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“The Role of the European Central Bank in the Financial Crash and the Crisis of the Euro-Zone”

Report based on a WEED Expert Meeting

Franziska Richter
Peter Wahl

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Executive Summary

The European Central Bank (ECB) is one of the most important actors in the Financial Crisis and the sovereign debt crisis in the Euro-zone. The way, how the ECB was operating before the crisis was strictly based on the monetarist concept of central banking, reducing central banks to the guardian of consumer price inflation. Inflation of financial asset prices was ignored, not to speak of financial stability, growth and employment. This reflects basic faults in the design of the ECB, in particular its monetarist obsession with consumer price inflation and its completely undemocratic, non-transparent and unaccountable status in the institutional arrangement of the EU.

The report makes a critical assessment of the ECB's role before the financial crisis and identifies it as a player, which contributed with its monetarist approach even to a certain extent to crisis. After the ECB had recognized that there was a crisis, it made a pragmatic Keynesian crisis management, serving as lender of last resort with some biases toward the interests of the financial industry and started indirect government financing. However, at present (April 2011) it is unclear whether this is a signal towards a paradigmatic change. The attitude of the ECB in the European debt crisis points into another direction.

The report also compares the main features of the ECB with the US Federal Reserve Bank, the Bank of Japan and the Bank of England. The conclusion is, that the ECB represents more than its homologues a pure monetarist approach to central banking.

Several proposals for reform are discussed such as a role for central banking in combating asset price inflation and macro-prudential regulation, control of credit expansion at macro level, mitigating exchange rate volatility and government funding. Also more transparency and democratic accountability are

While there was a consensus, that the proposals all reflect desirable goals, it was controversial whether a broadening of the mandate and competences of the ECB would not give too much power to this institution and that many of desirable tasks in financial governance could not be better done through other institutions and instruments.

The crisis and the debate on reforms present a window of opportunity to push for alternative visions of the central banking in Europe.

1. Introduction

The European Central Bank (ECB) is one of the most important actors in the financial crisis and the sovereign debt crisis in the Euro-zone.

However, there is almost no attention of civil society – NGOs, trade unions, social movements - for this key player. It is the purpose of this report to trigger more interest for what the ECB is doing, because its behaviour and its decisions are not only affecting heavily the financial sector but the entire economy and hence wages, social systems and in the end the every day life of all citizens.

The way, how the ECB was operating before the crisis was strictly based on the monetarist concept of central banking, reducing central banks to the guardian of consumer price inflation. Already the inflation of financial asset prices was ignored, not speak of systemic financial stability, growth and employment.

It is therefore not surprising that the ECB did not see the crisis coming. In early July 2008, when the US subprime crisis was already ravaging and some European banks such as the German IKB had collapsed, the ECB decided an increase of the interest rate to the historic high of 4,25%. An extraordinary case of blindness of such an institution vis à vis the reality.

After the Lehmann collapse the ECB made however a surprising turn. It played the role of a lender of last resort to the banks in trouble, although being very generous and allowing a lot of windfall profits. The ECB also broke with some of its own rules by giving – indirectly - money to governments under stress through the purchase of government bonds at the secondary market.

There are some basic faults in the design of the ECB. The most important are:

- its monetarist obsession with consumer price inflation and
- its completely undemocratic, non-transparent and unaccountable status in the institutional arrangement of the EU.

Of course, inflation is an issue to be taken serious, but reducing the role of central banking to the one and only function of inflation targeting reflects a dogmatic point of view, which with the financial crisis has definitively proven to be flawed.

The financial crisis has been transformed into a sovereign debt crisis, which is threatening not only Greece, Portugal and Ireland. The future of the Euro as the common currency of 17 European countries is at stake, and hence the future of the central bank for this currency. The traditional receipts of structural adjustment with painful austerity programs for the ordinary people don't' work, as the case of Greece demonstrates. In spite of dramatic reductions in public spending with highly negative consequences for future growth perspectives, the debt burden is increasing. The crisis is far from being over. New and innovative ways out of the crisis have to be found. This means also, that the ECB cannot continue with business as usual. Substantial changes are required, otherwise the collapse of the Euro-zone will be inevitable.

This report is trying to put the future role of the ECB as part of an overall alternative to the present crisis management on the agenda of civil society. Of course, it cannot discuss exhaustively all the issue of central banking. Its main purpose is to draw attention of civil society, that without changes in central banking it will not be possible to establish a fairer, more stable, sustainable and equitable economic order in the EU.

The report is based on the European Expert Meeting "*The role of the European Central Bank in the Financial Crash and the Crisis of the Euro-Zone*" which took place in Berlin on April 12th 2011, organised by WEED.

The main speakers were: Marica Frangakis, Poulantzas Institute, Athens, Dominique Plihon, University of Paris, Mario Tonveronachi, University of Siena, Lucas Zeise, Financial Times Germany. The report draws very much on their inputs. Errors in this report are, however, at the sole responsibility of the authors of the report.

Also more than 20 German and international participants contributed to the discussion with their expertise coming from universities, trade unions, research institutes, civil society organisations, political foundations, parties and parliaments.

The paper summarises the discussions of this meeting. While opinions differed on some issues – see in particular chapter 7 - all participants agreed upon the fact that the ECB'S mandate, tasks and instruments as well as its role in the new financial architecture need to be substantially reformed.

2. Some basics on central banking

A central bank is a public institution that manages the monetary policy of a country or – in the case of the Euro-zone - a group of countries. This usually includes

- the mandate to regulate money supply,
- to control the interest rate and
- to manage foreign exchange reserves or exchange rates.

In most cases central banks (but not the ECB) also have **supervisory functions** over the banking sector (i.e. commercial banks) or control of credit supply.

In times of financial crises, central banks have an extremely important role as **lender-of-last-resort**. This means that they take exceptional measures to insert liquidity into the banking sector in order to avoid a credit crunch and a collapse of the finance system. This function is often described metaphorically as *financial fire-brigade*.

They may also act as the Government's banker by **lending to government**.

Depending on their specific mandates, central banks may pursue a number of general goals. Since the monetarist theory has become dominant (see chapter 2), the most prominent goal is to maintain **price stability** of consumer prices, which usually means keeping a steady, low rate of inflation. This function has become a kind of mantra, which – until today – is broadly hegemonial in most industrial countries, whereas the inflation of financial asset prices, i.e. the bubbles at the financial markets, are ignored both by monetarist theory and the policies of central banks.

With regard to their formal or official mandate central banks have – with the exception of the ECB – had or still have additional goals, such as **supporting economic growth, creating jobs**, maintaining **stable exchange rates** and ensuring the **stability** of the financial system.

3. Historical changes in central banking[1]

The dominant perception of central banking as key instrument to combat inflation appears today to many people as quasi natural. But as a matter of fact, Central banking is historically embedded and has undergone several phases and considerable con-

[1] Chapter 3 and 4 of this report draw on Marica Frangakis' presentation on the WEED ECB expert meeting, "*The role of the European Central Bank in the Financial Crash and the Crisis of the Euro-Zone"*. The full paper is available on the WEED homepage.

ceptual changes. In each of these phases, the understanding of the role of central banks has differed significantly. In the post-World-War II period, the scope of central banking was very broad and included policy advice and the management of the entire financial system.

After the *Bretton Woods* system had collapsed in 1972, a new and quite different phase of central banking started, which was heavily influenced by the theory of *Monetarism*. This theory, which can be considered to be the "theoretical backbone of neoliberalism" has been popularised by Milton Friedman.[2] It defines money supply as the single most important factor in the governance of the economy. A stable quantity of money circulating in an economy is, according to the theory, decisive for economic growth. Consequently, the primary goal for central banks should be to combat inflation. Until the crisis, most central banks have adopted more or less monetarism as theoretical fundament and have aligned their policies accordingly.

In the new era, central banks were assigned a very limited role: maintaining consumer price stability. At the same time, **independence** from governments was considered crucial for the functioning of central banks. The concept of independence is strongly embedded into neoliberal theory in general and into the theory of political business cycle in particular. The latter states that politicians mainly pursue their own interest of being re-elected. Thus, they tend to orient their fiscal and economic policies toward elections. While they might be willing to cut spending at the beginning

The ECB – at a glance[1]

Establishment: 1 June 1998

Legal Basis: Statute of the European System of Central Banks and of the European Central Bank

Responsibility: Monetary policy in the euro area (all EU countries that have adopted the Euro)

Location: Frankfurt am Main, Germany

Mandate: Maintaining price stability

of their term, they will spend more than reasonable before elections. In order to limit inflationary pressures from government spending, the central bank should not be an instrument of government, but rather create a counterbalance. This is, according to the monetarist concept, only possible if the central bank is completely independent from the government.

4. Institutional design and tasks of the ECB

Many central banks around the world have been shaped according to the monetarist theory in the 1980s and 90s. However, the design of the European Central Bank (ECB) follows more than any other central bank the monetarist concept.

[2] US economist. 1912-2006. Nobel price for economy in 1976. Probably the most influential economist of the 20th century after Keynes.

The was established in 1998 to replace the national currencies in the nascent Euro-zone and to govern the common monetary policy for the countries in the currency union. While national central banks still exist, their most important role – conducting monetary policy – has been transferred to the ECB. The latter is also heading the European System of Central Banks" (ESCB), the institutional framework of all central banks within the Euro-zone[3]. The ECB has been designed after the model of the German central bank, the *Bundesbank*. Through the ECB Germany managed to impose its very strict monetarist position to the other members of the Euro-zone.

4.1. Official Mandate of the ECB

The objective of the ECB and the ECBS is defined as follows:

> *"…the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2 of this Treaty. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources and in compliance with the principles set out in Article 4 of this Treaty"*[4]

While other economic objectives are mentioned in the statute, they are clearly subordinated to the maintenance of price stability. The role of ensuring financial stability is not mentioned in the statute. The ECB has therefore been referred to as the "ultimate narrow central bank"[5]. The monetarist concept has been further enshrined into the statute through the explicit reference to "open market economy", "free competition" and "efficiency" within ECBS statute.

Behind this background one can argue, that the pre-crisis policies of the ECB have a certain co-responsibility for the crash.

4.2. Independence

The principle of independence is not only constituted in the Statute of the ECBS, but even in the European Union treaty of 1992 (Maastricht treaty). Article 107 states:

> *"…, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body".*

Several arrangements guarantee this independence: The ECB is financially separated from the European Union and has its own budget through the national central banks. Despite being nominated by the European Finance Ministers and elected by the European Council, the members of the Governing Council are quite independent. They are elected for a relatively long term of eight years and cannot be reappointed. Most importantly, the ECBS is prohibited from giving loans to any public authority within the European Union, be it national, regional or local (art. 124.1 of the Treaty and art 21.1 of the Statute). This is an important difference compared to the central banks of other big OECD countries, such as the US, Japan and the UK.

As the ECB is the central bank of 17 EU member states the issue of independence has an additional dimension: the sheer number of countries and the considerable heterogeneity in terms of economic development and interests and political diversity makes the independence of the ECB even stronger. Of course there are some informal channels of influence, in particular through the leading personal, but even they

[3] http://www.ecb.int/ecb/10ann/html/index.en.html
4 Statute of the European System of Central Banks and of the European Central Bank. article 2.
[5] G. Schinasi 2005, Safeguarding Financial Stability. International Monetary Fund

have less impact, as if there would be one governmental counterpart to the central bank.

The ECB has used this independence to define on its own quantitatively the inflation target. They have taken 2% nominal inflation in the Euro-zone as a threshold. Is inflation going beyond this limit, the ECB will intervene, i.e. raise interest rates. There is no legal basis for the ECB to define the limit of 2%. It could also be 2,5% or 3% or 1,5%. The ECB has bluntly usurped the definition power over what is inflation and what not.

Another problem linked to the 2% target, is its “one size fits all format”. Whereas inflation might be different in different countries of the Euro-zone, the 2% target does not take this into consideration. The result is that what be might make sense for one or several countries, might be detrimental to others. Thus, the inflation policy can contribute to the deepening of the heterogeneity in the Euro-zone.

4.3. Tasks

The tasks of the ECB are specified in article 127.2 of the Treaty and article 3 of the ECB Statute. They are

- to define and implement the monetary policy of the Union;
- to conduct foreign-exchange operations consistent with the provisions of Article 219 (Article 219 specifies that exchange rate policy remains within the authority of the Council, which may alter exchange rates and decide on the general orientation of exchange-rate policies after consulting with the ECB);
- to hold and manage the official foreign reserves of the Member States;
- to promote the smooth operation of payment systems.
- to authorise the issue of the euro banknotes (Article 128.1)

Not only the mandate, but also the tasks assigned to the ECB limit its activities almost exclusively to monetary policy.

4.4. Accountability

There are relatively few provisions concerning the accountability and transparency of the ECB. Its relation to the European Parliament (EP), the only body of the EU being directly elected, is very limited. The ECB has to submit annual reports to the EP and its representatives participate in the EP’s committees at the request of its members or on its own initiative (Article 284.3 of the Treaty and Article 15.3 of the Statute). As the European Parliament has, compared to full fledged parliaments as in the US or the UK, a very weak position in the institutional arrangement of the EU, the ECB is even more independent from democratically legitimized bodies then its homologues in the OECD.

5. ECB, FED, Bank of Japan, Bank of England in comparison

As stated before, central banking is historically embedded. Different eras have had different conceptions of central banking and monetary policy worldwide. Still, important differences can be observed when comparing the central banks of the major economies. For the purpose of this report, the ECB will be compared to the **Federal**

Reserve of the United States of America (Fed), the **Bank of Japan** and the **Bank of England**. The aspects compared are the mandate, independence and accountability.

5.1. Mandate

Compared to the ECB, all three central banks have broader mandates.

The Fed has the most encompassing mandate as specified in the Federal Reserve Act: It

> "*shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates*."[6]

Here, price stability is just one goal among others; full employment and growth are equally important.

The Bank of Japan has a narrower mandate; still, it is broader than that of the ECB. The Bank of Japan Act defines its goals as follows:

> "*Currency and monetary control by the Bank of Japan shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy*[7]

While (consumer-)price stability is clearly the primary goal, the mandate allows for additional activities at the service of sound development of the national economy.

The Bank of England, which is the central bank of the UK, had the primary mandate to ensure monetary stability before the crisis. This is specified in the Bank of England Act (1998, Article 11):

> *"In relation to monetary policy, the objectives of the Bank of England shall be – (a) to maintain price stability, and (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment.*

Like in Japan and in the Euro-zone, price stability was the primary goal in the UK, too. However, the secondary objectives – growth and unemployment - are clearly defined. Moreover, as a lesson from the financial crisis, the goal of financial stability was assigned to the Bank of England in 2009. This objective is at equal level with the goal of monetary stability. The amendment (Art. 2A) states that "

> *(1) An objective of the Bank shall be to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom (the "Financial Stability Objective").(2) In pursuing the Financial Stability Objective the Bank shall aim to work with other relevant bodies (including the Treasury and the Financial Services Authority).*

5.2. Independence

For all three central banks examined, independence is high. Nevertheless, the comparison reveals that the ECB has the strictest provisions, especially regarding loans to governments.

The members of the Fed's Board of Governors are nominated by the President and have to be confirmed by the Senate. In order to ensure personal independence, terms are very long (14 years) and members cannot be reappointed (Federal Reserve Act, Article 10). The Fed does not receive any direct funding from government. Its income comes primarily from the interest on government securities that are purchased through open market operation[8]. The provisions for independence are thus

6 Federal Reserve Act. Section 2a. Monetary Policy Objectives. http://www.federalreserve.gov/aboutthefed/section2a.htm
[7] Bank of Japan Act, § The Principle of Currency and Monetary Control 2 http://www.boj.or.jp/en/about/boj_law/bojlaw1.htm/
[8] http://www.federalreserve.gov/faqs/about_12799.htm

very similar to those in Europe. However, a striking difference is that the Fed is allowed to acquire and hold government bonds (Article 14).

Independence of the Bank of Japan was achieved in 1998, when the provision of oversight by the Finance Ministry was dropped from the Bank of Japan Act. Members[9]. However, Article 4 of the Bank of Japan Act establishes a relatively close relationship with the government:

> *“The Bank of Japan shall, taking into account the fact that currency and monetary control is a component of overall economic policy, always maintain close contact with the government and exchange views sufficiently, so that its currency and monetary control and the basic stance of the government's economic policy shall be mutually compatible.”*

What is more, the Bank of Japan is allowed to give loans to the national government (Article 34). The governor and the deputy governors are elected by the Cabinet; both the House of Representatives and the House of Councillors have to give their consent. A term lasts 5 years; however, Governors and Deputy Governors may be reappointed.

Overview ECB, FED, Bank Of Japan, Bank of England in comparison

	ECB	***Federal Reserve***	***Bank of Japan***	***Bank of England***
Mandate	Price stability	Price stability growth, employment,	Price stability (primary) sound development (secondary)	Monetary Stability, Financial Stability
Independence	Executive Board nominated by EU Finance Ministers and elected European Council 8 year term No reappointment No loans to governments Independent since its creation 1998	Board of Governors nominated by President, confirmed by Senate 14-year-term No reappointment Acquiring and holding bonds allowed	Governors elected by Cabinet; both Houses t have to give consent 5-year-term Reappointment allowed Loans to national government allowed Independent since 1998 (but close relationship to government prescribed in BoJ Act)	Appointed by the Crown 5-year term One reappointment allowed Lending to government allowed Independent since 1998
Accountability	annual reports to EP participate in the EP’s committees at the request of its members or on its own inititative	Annual report to Congress Semi-annual hearings before Congress Annual hearings at House of Representatives Can be requested to additional hearings at any time	Semi-annual reports to the Diet Shall attend hearings when requested by one of the two chambers.	Annual report to Parliament Regular hearings at the House of Commons New Members have to present themselves before House of Commons

[9] Kevenhörster et al 2010, Wirtschaft – Gesellschaft – Politik. VSA-Verlag für Sozialwissenschaften.

In 1998, the Bank of England Act (Part II Section 4.I) was amended to exclude monetary policy from the oversight and influence of the Treasury[10]. However, the Bank of England is allowed to engage in government lending. Governors, Deputy Governors are appointed by the Crown for a relatively short period of five years and may be re-appointed once (Schedule 1).

5.3. Accountability

Compared to the Fed's transparency and accountability requirements, the ECB is relatively unaccountable. The Bank of Japan and the Bank of England have similarly lax requirements.

In the US, however, the Chairman of the FED has to *"appear before the Congress at semi-annual hearings,"* and *„before the Committee on Banking and Financial Services of the House of Representatives on or about February 20 of even numbered calendar years and on or about July 20 of odd numbered calendar years"* as well as *„before the Committee on Banking, Housing, and Urban Affairs of the Senate"* (Statutes of the Fed, Section 2B). In addition, the Fed can be called for congressional hearings on request at any time. Its reports have to deal with *"monetary policy and economic developments and prospects for the future, taking into account past and prospective developments in employment, unemployment, production, investment, real income, productivity, exchange rates, international trade and payments, and prices."* (ibid.)

In contrast to the FED, the Bank of Japan and the Bank of England have accountability requirements that are quite similar to the ECB.

The Bank of Japan has to submit reports twice a year to the Diet, the Japanese House of Representatives (Bank of Japan Act, Article 54.1). This report is to be presented by a Bank's representative in front of the Diet (Article 54.2). In addition, *"the Bank of Japan's Governor or the chairperson of the Policy Board, or a representative designated by them, shall attend the sessions of the House of Representatives, the House of Councillors, or their Committees when requested by them, in order to explain the state of the Bank's business operations and property."* (Article 54.3)

The Bank of England has to publish an annual report that is presented to the Parliament before becoming publicly available (Bank of England Act 1998, Article 4). The Bank is accountable before the House of Commons Treasury Committee through regular hearings, where the Bank's representatives give evidence on the Inflation Report. Newly appointed members of the Monetary Policy Committee have to present themselves at the House of Commons Treasury Committee and proof that they meet the requirements for independent central bankers[11].

5.4. A paradigmatic change is needed

The ECB has been subject to substantial criticism since its creation in 1998. Its too narrow focus on price stability and its monetarist bias are one point of critique. After all, monetarism is only one economic theory among others. The financial crisis has shown, that its theoretical assumptions are flawed. This is not a statement of the political left, but an insight which has now reached the economic mainstream. For instance, IMF director Strauss-Kahn realized, that the crisis "*devastated the intellectual*

[10] Bank of England 2011, Bank of England Legislation, the Charters of the Bank and related documents http://www.bankofengland.co.uk/about/legislation/legis.htm

[11] Bank of England 2011: The Bank's relationship to the Parliament. http://www.bankofengland.co.uk/about/parliament/index.htm

foundations of the global economic order of the last quarter century" a theory which "*had a number of basic mantras. Simple rules for monetary and fiscal policy would guarantee stability. Deregulation and privatization would unleash growth and prosperity. Financial markets would channel resources to the most productive areas and police themselves effectively.*"[12]

As for the central mantra of monetarism, that central banking has to concentrate on consumer price inflation, the chief economist of the IMF, Blanchard recently wrote: *"that the behavior of inflation is much more complex than is assumed in our simple models and that we understand the relationship between activity and inflation quite poorly, especially at low rates of inflation."* [13] From there he concludes that inflation targeting should be more flexible and a 2% rate might be too low.

Nevertheless, the theoretical concepts of monetarism are the fundament of the ECB statute and are even anchored in the Maastricht Treaty, which a kind of constitution of the EU and the Euro-zone. Thus, these concepts have been enormously privileged over alternative concepts of monetary policy and central banking. Monetary policy and the role of the ECB can neither be subject to democratic debate nor be adjusted to the progress in economic theory. Even the Bundesbank, which served as blueprint for the ECB, did not have such an irrevocable bias toward one single economic theory.

6. Pragmatic Keynesianism – the ECB in the crisis

The ECB did not understand the dimension and depth of the crisis until summer 2008. In fact, it even increased the target rate from 4.0 to 4.25 % in July 2008, strictly following the principle of inflation targeting. It was only after the collapse of Lehman Bros that the ECB had understood, that there was an exceptional crisis and started to change its policies, gradually decreasing the interest rate until it reached a historic low of 1% in May 2009.

In order to insert liquidity into the system, the ECB started its so called *Enhanced Credit Programme*. Among other measures, this included encompassing purchases of bonds, eased lending requirements, relaxed criteria for collateral, and lengthened maturities of refinancing operations. The ECB thus acted as a lender of last resort. It did so in an indiscriminate way, by giving liquidity to all banks, and sometimes against very questionable collateral, such as asset backed securities.

All this was a fundamental break with the basic philosophy of the ECB, which was built on the assumption that financial markets were efficient and could regulate themselves. The ECB had to learn, that central banking should be more than just combating consumer price inflation.

Originally, the exceptional measures were intended to be phased out soon. However, in the light of the unfolding sovereign debt crisis in Europe, the ECB decided to further deviate from its principle of not lending to any authority. The Securities Market Programme was initiated with the intent to indirectly lend money to governments through buying sovereign bonds on the secondary market. This trick allowed to maintain the fiction that the ECB would not fund governments, but in practice it did.

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[12] Speech by Oliver Strauss-Kahn, at the George Washington University, Washington D.C. April4, 2011 http://www.imf.org/external/np/speeches/2011/040411.htm

[13] Blanchard, Olivier/Dell'Ariccia, Giovanni, Mauro, Paolo (2010): Rethinking Macroeconomic Policy. IMF staff paper. Washington. http://www.imf.org/external/pubs/ft/spn/2010/spn1003.pdf

By the end of 2010, the ECB had spent about 13 billion Euros on this endeavour, acting as the Government's banker against its original principles.

Apart from their initial blindness for the depth of the crisis, the ECB has acted quite pragmatically in the crisis. Neglecting its own rules, the central bankers deviated significantly from their strictly monetarist principles and converted de facto to Keynesianism in order to stabilise the system. The ECB thus contributed to prevent a collapse of the banking system as well as to curb the deflationary spiral in the US and the EU.

The Eurosystem's Covered Bond Purchase Programme[14]

The CBBP was announced in May 200ß and aimed and stimulating the euro area covered bond market.

Duration: 12 month, July 2009-June 2010

Type of purchases: 422 different bonds

Place of purchases: 27% on primary market, 73 % onsecondary market

Total amount of purchases: € 60 billion

However, by indiscriminately pumping liquidity into the banking system, the ECB caused a strong moral hazard problem, especially since almost any form of collateral was accepted. Furthermore – and consistently with their usual monetarist principles – the ECB strongly favoured the private sector. While it acted fully as a lender of last resort to the private banking sector, it provided funds to governments in a much more cautious and complicated way. In comparison, the FED and the Bank of Japan bought governments to a much higher extent, and they did it on the primary market.

7. The ECB in a new financial architecture

What should be the role of the ECB in a new financial architecture? There are several aspects to be discussed: first and foremost, should the ECB's mandate be enlarged to include macroeconomic stability? Second, should regulation allow for more discretion in case of extraordinary situations and crises? Or, on the contrary, should there be clearer rules for central bankers to follow in order to avoid arbitrariness? Beyond, there are other proposals to reform the ECB that address its independence and accountability, the control of credit expansion as well as a more differentiated approach to managing financial diversity in Europe.

7.1. Enlarging the mandate to include macroeconomic stability?[15]

Micro- and macro-prudential regulation

The financial crisis has revealed the overreliance on micro-prudential regulation with a harmful neglect of macroeconomic stability. Micro-prudential regulation refers to the oversight and stability of individual entities within the financial system, such as individual banks and other financial institutions. It consists of rules how these institutions and their employees should operate, such as minimal capital requirements for banks.

[14] http://www.ecb.int/pub/pdf/other/monthlyreporteurosystemcoveredbondpurchaseprogramme201007en.pdf

[15] Chapter 7.1. is mostly based on contributions to the expert meeting made by Dominique Plihon ("Is there a case for macro-prudential functions of the ECB?) and by Mario Tonveronachi ("The ECB in a new financial architecture) as well as on Plihon et al 2010, Central Banks and Financial Stability, Analyses Economiques vol. XI-01 http://www.cae.gouv.fr/IMG/pdf/CAE96_Resume_EN.pdf

The strong reliance on micro-prudential regulation in the pre-crisis era was based on the belief that stability within each financial entity would result in stability of the system of a whole, since it is composed of the single actors. However, this view is flawed, since it ignores that "*risk of a financial system is more than an aggregation of risks in individual institutions; it is also about endogenous risks that arise as a result of the collective behaviour of institutions*"[16]

The lack of macro-prudential supervision has generally been accepted in the midst of the crisis. Consequently, the de Larosière report, a report by the High Level Group on Financial Supervision in the EU of 2009, suggested the establishment of the European Systemic Risk Board (ESRB). The secretariat of this independent EU body is ensured by the ECB[17]. However, the ESRB has no binding powers.

The case for macro-prudential regulation within the ECB

In a study for the French minister of finance a group of both orthodox and heterodox economists,[18] argues that the ESRB is not enough to fully ensure financial stability and macro-prudential regulation. Therefore, the ECB should be endowed with a wide range of macro-prudential instruments. The principle of separation between monetary policy and financial stability policy should be abandoned, since the links between the two are more complex than usually thought. This approach derives from the paradox of credibility proclaimed by Claudio Borio (Bank of International Settlements). According to him, central banks' efforts to gain credibility by ensuring monetary stability may paradoxically lead to financial instability. Trusting in the central banks' capacity to maintain monetary stability, financial actors are encouraged to take more and more excessive risk. This has been the case during the phase of the so-called *Great Moderation* in the 2000s, which was characterised by non-inflationary growth. It led to an underestimation of risk both by economic actors and by the ECB, thus triggering excessive risk taking.

If the paradox of credibility holds true, monetary stability does not guarantee financial stability. However, the two goals are interrelated. This is why the ECB should pay equal attention to both goals, and it should be able to use more instruments than the adjustment of interest rates alone. A wide range of macro-prudential instruments is required for the ECB to address both goals at the same time[19].

Macro-prudential instruments

Several instruments and measures are being proposed for macroeconomic supervision by the ECB. These measures should aim at preventing pro-cyclical behaviour and excessive risk-taking. This could include

- <u>Dynamic provisioning</u> as used by the Bank of Spain. Additional provisions were charged on top of general and specific provisions. In periods of expansion, they reflect the general underestimation of credit default risk. Thus, they have a counter-cyclical effect. [20]
- <u>Loan to value ratios</u> that limit leveraging effects.
- <u>A system of progressive reserves on bank loans based on a sectoral basis and on the supervision of individual banks.</u> A sector-based reserve require-

[16] WorldBank 2009: Macroprudential Regulation. Crisis Response Note no. 6. http://rru.worldbank.org/documents/CrisisResponse/Note6.pdf
[17] http://www.esrb.europa.eu/home/html/index.en.html
[18] Among them the speaker at the WED expert meeting, Prof. Dominique Plihon.

[20] To read more about dynamic provisioning see http://rru.worldbank.org/documents/CrisisResponse/Note7.pdf

ment could channel funds to particular sectors considered to be important for economic development (for example renewable energies). Adjusting reserve requirements to the supervision of individual banks would make them more adequate to the banks' situation.

- Similarly to the last point, reserve requirements could be adjusted to individual Member States' situations. Thus, the growing financial diversity in Europe could be managed more adequately than with the current approach of "one-size-fits-all". This would be a substantial deviation from the neoliberal principle of "level playing field" in Europe.
- More cooperation of Central Banks with other supervisory authorities: A common information network for Central Banks and other supervisors should be established. The Dodd-Frank-Act provides a good example. This act also established an independent agency for financial consumer protection, which should be imitated in Europe.

7.2. A too broad mandate for the ECB?

While the argument of enhancing the ECB's mandate is very conducive, two things are being neglected: Firstly, the recent reforms did indeed already give some macro-prudential competences to the Central Banks, since they are the main stakeholders in the *ESRB*. The ECB and especially the national Central Banks are highly overrepresented in comparison to other bodies, such as the European Commission, the *European Banking Authority*, or the *European Securities*[21]. In comparison, the US *Financial Stability Oversight Council*, which has been established by the *Dodd-Frank Act*, is dominated by the Treasury, i.e. by politics.

Second, and more important, defining macro-prudential regulation as an additional task of the ECB might give too much power to this institution. After all, the ECB is not a democratic institution, and the neoliberal mindset of many central bankers has not changed. It might therefore be counterproductive to claim for more power for an institution that many heterodox economists and civil society do not have any trust in.

This criticism is also relevant for other proposals presented in this chapter, since they would assign the ECB with additional tasks that go beyond their current mandate. This could include control of credit expansion in the economy and a tighter control of exchange rates. As long as the ECB does not undergo serious reforms to be more democratic and more accountable, this problem will always be prevalent. Especially the principle of independence has to be redefined: The ECB should not be independent from democratic control, but rather from the financial sector's one-sided lobbyism. This does not mean, that it should be obliged to respond to each demand of a government. There could be mechanisms, which on the one hand increase democratic control and on the other hand prevent intervention of governments for purely electoral reasons.

7.3. More or less discretion for Central Bankers?

A further point of debate is whether or not Central Banks should have more discretion, especially in exceptional situations and crises. Allowing for more discretion would be a breach with the neoliberal paradigm that governed central banking in the last decade. By anchoring price stability as the primary goal in the ECB status, the possibility for alternatives in the policy of the ECB has been practically eliminated.

[21] More about the structure of the ESRB: http://www.esrb.europa.eu/about/orga/board/html/index.en.html

Therefore, the hierarchy of goals and instruments can only be democratically decided upon if legislation allows for more discretion[22]. Moreover, discretion would allow for more flexible and pragmatic reactions in cases of financial turmoil. On the other hand, more discretion would also mean more power for central bankers. They might use it in a pragmatic and sensible way to manage crises – but they might also pursue the wrong policies and could not be hindered to do so. Only clear rules could constrain central bankers' power.

7.4. Further proposals

There are further proposals to reform the ECB and its targets that are under debate. They all go into the direction of tighter regulation. Some of them are quite far reaching and raise questions about undesirable side effects, technical feasibility and whether the ECB is the appropriate player. Nevertheless, they deserve attention and civil society should discuss them.

Control of credit expansion?

Within the current financial and monetary architecture, the ECB does not control credit expansion at all. Credit expansion is only (vaguely) limited by capital requirements as defined in the Basle agreements. However, these rules only limit the issuance of credit at the micro-level, they to not set a limit for the aggregated amount of credit. Central banks provide as much liquidity as commercial banks require as long as the latter provide sufficient securities. Thus, credit can expand without any limits.

This has not always been the case. Before the ECB was founded national central banks at least kept an eye on credit expansion; more importantly, capital flows were much more restricted. In order to regain control over credit expansion, and thus hold the financial sector stable, the ECB could be assigned the task to control the overall amount of credit expansion.

Combating inflation of asset prices and bubbles

The orthodox approach regarding central banks' role in relation to asset bubbles was that they should "mop up afterwards" (meaning the injection of massive liquidity) instead of targeting bubbles when they emerge. However, this view seems to get less support after the crisis. A recent study by Otmar Issing,[23] published by the IMF, suggests that central banks should use their instruments to counter rising asset prices. This study clearly states that central banks do have the instruments to prick bubbles when they emerge, thus contributing to financial stability.[24]

Funding government budget

The debt crisis in Europe in general and the risk of sovereign default clearly shows, that the dependence of government finance from financial markets is a basic problem of design for contemporary societies. Financialisation in the last three decades has led to a tremendous influence of financial markets over nation states, producing a qualitative shift in the relationship between democratic politics and finance. As a result, governments have become increasingly dependent from the mercy of the markets. However, as markets have totally failed in the financial crisis, and as they nei-

[22] Trevor Evans' contribution on the expert meeting
[23] Issing is former director of the Bundesbank
[24] http://www.imf.org/external/pubs/ft/wp/2011/wp1197.pdf

ther are efficient nor can they regulate themselves, it is time to reverse the balance of power between financial markets and nation states.

To reach this goal, a multiple set of instruments can be used, such as taxation of capital flows, capital controls, regulation of credit rating agencies, ban of dangerous instruments and shadow finance and others. One important element in such a toolbox would be to increase the possibility of financing government expenditure through the ECB. This is not a revolutionary proposal. In the US, Japan, the UK and many other countries the central bank has since a long time a role to play in financing the public budget. By purchasing Greek and Portuguese bonds from the secondary markets, the ECB made a step in the same direction. What has been declared as an exception in times of crisis should be considered to become a normal policy.

Of course there are risks, but a discussion under which conditions the ECB should give loans to public entities is necessary.

Tighter control of exchange rates

The exchange rate is a strategic price, which has a tremendous impact on the entire economy. The volatility of exchange rates has increased considerably in the last decades. Volatility is the nutrient medium for speculation. Speculators need volatility like the fish needs the water. But at the same time volatility makes a steady development of real economy more difficult. This is why there is a case for the stabilisation of exchange rates. There are many ways to reach this goal. As an intermediate step, corridors for exchange rate variations could be defined and central banks could be required to intervene, if the rates cross the limits of the corridor.

But here again the question is, whether the central bank is the best placed to achieve a stabilisation of exchange rates. Other tools, such as the two-tier currency transaction tax as proposed by Spahn already in the nineties might be better suited to reach this goal.[25]

8. Conclusion

During the crisis, the ECB started to deviate from its strict monetarist ideology. But does this mean that we are at the beginning of a true and lasting policy shift? After all, the basic concepts are still in place and the recent policies and comments of the ECB in the sovereign debt crisis in the Euro-zone are very much the old monetarist style, which has not drawn the lessons from the crisis. But the crisis in the Euro-zone will continue. In such a dynamic historic conjuncture forecasts are particularly risky.

But there are signs of change. Even mainstream economists, such as the former central bankers Goodhart and Lamfalussy, argue that central banks should be given more supervisory functions and should work closer with governments. This would not interfere with the banks' general price setting role and their independence, they say.

The global financial crisis has unleashed powerful pressure. The allegedly complex issues of central banking and monetary policy have to be better communicated to social movements in order to continue and channel this pressure. The crisis and the still ongoing public debate on reforms present a unique window of opportunity to push for alternative visions of the central banking in Europe.

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25 Spahn, Paul Bernd (1995): International Financial Flows and Transaction Taxes: Survey and Options, Working Paper Series No. WP/95/60, International Monetary Fund, Wash-ington D.C., http://www.wiwi.uni-frankfurt.de/fessoren/spahn/Spahn_010618.pdf.