Reforming the European Central Bank

Christophe Blot, Paul Hubert, Fabien Labondance

6

Reforming the European Central Bank

Christophe Blot, Paul Hubert, and Fabien Labondance

1 Introduction

In the early 1990s, the independence of central banks became a pillar of a new model of central banking oriented toward price stability. These changes have been part of a new paradigm stemming from theoretical literature on monetary policy of the mid-1980s (see Chap. 2). This literature has strongly influenced the setup of central banking in the European Monetary Union. The Bundesbank, because of its successes and influence, has established itself as the natural example in terms of credibility and functioning toward which the European Central Bank (ECB) was to

C. Blot (✉)
OFCE, Sciences Po, Paris, France

Université Paris Nanterre, Nanterre, France
e-mail: christophe.blot@sciencespo.fr

P. Hubert
OFCE, Sciences Po, Paris, France

F. Labondance
CRESE Université de Besançon, Besançon, France

J. Creel et al. (eds.), *Report on the State of the European Union*,
https://doi.org/10.1007/978-3-319-98364-6_6

strive. All this has contributed to the Maastricht Treaty promoting this model and giving the ECB the main objective of price stability that has been included in the Treaty on the Functioning of the European Union (TFEU, see Chap. 3). Fiscal issues are certainly at the heart of recent thinking aimed at reforming and strengthening European governance; however, monetary policy and especially the role and tasks of the ECB cannot be completely overlooked.

Indeed, since the subprime and sovereign debt crises, the prerogatives and objectives of the ECB have been enlarged. Thus, the ECB has taken over the objective of financial stability and expanded the range of its instruments by purchasing massively public debt securities, which has increased the interdependencies between monetary and fiscal policies. The ECB is now responsible for the supervision of banks in the framework of the European Banking Union. All these actions have taken place without a change in the treaty. However, defining the objectives of the ECB is a central element of the treaty, which raises the question of potential reform. Similarly, the ECB has been pragmatic and has adapted its operational framework to deal with the crisis. It has thus taken decisions which had not been envisaged during the drafting of the treaty and whose legality was contested. Finally, since 1999, the euro area has grown from 11 to 19 members, which raises the question of the decision-making process. Though changes have already been implemented, there is still a need to make the decision-making process more efficient and transparent. This contribution looks back at these elements of the monetary governance of the euro area and suggests ways of reform that would improve the implementation of monetary policy. Thus, we discuss the issue of expanding the ECB's mandate to financial stability, the need to clarify the border between monetary policy and public finances and the reform of the decision-making process.

2 Broadening the Mandate of the ECB

Enhancing financial stability has been a major challenge in most industrialized countries since the outbreak of the Global financial crisis. Recent evidence over financial crises reminds that they are extremely costly in terms of economic performance (Creel et al. 2015a). It is therefore important that an economic authority tries to prevent instability. Historically, the creation of first central banks has often been motivated by the stabilization of the banking system. The regulatory role, particularly of the banking sector, has long been vested in central banks (Goodhart 2011) and the latter have recaptured it during the crisis.

Before the crises, the Jackson Hole consensus prevailed stating that central banks should primarily promote price stability and take into account financial imbalances only to the extent that they affect inflation expectations (Smets 2014). If the assumption of market efficiency had long been contested, the fact remains that the best contribution of central banks and monetary policy to financial stability should be to guarantee price stability. This idea—formulated by Schwartz (1995)—was based on the belief that price stability and financial stability were linked. A central bank that would ensure price stability would de facto achieve financial stability. But if this link is confirmed especially in times of hyperinflation, the Great Moderation, which corresponds to the period during which inflation remained stable and low in the 1990s and 2000s, and the Great Recession largely question this relationship. Blot et al. (2015) examine this relationship between price stability and financial stability in the United States and the euro area over the period of Great Moderation. They come to the conclusion that Schwartz's hypothesis is not confirmed for the periods analyzed. Since price stability is not a sufficient condition to guarantee financial stability, the question arises about the instruments that can be mobilized to achieve it and the actors in charge of their implementation.

The banking crisis and the sovereign debt crisis have exacerbated the pitfalls of the euro area governance and highlighted the imbalance between centralized monetary policy and decentralized regulatory and fiscal policies. Gradually, and following the jolts of the crisis, the financial supervision architecture of the euro area has been reformed. A first wave of reform has involved setting up new supervisory authorities. In September 2009, the European Commission proposed to modify the pre-existing system by introducing a European System of Financial Supervision. In January 2011, a European Systemic Risk Board (ESRB) and three European Supervisory Authorities (ESA) were established. The latter must coordinate the regulations of the national financial sectors within the European Union (EU). These authorities are the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). However, the principle of subsidiarity remains and regulatory powers remain national. It is only with the deepening of the sovereign debt crisis that member states of the euro zone, confronted with the question of the survival of the euro zone, have gone one step further and created the Banking Union which entered into function on November 4, 2014.

The Banking Union proposes a uniform regulation that applies to the main banking institutions in the EU (Antonin and Touzé 2014). In particular, these regulations lay down rules on own funds or the protection of depositors. The functioning of the Banking Union is based on two mechanisms. The first is a Single Supervisory Mechanism (SSM), which places significant banks (see ECB Regulation 468/2014) of the euro area countries under the supervision of the ECB. In the context of a second mechanism, and in the event of supervision being in default, the Banking Union also sets up a Single Resolution Mechanism (SRM) applicable in the event of a bank failure. Within this framework are created a single resolution fund and the terms of use of this fund and management of bank failures. In particular, the bail-in principle is preferred to external bailouts, particularly by the government (bail-out). Since January 2016, the single resolution fund has been funded by contributions mainly from credit institutions.

The crisis has also shown the need to go beyond micro-prudential supervision and promote a so-called macro-prudential tool dedicated to the analysis of aggregate trends and existing imbalances in the financial system that can create systemic risk. The objective of macro-prudential regulation is to ensure the viability of the economic and financial system as a whole. The macro-prudential tool aims to detect and prevent systemic risk by, for example, varying the capital requirements of banks in order to ensure their solvency when micro-prudential supervision is concerned with ensuring the safety of banks. The micro-prudential policy is now entrusted to the ECB while the ESRB, chaired by the President of the ECB, is in charge of macro-prudential policy. However, the ESRB does not define regulation but may issue warnings and recommendations for the European as a whole and for one or more member states. Concrete decisions are taken by national authorities.

Credit developments are critical to understanding potential occurrences of financial instability that can produce systemic risk (Creel et al. 2015b). Banking regulation, and particularly macro-prudential regulation, cannot be separated from monetary policy, as they both have influences on the supply and demand for credit. Therefore, it seems relevant that the central bank integrates prudential policy into its action (Beau et al. 2012), which was not the case at the origins of the euro zone, banking supervision being the responsibility of the competent national authorities.[1] The result of these various reforms is a complex financial regulatory architecture that intertwines national competences, euro area-specific competences and EU-wide competences. The jurisdiction of the banking regulatory authorities thus extends to the whole of the EU when the single banking supervisory mechanism is limited to the euro area a priori and relies on the competence of the ECB.

Finally, the crisis has also led to questions about the effect of monetary policy on financial stability, through the risk-taking channel emphasized by Borio and Zhu (2012). Consequently, all missions currently carried out by the ECB have an impact on financial stability, although the mandate of the ECB does not explicitly mention it.

One can now consider that, de facto, the ECB has three objectives: price stability, support for activity and financial stability (Blot et al. 2014). However, the articulation of this triple mandate deserves clarifications. Even without changes to existing treaties, it is important that ECB leaders be more explicit in the different objectives pursued and notably whether the stance of monetary policy will be adjusted for financial stability purposes. The priority over price stability no longer seems to correspond to the practice of monetary policy. Achieving maximum employment and financial stability seem as important. More transparency would make monetary policy more credible and certainly more effective at preventing another banking and financial crisis. Besides, it is not clear whether the complex architecture for dealing with financial stability will really help to achieve it. However, as macro-prudential inherently raises distributional issues, the responsibility of decisions may be assumed by elected bodies. Consequently, there is a trade-off between granting decisions regarding financial stability to central banks (to improve efficiency and internalize externalities between monetary policy and financial stability) and keeping financial supervisory and monetary authorities independent.

3 Clarifying the Border Between Monetary Policy and Public Finances

During the crisis, the ECB massively purchases sovereign bonds issued by euro area countries, first to contain the sovereign debt crisis and then to curtail the risk of deflation. The solution implemented by the ECB to the sovereign debt crisis was first to launch the SMP (Securities Market Program) in May 2010 and the OMT (Outright Monetary Transaction) announced in September 2012. However, this was disputed within and outside the ECB, since the case was brought to the Court of Justice of the European Union (CJEU, see also Chap. 3).

The objective of the SMP and OMT was to lower interest rates on sovereign debt through targeted purchases of securities.[2] Beyond a legitimate debate about the effectiveness and potential risks associated with these measures, their legality has been disputed. The SMP was debated within the ECB by Jürgen Stark, then a member of the Executive Board.[3] He considered that the SMP amounted to financing the debt of some member states, violating two provisions of the Treaty: the clause of non-bailout of states within the euro area and the ban on funding of budget deficits by the central bank. By resigning in September 2011, he expressed his deep disagreement with a policy that he felt was erasing the border between monetary policy and fiscal policy. The OMT, the second mechanism implemented by the ECB, was also strongly criticized by the Bundesbank and by German citizens considering that it might lead to a budgetary transfer between European countries. There is therefore implicitly a budget commitment of the German government without the prior consent of the Bundestag. The opinion of the CJEU, delivered in June 2015, validated the legality of the OMT, the Court considering not only that "the purchase of sovereign debt securities constitutes a measure of monetary policy" but also "that the acquisition of sovereign debt does not constitute monetary financing prohibited by the Article 123 of the TFEU". While the signal effect linked to the announcement of the program in 2012 has apparently helped to reduce the credit spreads that have emerged in the euro area (Altavilla et al. 2014), it has placed the ECB in a difficult position creating a legal uncertainty that has or could have limited the implementation of the program and thus its effectiveness.

In addition, if the ECB provides liquidity to banks in euro area countries as part of monetary policy operations, so-called Emergency Liquidity Assistance (ELA) operations continue to be implemented by national central banks with ECB agreement. Thus, despite the extension of the powers of the ECB in banking supervision, the role of lender of last resort remains under the responsibility of states and therefore of their central bank.[4] Whelan (2015) notes, however, that these transactions have so far been of a secret and discretionary nature. He criticizes the role played by the ECB during the Irish and Greek banking crises, which used these liquidity operations to exert political pressure on the states. In June 2015, the ECB refused to extend the ceiling of this liquidity a few days before the referendum organized by the government on a new agreement with European creditors, in a context marked by significant leakage of banking system deposits by fear of a Grexit. If the risk of exit from the euro area was real, the decision of the ECB strengthened it by precipitating the banking system in the crisis and taking the risk of leaving the Greek government no alternative to the issuance of a parallel currency. In the end, the ECB played a key role in lender-of-last-resort operations by allowing liquidity to be granted to Greek banks. But it also used this lever to exert political pressure on the Greek government. It should also be noted that the ECB is part of the troika, alongside the European Commission and the IMF, which is responsible for monitoring the implementation of refinancing agreements with creditors in countries under financial assistance. It entails influencing and monitoring national fiscal policies. This very political role is not part of the ECB's mandate. Central banks are non-elected bodies and cannot play a role for which they are not fully accountable.

What lessons can be drawn from these events? Firstly, it is contradictory that an independent institution which cannot request or accept instructions from another institution, government or other body of the Union is involved in a political process of monitoring budgetary policies of some member countries. In fact, the ECB is creditor of these states since it holds debt securities that they issued. But these securities were acquired as part of monetary policy operations and not as loans granted by the ECB to member states. Secondly, the decision of the CJEU on the OMT also validates the quantitative easing programs implemented by the ECB and thus confirms the independence of the ECB in its assessment of the means (the instruments) that it deploys to achieve its objectives and fulfill its mandate. Thirdly, it is necessary to clarify the role of the ECB as lender of last resort, a function that remains today entrusted to the national central banks. However, as part of the banking union, the ECB collects information that allows it to make a diagnosis on the solvency of banking institutions. From there, it can therefore fully judge the situation of banks and decide to grant liquidity when it considers that the institution is solvent or refer the issue of a possible restructuring or bankruptcy to the Single Resolution Board. This argument argues for this function to come back to the ECB (Goodhart and Schoenmaker 2014).

It should be reminded that the ECB derives its legitimacy from a treaty that aims to isolate its decisions from all political pressures on the pretext that they would have a mainly technical dimension (the setting of the short-term interest rate, terms of the refinancing operations, banking supervision), the objectives of monetary policy being set within a political framework defined by the TFEU ratified by all member states. During the crisis, the ECB played a key role in preserving, if not saving, the monetary union, making up for the shortcomings of fiscal and political governance. But these situations show that the decisions taken by central banks have a strong political dimension, especially in times of crisis. Securities purchase transactions have a direct impact on fiscal policy by their effect on the interest rate on sovereign debt. The decision to support a bank or not also has obviously a budgetary impact. The pressures exerted by the ECB on the governments of countries in crisis have been for political reasons rather than to achieve its objectives. These interactions justify a reflection on governance and the ECB's relations with political power.

We must consider recognizing the interactions by strengthening the debate and the democratic control of the ECB. Today, the only interactions of the ECB with democratic bodies are via the quarterly testimonies of the President of the ECB by the European Parliament. They are not sufficient to give democratic legitimacy to its action. The control cannot be solely that of the judge. It must be political so that the definition of objectives and the implementation of monetary policy can be regularly debated and defined within a representative political body.

The new instruments of monetary policy have significantly increased the interactions between monetary policy, fiscal policy and financial stability and increased interdependencies between those institutions in charge of these objectives. It thus requires greater coordination to avoid negative externalities, at least at the zero lower bound when public debt is partly monetized (Balls et al. 2016). The persistence of a deflationary risk (inflation risk, respectively) despite an expansionary monetary policy (respectively restrictive) calls for an expansionary (respectively restrictive) fiscal policy for the euro area as a whole. However, as long as national fiscal policies are fully decentralized, coordination will remain imperfect, if not impossible. This could be detrimental for growth in the euro area.

4 Reforming the Decision Process

The last issue on which the ECB could evolve concerns the decision-making process in the Governing Council, the main decision-making body of the ECB. Currently, it is composed of the six members of the Executive Board, and of the governors of the national central banks of the 19 countries of the euro zone. They usually meet twice a month to discuss issues related to the tasks and responsibilities of the ECB and the Eurosystem.[5] In order to ensure the separation between monetary policy missions and the other tasks of the ECB (banking supervision and prudential supervision), separate meetings of the Governing Council are organized. The Governing Council assesses economic and monetary developments and now takes its monetary policy decisions every six weeks.[6]

The President of the Council of the EU, the Eurogroup and a member of the European Commission can participate in the meetings, but they do not have the right to vote. Until the beginning of 2015, each member of the Board of Governors had one vote and, unless otherwise stated in the statutes, the decisions of the Board of Governors are taken by a simple majority. In the event of a tie vote, the President has the casting vote. Although the meetings are confidential, the Governing Council communicates the results of its deliberations, particularly those relating to the setting of key interest rates, through a press conference following the meetings on monetary policy decisions.

The accession of Lithuania to the euro area in 2015, bringing to 19 the number of its member states, led to a change in voting rights, as the Governing Council had envisaged in December 2002. The ECB has decided to implement a rotation system which rules the distribution of voting rights among the members of the Governing Council of the ECB. This rotation system is supposed to allow the Governing Council to retain its decision-making capacity despite the increase in the number of countries participating in the euro area. According to the EU Treaties, the rotation system had to be implemented as soon as the number of governors exceeded 18.

In this rotation system, the countries of the euro area are divided into several groups according to the size of their economy and their financial sector. A ranking is established to determine which group each national central bank governor belongs to. The governors of countries ranked from 1 to 5 (currently Germany, France, Italy, Spain and the Netherlands) share four voting rights. The other 14 countries have 11 voting rights. Governors vote in turn on a monthly rotation. At each meeting, 21 votes are cast, the members of the Executive Board of the ECB having a permanent right to vote.

By way of comparison, the Monetary Policy Committee of the Federal Open Market Committee (FOMC) uses a system similar to that of the ECB. The FOMC has 12 voting members, seven are members of the Board of Governors with permanent voting rights. The president of the Federal Reserve Bank of New York votes systematically, the presidents of the Banks of Chicago and Cleveland every other year and the nine presidents of the other regional reserve banks vote one year out of three. Rotation in the United States occurs annually, whereas it is done monthly for the ECB.

A first criticism of the ECB's decision-making process concerns the "national" mode of representation of the Governing Council. Whether before January 1, 2015 with the principle of "one member, one vote", or with the rotation system that has come into force since, 19 of the 25 members are appointed in relation to their national responsibility and ultimately their nationality. Since the ECB's monetary policy is conducted for the euro area as a whole, this characteristic of the composition of the Governing Council raises the question of the relevance of this criterion for determining its composition. If the objective of the ECB is to maintain the stability of the euro area consumer price index, the nationality of the members of the committee should be of little importance.[7] The fear that national concerns may bias votes of national governors—and even of members of the Executive Board—explains why the ECB has been reluctant up to now to release the votes as is done by the Bank of England and the Federal Reserve. Like Buiter (2014), we argue that making all votes public would make the members of the Governing Council more responsible and accountable of their decisions. This composition, regardless of its relevance, raises a second question. The principle of "one central bank, one vote" tends to overweight the weight given to small countries: the governor of the Banque de France who represents more than 65 million people has the same weight as the governor of Malta who represents 400,000. The choice of a national composition thus generates a representativity bias.

The forced resignation of Lorenzo Bini Smaghi, a member of the ECB Executive Board from June 2005 to November 2011, is symptomatic of the importance of the issue of nationality in the Governing Council. He had to resign when Mario Draghi was appointed President of the ECB because three Italians (with the Governor of the Bank of Italy) would have been present on the Board of Governors.

The rotation system does not answer either of the two questions. Small countries are always overrepresented and the composition still depends on nationality. It also raises another remark. With this system, there are now three categories of members on the Board of Governors: the members of the Executive Board who vote at all meetings, the governors of the five major countries that vote at 80% of meetings and those of the 14 small countries that vote in 78% of meetings. This system disadvantages small countries in favor of members of the Executive Board. It is therefore subject to criticism from small countries committed to the principle of equality between the countries of the euro zone and critics of the major countries which, at a meeting out of five, no longer have the right to vote.

A first way to respond to these criticisms is to fix the voting rights in proportion to the capital held by each central bank to the capital of the ECB or in proportion to the population (or GDP) of each country in relation to the population (or GDP) of the euro area. This would answer the question of representativeness. Such a measure, however, would only accentuate criticism of the national composition of the Governing Council. A second track therefore concerns the number of members of this council. There is no obvious reason, if the monetary policy of the ECB is conducted for the euro area as a whole, to have a number of members equal to the number of countries making up the euro area. Thus, the FOMC in the United States does not include 50 members as the number of states, while the Bank of England's monetary policy committee is made up of nine members, regardless of the number of regions in the United Kingdom. This number of members could be set in relation to other criteria (see Sah and Stiglitz (1988) on the optimal size of committees) and regardless of the number of countries in the euro area.

5 Conclusion

This chapter deals with central banking and monetary policy issues in the euro area. We first observe that the powers of the ECB have been enlarged during the crisis. It is now strongly involved in financial stability. These new functions have been devoted to the ECB without any change in the treaty. It remains that it has raised the complexity of the institutional setup for dealing with financial instability. Besides, the ECB should also make clearer by an appropriate communication whether monetary policy will also account for financial stability. The crisis has also made necessary the use of additional for monetary policy, increasing the interactions between monetary and fiscal policy. Consequently, it requires closer coordination between the ECB and institutions in charge of fiscal policy. Finally, there is room to make the decision-making process of the ECB on monetary policy more efficient and transparent. We point to the risk of national bias in the votes of the member of the Governing Council and to the over-representativeness of small countries. A proposition might be to reduce the number of personalities sitting in the decision-making body and to avoid appointing them upon nationality criteria.

Notes

1. See paragraph 6 of Article 127 of the TFEU.
2. In fact, the maximum outstanding amount of Greek, Portuguese, Irish, Spanish and Italian sovereign securities acquired under the SMP reached 219 billion in March 2012. As for the OMT, it has never been mobilized.
3. We should also remember that before Jürgen Stark, Axel Weber, the President of the Bundesbank who opposed the measures adopted in May 2010, also resigned.
4. In concrete terms, this implies that the risks and potential losses on ELA loans are borne by the national central banks, which is not the case for standard liquidity and losses are shared between EU member states.
5. The Eurosystem defines and implements the monetary policy of the euro area. It is composed of the ECB and the national central banks of the countries that have adopted the euro.
6. Prior to 2015, meetings on monetary policy guidance were monthly and from 1999 to November 2001, Governing Council could decide to change the stance of monetary policy twice a month. However, only the first meeting was followed by a press conference. Yet, in practice, most, if not all, changes in monetary policy were made during the first meeting.
7. Hayo and Méon (2013) illustrate the ambiguities of this process and suggest that the governors of national central banks take their decision according to national objectives.

References

Altavilla, Carlo, Domenico Giannone, and Michele Lenza. 2014. *The Financial and Macroeconomic Effects of OMT Announcements*. Centre for Economic Policy Research (CEPR).

Antonin, Céline, and Vincent Touzé. 2014. *Europea bancaire:l'Union fait-elle la force ?* Note OFCE, No. 46.

Balls, Ed, James Howat, and Anna Stansbury. 2016. *Central Bank Independence Revisited: After the Financial Crisis, What Should a Model Central Bank Look Like*. M-RCBG Associate Working Paper Series 67.

Beau, Denis, Laurent Clerc, and Benoit Mojon. 2012. *Macro-prudential Policy and the Conduct of Monetary Policy*. Banque de France Working Paper, No. 390.

Blot, Christophe, Jérôme Creel, Paul Hubert, and Fabien Labondance. 2014. Dealing with the ECB's Triple Mandate? *Revue de l'OFCE-Debates and Policies* 134: 163–173.

Blot, Christophe, Jérôme Creel, Paul Hubert, Fabien Labondance, and Saraceno Francesco. 2015. Assessing the Link Between Price and Financial Stability. *Journal of Financial Stability* 16: 71–88.

Borio, Claudio, and Haibin Zhu. 2012. Capital Regulation, Risk-Taking and Monetary Policy: A Missing Link in the Transmission Mechanism? *Journal of Financial Stability* 8 (4): 236–251.

Buiter, Willem. 2014. Central Banks: Powerful, Political and Unaccountable? *Journal of the British Academy* 2: 269–303.

Creel, Jérôme, Paul Hubert, and Fabien Labondance. 2015a. Financial Stability and Economic Performance. *Economic Modelling* 48: 25–40.

Creel, Jérôme, Paul Hubert, and Fabien Labondance. 2015b. *The Intertwining of Financialisation and Financial Instability*. OFCE Working Paper, No. 14.

Goodhart, Charles A. 2011. The Changing Role of Central Banks. *Financial History Review* 18 (2): 135–154.

Goodhart, Charles, and Dirk Schoenmaker. 2014. *The ECB as Lender of Last Resort?* VOX CEPR's Policy Portal.

Hayo, Bernd, and Pierre-Guillaume Méon. 2013. Behind Closed Doors: Revealing the ECB's Decision Rule. *Journal of International Money and Finance* 37: 135–160.

Sah, Raaj Kumar, and Joseph E. Stiglitz. 1988. Committees, Hierarchies and Polyarchies. *The Economic Journal* 98 (391): 451–470.

Schwartz, Anna J. 1995. Why Financial Stability Despends on Price Stability. *Economic Affairs* 15 (4): 21–25.

Smets, Frank. 2014. Financial Stability and Monetary Policy: How Closely Interlinked? *International Journal of Central Banking* 10 (2): 263–300.

Whelan, Karl. 2015. *The ECB and Financial Assistance Programs: Has ECB Acted Beyond Its Mandate?* Monetary Dialogue, October.