EMU structures – in fact provides space for a further sharpening of inner-European economic imbalances.

## 4.2 Paradigm shift within the crisis?

When the world economic and financial crisis started to shake the European economies to the core, the ECB definitely missed this grave situation. Having a closer look at the ECB key interest rate, one can see that even in the very centre of the crisis, the European monetarists still adhered to their one and only target, namely low inflation rates. The fact that the central bank augmented the key interest rate from 4 % to 4.25 % in late July 2008 provides evidence for this assumption (Figure 4).

With this policy in times of economic crises, the ECB definitely minimised the opportunity for EMU countries to smoothly overcome the crisis. This is particularly important for Greece. The Greek banking sector would have needed a more courageous and faster lowering of the key interest rate within the crisis in order to provide the investors and the inter-banking money market with the much-needed certainty (Gerlach 2010, pp.3-4). This first finding generally supports the assumption that the ECB's policy worsened the outcome of the crisis for Greece. Another particularity of the EMU is the existence of national bonds with different bond yields within the union. Although the ECB is not supposed to directly intervene into these bond markets, the provision of a key interest rate which is equal for every EMU member led to a constant convergence of the national bond interest rates after launching the EMU (Figure 6).

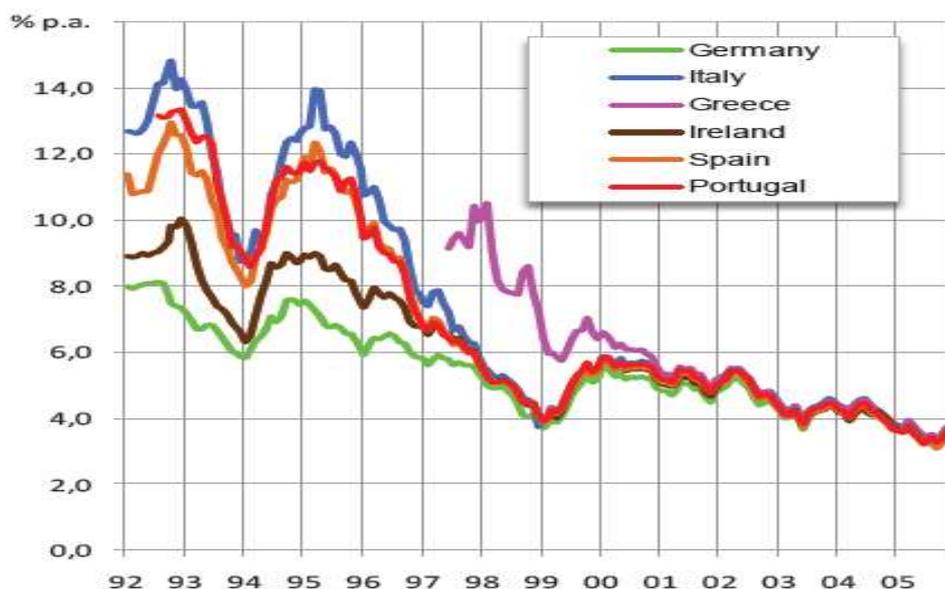


Figure 6: Interest rates for 10-year governments bonds (Bundesbank 2011)

With the convergence of bond interest rates from the EMU members which started in the year 2001, nearly all EMU countries had to pay similar interest rates at the world financial markets for re-financing their debt. This situation drastically changed with the upcoming sovereign debt crisis in Ireland and later on in Greece. Figure 7 underlines this thesis.

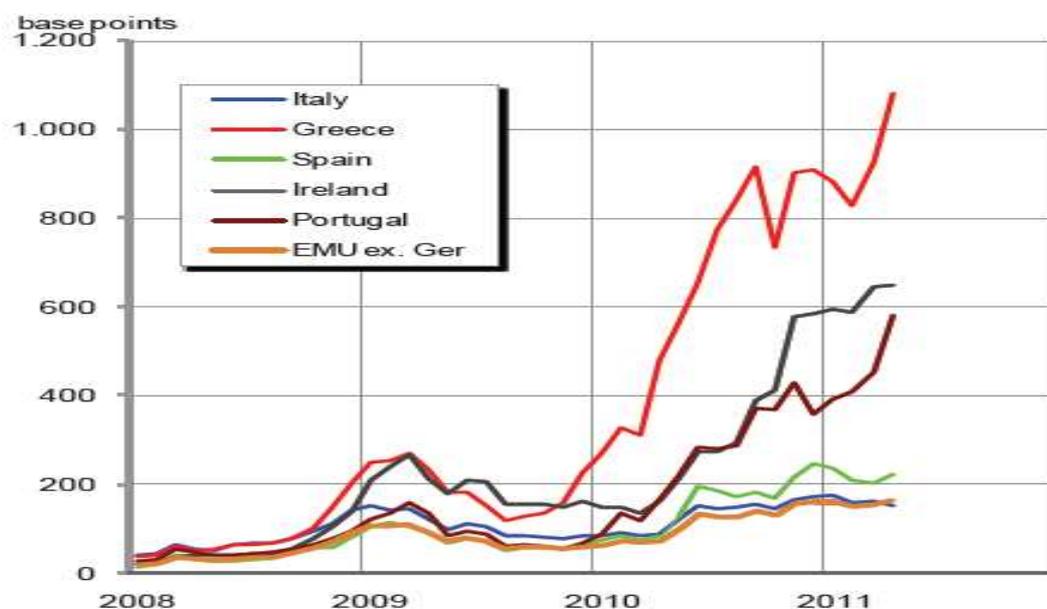


Figure 7: Interest rates across EMU relative to German 10-year government bonds (Bundesbank 2011)

The fact that both the European elites and the ECB acted fairly reluctantly when this grave situation occurred, finally led to radically increasing interest rates for Greek bonds.

What is clear is that the ECB cannot be accused for the development on the world bond markets. With a more courageous and unconventional monetary policy, however, the central bank could have contributed to a less emotionally charged situation on the bond markets. Both Gerlach and Richter/Wahl describe the ECB's role in the Greek crisis in a similar way (Gerlach 2010, Richter/Wahl 2011).

What is exceedingly interesting, in this respect, is the way the ECB finally changed its behaviour and started to directly intervene on the world bond markets in order to avoid a failure of the Greek economy. With the *Enhanced Credit Programme* which makes it easier for countries like Greece to get credits, the ECB took a first step in 2009 towards a more pragmatic Keynesian monetary policy (Richter/Wahl 2011, pp.11-12). The idea of an efficient and self-regulated market seemed to have reached

its limit. In 2010, when the ECB finally started buying Greek bonds on the financial market in order to assure the liquidity of Greece, the reality was catching up with the ECB's leading economists. Taking all these aspects into consideration, one can deduce that the ECB with its targets and its performance in the pre-crisis year indeed supported a further sharpening of the asymmetry within the EMU. With the beginning of the Greek crisis, however, the outcome of the ECB policies started to look entirely different. The central bank acted fairly pragmatically and not quite as backwards-looking as it was assumed within the research hypothesis for this chapter.

## **5. How to reform the ECB?**

As the previous chapters clearly demonstrated, the ECB and its monetary policy neither met its targets (i.e. M3 rate) nor fully tapped Euroland's growth potential. Against this background the question of how the "undemocratic and economically inefficient" (Bibow 2005a, p.20) work of the ECB can be improved arises. The many attempts to reform the ECB provide subject matter for academic writers. What many of them have in common is the proposal to introduce more accountability and democracy to the system of the ECB. As already mentioned, neither the Council of Minister nor the European Parliament has any rights to force the ECB to change its policies. If one takes the attempt to introduce more political accountability to the ECB seriously, the European Parliament should have the right to define the meaning of price stability. This would not only be a kind of democratic symbolism, it would also even increase the legitimacy of ECB's decisions. This is something which worked out quite well in the US, where the FED now has to justify its policies in front of democratically elected bodies (Fitoussi 2002, p.47). Since it is not specified who determines the meaning of price stability in the Treaty of the European Union, no major change in the legal framework would be needed to implement this proposal. Considering the near future of the EMU, the quasi 2% inflation target of the ECB will be too tight for an enlarged Euroland. The associated members, who probably have relatively high rates of growth and inflation, do need a far greater discretion for their inflation target. This, simultaneously, would provide the ECB with more scope for modification of the key interest rate.

A second proposal for reforming the ECB concerns the polity structure and the decision-making processes within the ECB. As the Treaty of the European Union

states that every member state of the EU shall have the Euro as its currency when meeting convergence criteria, the EMU will inevitably grow to an extent in which decision-making would become more and more difficult in the Governing Council of the ECB. Hence, a restructuring of the council is urgently needed. A system of rotation could be implemented, reserving permanent seats for the large countries (i.e. Germany, France) in order to avoid a domination of the small member states. Another even more democratic proposal would be to nominate the members of the council directly. Politics would thus play a more prominent role, while the quality of information provided for the public would be better and the transparency would be consequently enhanced.

## **6. Conclusion**

It has been argued here that the ECB's monetary policy strategy is strongly characterized by assumptions provided within the quantity theory. It is thus not astonishing that the ECB used its independence to clarify its main objective, namely price stability, by fixing a money supply rate. Throughout this analysis it becomes obvious that the ECB did not match its targets perennially. A closer look at the performance of the ECB in the last ten years highlights more serious deficiencies. Answering the introductory question of this paper, one can stress that the Governing Council of the ECB set the key interest rate frequently too high and thus in fact jeopardized a proper economic growth in Euroland. The monetary policy in Europe is far from being sound or conducive. Additionally, the slow reaction of the ECB in the face of changes in the world economy, such as the most recent crisis, unearthed the truth about the nontransparent and inefficient decision-making structures in the ECB. Coming to the role of the ECB in the recent crisis, the findings look quite different; although it is clear that the central bank's monetary policy in the pre-crisis years contributed to the emerging economic imbalances, its policy within the Greek crisis was more characterised by fairly pragmatic decision making. Still, it has been pointed out that a reform of the Governing Council is urgently needed in order to promote political accountability and democracy in the ECB's system.

With its characteristics of today, the future of the ECB will be determined by how far it can adopt to the new challenges occurring from the enlarged EMU. With more member states, the decision-making in the Governing Council will inevitably slow

down and thus courageous decisions will have to be made by the political elites in Europe. The question is therefore, which of the current leaders of the huge European 15 economies can and will do this? Tragically, forward-looking personalities with an appropriate understanding of European economics seem to be out of eyeshot.

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