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The ECB: towards a monetary authority of a federal Europe

by

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Abstract

The article explores the present role of the ECB in European economic governance and point at the required steps to make such governance effective in tackling the challenges of the Eurozone and of the European Union in the global economic order.

Key-words

European Central Bank, Economic and Monetary Union

1. Introduction

There is a widely held opinion, in the debates of the last few years on the crisis hitting some euro-zone sovereign debts, on the alleged shortcomings of the ECB. Some have pointed at its too narrow mandate to price stability as a myopic strategy in times of credit crunch. Others have argued that, irrespective of such mandate, the ECB could have done more. Many have provided evidence of the fact that a Central Bank without the capacity to act as lender of last resort is inefficient in protecting the underlying economy from speculative attacks.

All these claims seem to highlight important elements of an inefficient governance of economic policy throughout the Eurozone. They nevertheless crucially miss the point in two major respects. Firstly, they accuse the ECB of something for which it can hardly be accused, being a technical agent constrained by a political agreement at the level of the Heads of States and Governments of the EU. Monetary policy alone is unable to recover a complex economy with structural problems such as in the case of Europe. Secondly, a reform of the ECB can only be envisaged within a completely different institutional framework, where the ECB becomes the Central Bank of a genuine federal constitutional system.

In order to illustrate these claims, we shall explore the present role of the ECB in European economic governance and point at the required steps to make such governance effective in tackling the challenges of the Eurozone and of the European Union in the global economic order.

2. The role and limits of the ECB: unconventional policies

Central Banks are key actors of economic policy. They manage liquidity and provide a reference price for the credit system, thus impacting on the real economy. They may change collateral and/or reserve requirements within the banking system, thus affecting the degree of systemic risk in the economy. And they usually play the role of lender of last resort in case of dramatic financial distress.

The European Central Bank is, in this conventional framework, a strange subject. Its statute, agreed upon by the European Council, commits the ECB to the stability of prices, (more or less) irrespective of other macroeconomic targets.

Inflation targeting, which is widely acknowledged as the dominant goal of monetary policies throughout the whole world in the last few decades, is for the ECB the mandatory aim. Within inflation targeting regimes, central banks usually set interest rates as a main tool to implement monetary policy. Nevertheless, in the last few months the ECB has made an effort to go beyond its explicit mandate, as far as making recent decisions to implement quantitative easing measures, i.e. to buy government bonds in exchange for newly created money.

After the speech of Mario Draghi on July 26th 2012 ("the ECB is ready to do whatever it takes to save the euro… And believe me, it will be enough"), threatening Outright Monetary Transactions to buy government bonds of those countries under speculative attacks, spreads on interest rates have decreased dramatically, allowing for more radical changes on the political side. Such radical changes from the European Governments, nevertheless, have not come yet.

In the meanwhile, the European economy was stabilized, but with hardly any perspective of balanced growth. The last few months have shown that worries about the risk of inflation following OMTs were wrong, as a few authors had already suggested (De Grauwe and Ji 2013). The ECB has reduced financial fragmentation and provided unlimited liquidity against changing collateral requirements. As Peter Praet (2014), Member of the Executive Board of the ECB, summed up:

> "Since the onset of the crisis, the ECB's mainstay response to this problem has been twofold: a policy of unlimited provision of liquidity at fixed interest rates against eligible collateral in the weekly main refinancing and longer-term operations, and an extension of maturity of the liquidity operations from 3 months to up to 3 years. This dual approach to crisis management has been reinforced by two further initiatives.
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> First, collateral rules have been adapted in various stages with a view to broadening the pool of assets that banks could mobilize for Eurosystem liquidity provision. This process – which has complemented the fixed-rate-full-allotment decision – has always balanced the need to be supportive to our counterparties with the goal of exercising an appropriate degree of risk control, and to protect our balance sheet. Incidentally, Portuguese banks have greatly benefited from these measures. For instance,

> they were able to strengthen collateral buffers by mobilizing additional credit claims for the purpose of obtaining Eurosystem liquidity – and more effectively than other banking systems in the euro area.
> Second, the refinancing risk faced by euro area banks has been minimised by giving them reassurance that monetary policy will remain accommodative for an extended period of time. In the course of 2013, this reassurance has taken two forms: conditional forward guidance on the level and direction of our policy rates in the future, and a pledge to maintain the fixed-rate-with-full-allotment policy for as long as needed and at least until mid-2015.
> These measures proved powerful in addressing the funding risk faced by our counterparties throughout the crisis, as evidenced, for example, by the significant decline in money market term premia."

For some (Beukers 2013; Weber and Forschner 2014), all these measures are challenging the independence of the bank, which may be seen to have acted under political pressures. On the contrary, we believe that they are true testimony of the independence of the ECB from the political impasse of the EU. Our key claim is that such improvements are not enough to make the EU and the Eurozone escape the present situation of structural crisis. The ECB has bought time for European Governments to do "whatever it takes" to overcome the present crisis. Until now, they have not done enough.

3. An architecture for growth

Expectations are the key single concept for economic health. When expectations are negative, agents behave in a way that prevents the economy from growing. This is a problem because expectations cannot be created and governed easily. Strong credibility is a necessity of the whole economic and political system of governance. And this is the weak point of European institutional arrangements, where the main tools of economic policy are inconsistent with one another.

The performance and responses of each economy to endogenous and exogenous shocks depend on their market and institutional structure. The European economy is characterized by a very peculiar architecture where monetary policy is constrained by severe rules and is managed at the supranational level. Budgetary policies, as well as most laws and rules affecting high public debts, financial regulation, macroeconomic supervision and trade are for a major part in the hands of institutions outside both national and European public institutions. Three relevant supply-side elements for the European recovery such as fiscal consolidation, markets liberalization and reforms of the labour markets are mostly a matter of national decisions; but they require a coherent supranational framework.

On the demand side, economic interdependence among European countries is so great that un-coordinated national demand policies may boost neighbouring countries rather than the domestic economy. In the short run, as another member of the ECB board, Tommaso Padoa-Schioppa†, used to argue, we should be able to combine economic rigour at the national level, where budgetary problems are relevant, with supranational expansionary policies, where debt is zero and favourable interest rates can be gained on the market.

In the long run, in such a context, a complex system of coordinated multi-layered governance is necessary to adapt the European economy to the challenges of world-wide competition. As ECB Governor Mario Draghi (2014) recently claimed:

> "The issue is not really whether policies to support demand should precede or follow policies to support supply. Reform and recovery are not to be weighed against each other. The whole range of policies I have described aims simultaneously at raising output towards its potential and at raising that potential. This combination of policies is complex, but it is not complicated. Each of the steps involved is well understood. The issue now is not diagnosis, it is delivery. It is commitment. And it is timing. I recently said of monetary policy that, at the current juncture, the risks of doing too little exceed the risks of doing too much. If we want a stronger and more inclusive recovery, the same applies to doing too little reform."

Let us now try to outline some of the main directions towards which such reforms should aim. European-wide collective public goods – such as communication and transport infrastructures, research, energy, and some redistributive measures – need to be financed by a supranational budget.

Nation-specific collective goods – such as local infrastructures, education (up to a certain point), and the major part of the welfare state – should be financed through national budgets, in a bottom-up logic of the principle of subsidiarity. This implies that a new constitution should be written to allocate competences to the different layers of government, which is something requiring a dramatic change of the Treaties or at least the implementation of enhanced cooperation among Eurozone members.

4. Towards an effective economic and political governance in Europe

This process can nevertheless be built by steps. Starting from the Roadmap *Towards a Genuine Economic and Monetary Union* of the Four Presidents of December 2012 (Van Rumpuy et al. 2012), the banking union should be completed as soon as possible. Significant steps in this direction have been taken. As was indicated in the document, the *Single Supervisory Mechanism* "will be a guarantor of strict and impartial supervisory oversight, thus contributing to breaking the link between sovereigns and banks and diminishing the probability of future systemic banking crisis" (Van Rumpuy et al. 2012: 5). And as for the *Single Resolution Framework*, it is designed to reduce the risk that banking failure might burden taxpayers.

The second step should be to foster financial integration. It should aim at providing the resources that are necessary to support growth. This in turn implies two directions: the first concerns greater budgetary coordination and surveillance; the second implies the ability to raise additional resources. The *Roadmap* suggests the following:

> "The crisis has revealed the high level of interdependence and spill-overs between euro area countries. It has demonstrated that national budgetary policies are a matter of vital common interest. This points to the need to move gradually towards an integrated budgetary framework ensuring both sound national budgetary policies and greater resilience to economic shocks of the euro area as a whole. This would contribute to sustainable growth and macroeconomic stability." (Van Rumpuy et al. 2012: 8).

We expect the provisions of the *Six Pack*, the *Two Pack* and the *Fiscal Compact* to be included within the new framework of European governance. The mid-term revision of the Treaties of 2016 should aim at including all these mechanisms.

But this may not be enough, because constraints are not a sufficient condition for growth, and the *European Stability Mechanism* is only designed to provide financial assistance to Eurozone members in difficulty, not as a fund to finance growth. Even the recent *Juncker investment plan* risks not being able to meet its explicit goals, as insufficient resources are envisaged. A braver step would be to issue project bonds to finance specific strategic goals, such as European-wide collective investments as previously identified.

In a broader perspective, nevertheless, the Eurozone should think about its own autonomous fiscal capacity (Moro 2013). From this point of view there are several proposals that may be considered. A carbon tax (Majocchi 2011) and a European use of the Financial Transaction Tax might be short-term solutions. And a specific share of income taxes might also be worth considering. This is of course a crucial step because it requires a change in the existing treaties on a key point: unanimity. We recall that Article 311 TFEU states:

> "The Council, acting in accordance with a special legislative procedure, shall unanimously and after consulting the European Parliament adopt a decision laying down the provisions relating to the system of own resources of the Union. In this context it may establish new categories of own resources or abolish an existing category. That decision shall not enter into force until it is approved by the Member States in accordance with their respective constitutional requirements. The Council, acting by means of regulations in accordance with a special legislative procedure, shall lay down implementing measures for the Union's own resources system in so far as this is provided for in the decision adopted on the basis of the third paragraph. The Council shall act after obtaining the consent of the European Parliament".

Unanimity by definition defends Pareto optimality but implies no move from the status-quo and the de-facto impossibility to make collective choices.

On the contrary, financial integration requires strategic collective choices on the use of such resources. The third pillar of the *Roadmap* is indeed a genuine economic union, where a federal Treasury is in charge of budgetary choices. When collective public choices are required, a democratic legitimation is necessary to guarantee their sustainability and social acceptance; as it is usually recalled: "No taxation without representation". This is the reason why the fourth step of the *Roadmap* is a political union, where Parliaments (in particular the European Parliament) are given genuine power over economic governance, now reduced by the constraining mechanisms of the Fiscal Compact and the other measures of macroeconomic surveillance. As Fasone (2012) sums up:

> "The participation of the EP in the 'management' of the EU economic governance is fundamental for the legitimacy and the effectiveness of the new regulatory framework, which appears to be highly fragmented also in terms of national positions expressed and thus dangerous for the tenure of the European integration process... In this regard, though the contribution of national Parliaments is also very important for the good functioning of the EU (Art. 12 TEU), especially on budgetary policy they are likely to defend national interests at the EU level, thus increasing the already divisive scenario that characterizes the EU at the moment. On the contrary, only the EP can constitute the place where

> national cleavages are willing to be pieced together through an open debate and mitigated in their most extreme manifestations. In other words, by their nature and when diverging points of view arise, both the Governments, individually and summoned in the Council and the European Council, and the national Parliaments are more prone to defend national self-interests to the detriment of the genuine spirit of integration and the achievement of the common European good. In order to make the new economic governance work, solidarity and mutual trust amongst Member States and national citizens are decisive … Therefore a suitable recipe for increasing the democratic legitimacy of the economic governance could be a further empowerment of the EP in this field, while, at the same time, the EP should try to involve also national Parliaments in the perspective of a coordinated enforcement of the new European provisions".

The central bank can support such processes in several ways. The first is to provide liquidity during the transition, as it is doing at present. The second is to put pressure on national governments so that they go on with structural reforms. The third is to lobby the European Council in order to make the constitutional changes that may enable a radical transformation of the EU in a multilayer federal system of coordinated governments (Fitoussi and Creel 2002). The forth point is to legitimate itself through a new strategy of monetary dialogue and communication with the European Parliament (Torres 2013).

5. Concluding remarks

The ECB, although designed for times of growth, when rules may be more effective than discretion in monetary policy, has recently made a huge effort to do "whatever it takes" to counter the crisis. It cannot be accused of having done nothing or not enough to face the crisis hitting the Eurozone in the last few years. The latter is the by-product of inconsistencies in the economic and political structure of governance of the European Union and in particular of the Eurozone.

The weakness of constitutional commitments towards collective responses to the crisis have eased, and resulted in boosted speculation against the sovereign debts of some euro-countries. The European governments have been unable to tackle this weakness with the necessary credibility and political commitments.

Nevertheless, it would be unfair to claim they have done nothing. They have - slowly and ambiguously - tried to build the first steps indicated in the document of the Four Presidents in 2012, starting with the banking union. And, more importantly, they have provided the (more implicit than explicit) political support to the choice of ECB to do *whatever it took* to contrast the crisis.

But structural crises cannot be dealt with through monetary policy alone. All the technicalities concerning the room for manoeuvre of a central bank were explored and attempted by the ECB, up to the quantitative easing of the recent times. Even against the explicit mandate of its original statute.

The question is now manifestly political. The shortcomings of the European economy do not depend on technical questions but on political decisions. A radical change in the structure of economic governance is urgent. The required reforms concern the creation of a multi-layered structure of economic and political institutions to tackle each specific part of the complex architecture of European economic governance, ranging from demand side support to structural reforms, from supranational monetary policy to budgetary policies at both national and EU level. It will only be possible to see if the European economy is still able to grow at a rate compatible with the maintenance of its welfare system once this restructured framework has been completed. And if it fails, then Europe will have to give up important and increasing shares of the welfare system, losing one of its crucial competitive advantages in the world economy.

These latter cases of autonomous parliamentary responses to the risk of an asymmetric distribution of parliamentary powers under the Euro crisis governance are to be preferred to the today more frequent ones of judicial struggle for the protection of parliamentary prerogatives, where sometimes in an attempt to protect democracy Courts might even trigger a worse scenario, whereby it becomes then very difficult to redress and justify imbalances among national parliaments in the EU once created via constitutional case law. When the protection of parliamentary prerogatives in Euro-crisis procedures is achieved through constitutional judgments, such a protection is rooted in more ambiguous bases, like in Germany, where it is grounded on a peculiar and creative interpretation of constitutional clauses by the *Bundesverfassungsgericht* (section 4.1). This Court is actually willing to protect the enforcement of the principle of democracy as such and not the Parliament *per se*. The *Bundestag* is incidentally guaranteed by the Court as long as the Parliament is capable to preserve the right of the people to elect their representatives and to be effectively represented by them. Otherwise, as threaten in the referral for a preliminary ruling, the Bundestag (and the Federal Government) can be sanctioned though a declaration of unconstitutionality by omission, without further specifications of what this implies, of how this would affect parliamentary prerogatives, and of whether the Parliament can be compelled to act based on the Court's instructions whenever it has not taken appropriate action to enforce citizens' rights. This explains why a very active Court not necessarily is the best solution for keeping parliamentary powers "alive".

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