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Economics of Monetary Union 12e

Chapter 9: The European Central Bank

Two models of central banking

- Two models of central banking
- *Anglo-French model versus German model*
- *These models differ with respect to*
 - Objectives pursued
 - Relations with government

Objectives of central bank

- In the *Anglo-French model*, the central bank pursues several objectives.

Price stability is only one of the objectives and does not receive any privileged treatment.

- In the *German model* price stability is considered to be the primary objective of the central bank.

Relations with the government

- In Anglo-French model
 - the monetary policy decisions are subject to the government's approval
 - **political dependence.**
- In German model,
 - monetary policy decisions are taken by the central bank without interference of political authorities
 - **Political independence**
- **The German model prevailed in the design of the European Central Bank.**

Statutes of the ECB

- Objectives

- “The primary objective of the ECB is the maintenance of **price stability**” (article 105)
- Without prejudice to the objective of price stability, **the ECB shall support the general economic policies** in the Community with a view to contributing to the achievement of the Community as laid down in article 2. (Article 105(1).)

- Political independence

- Enshrined in article 107: “**The ECB (...) shall not seek nor take instructions from Community institutions or bodies**, from any Government of a Member State or from any other body”.
- The Treaty also recognizes that **political independence is a necessary condition for ensuring price stability**.

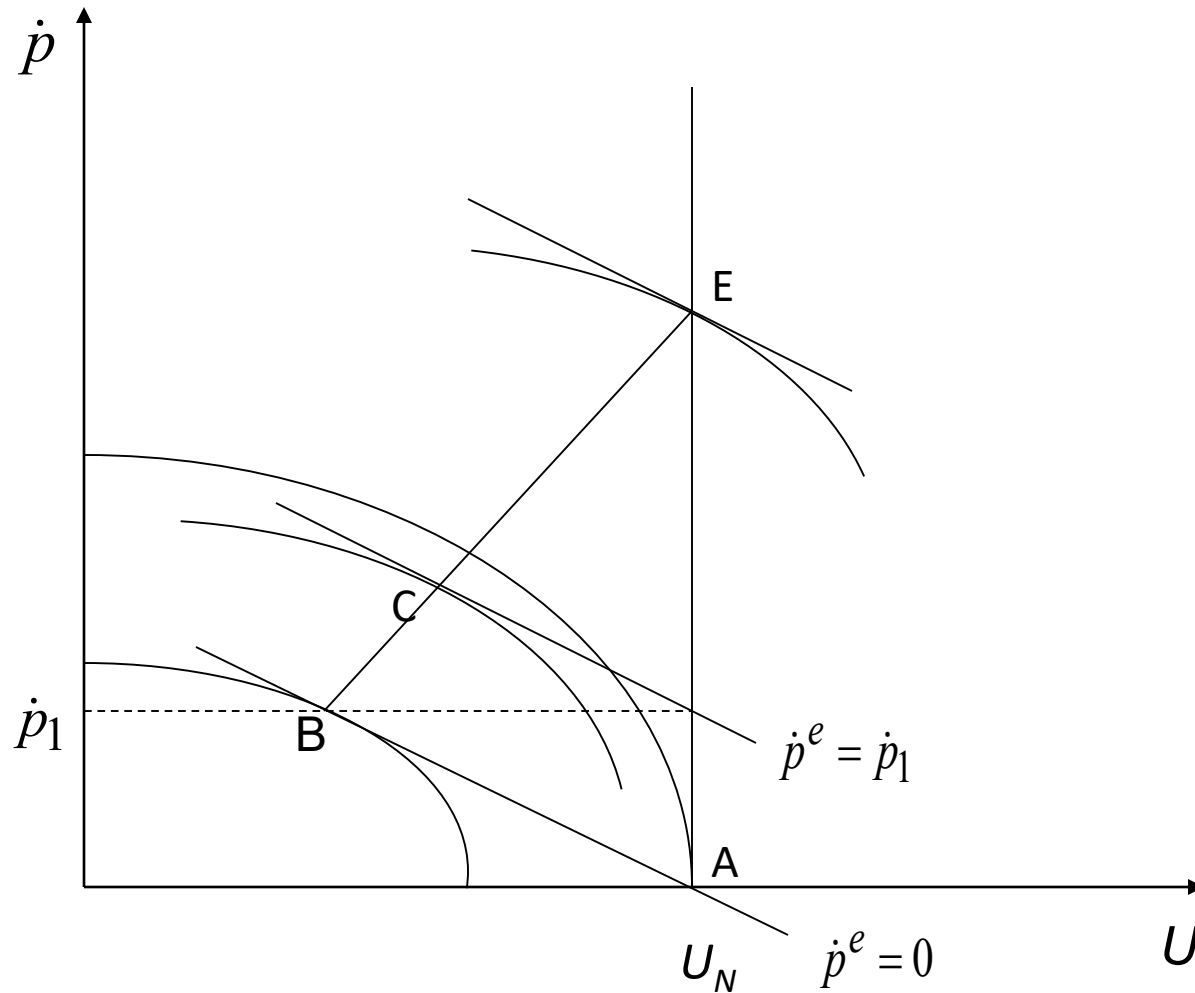
Why has the German model prevailed?

- Two reasons:
 - intellectual development, i.e. the ‘monetarist counter-revolution’
 - strategic position of Germany in the process towards EMU
- In order to accept EMU, the German monetary authorities insisted on having an ECB that gives an even higher weight to price stability than the Bundesbank did.
- This victory was greatly facilitated by the fact that most central bankers had been converted to monetarism.

The ECB: a 'conservative' central bank

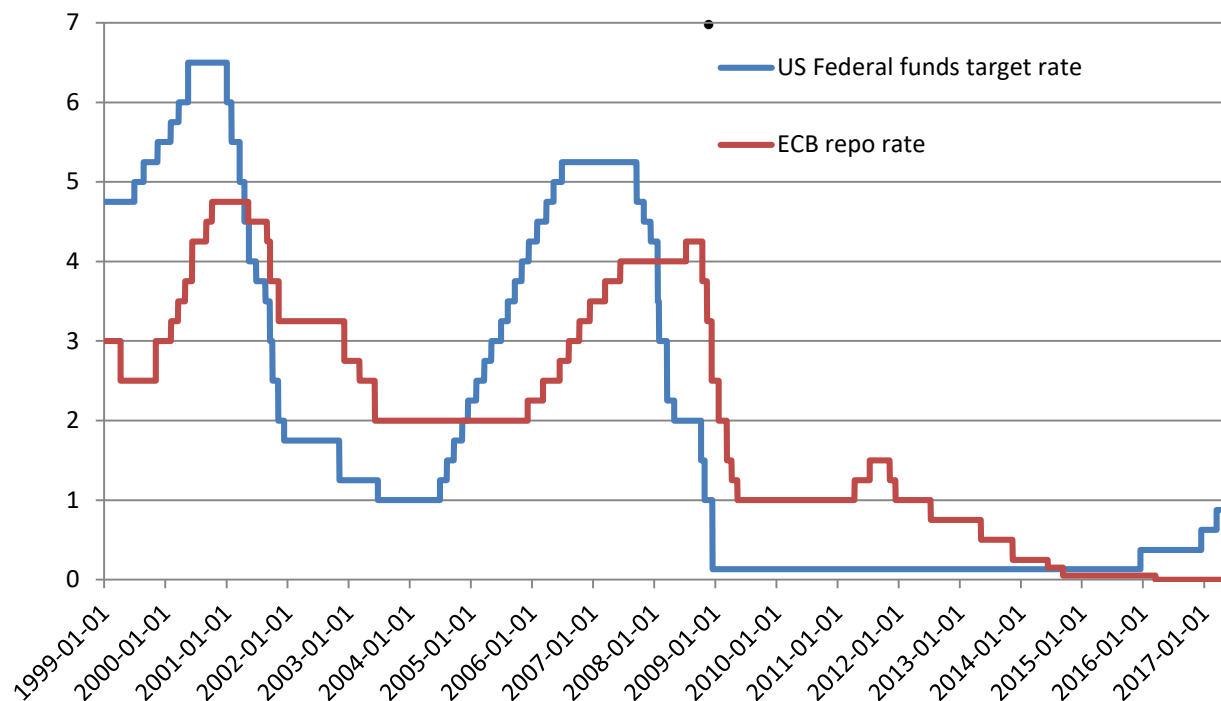
- Creation of ECB was dominated by fear of **inflation bias**.
- This led to idea that ECB should be conservative, i.e. given overriding importance to price stability **neglecting output and unemployment stabilization** if necessary.
- Is there **evidence** that ECB behaves in a **more conservative way than the Fed**?

The equilibrium inflation rate



Is there evidence that the ECB acted as a conservative central bank?

Figure 9.2 Policy rates in the Eurozone and the USA (%).

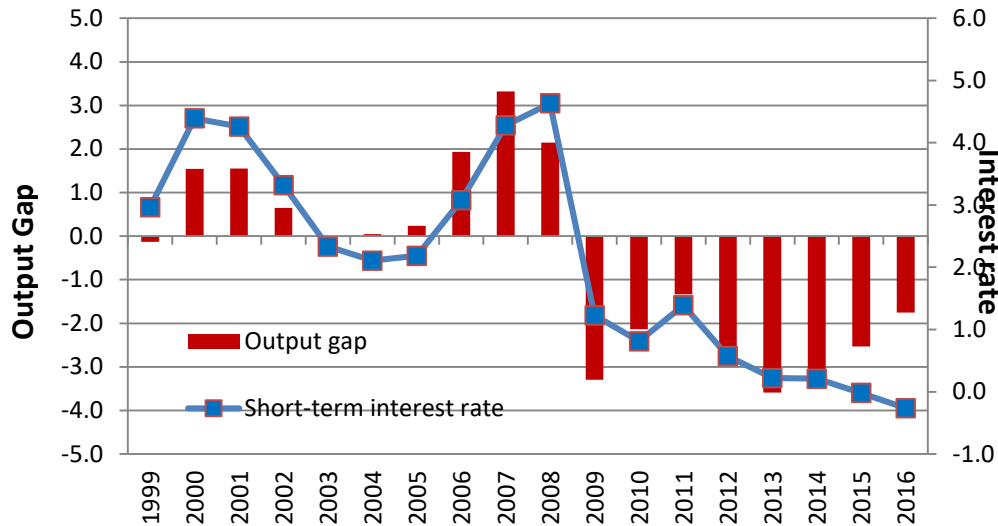


Sources: Board of Governors of the Federal Reserve System and European Central Bank.

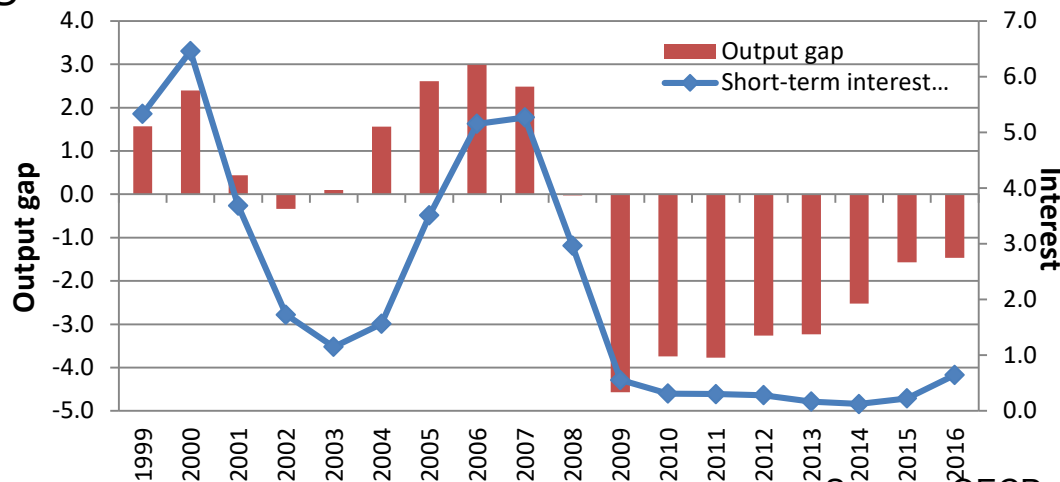
- US Fed seems to have reacted more to economic slowdown of 2001 than ECB (keeping interest rate too low for too long)
- Then it reacted sharper to the boom of 2004-06 and the recession of 2007- 08) than the ECB

Figure 9.3 Short-term interest rate and output gap (1999–2016)

Eurozone



US



- ECB does react to movements in output gap
- Thus it gives some weight to output stabilization
- US Fed reacts more strongly to decline in output gap than ECB
- It appears that Fed attaches greater weight to output stabilization than ECB
- In this sense ECB is more conservative than Fed
- Note that US Fed may have kept the interest rate too low during 2002-05

- Conclusion: the ECB appears to be more conservative than the US Federal Reserve.
 - it attaches greater importance to price stability and it is more cautious in reacting to movements in the business cycle than the US Fed.
- This does not mean that the Federal Reserve followed better policies than the ECB.
- There is now consensus among economists that the Fed's monetary policies during 2001–04 were too expansionary for too long
 - fueling a boom in the US housing market.
 - contributing to a general consumption boom in the US.
 - These booms came to a spectacular end in 2007.

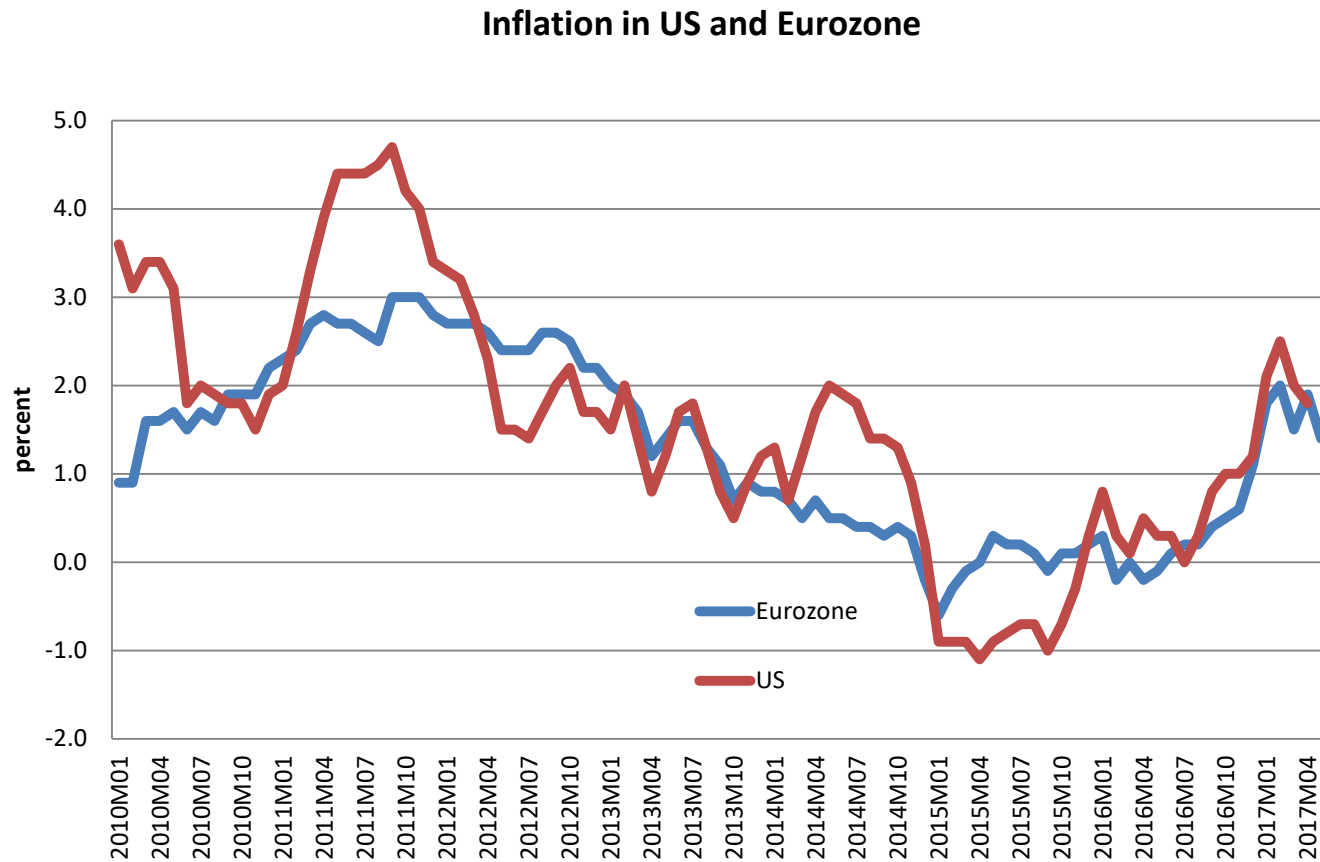
QE in US and Eurozone

- Legacy of the financial crisis: low inflation even deflation
- deflationary pressures pushed the nominal interest rates towards zero
- Central banks that wanted to stimulate the economy to avoid deflation had to use “unconventional” methods of monetary stimulus, called quantitative easing (QE).
- This consists in **buying government bonds**.

QE in US and Eurozone

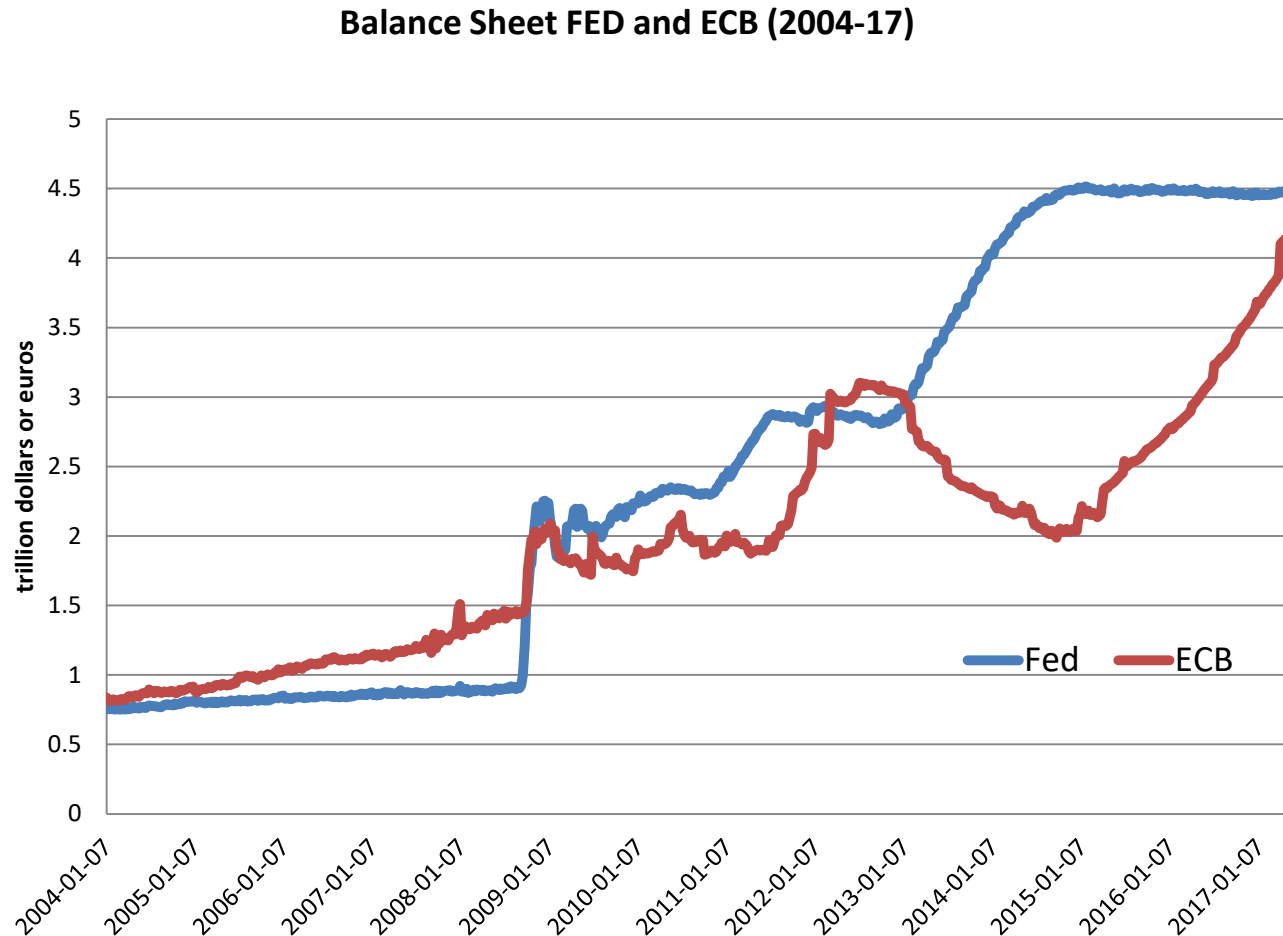
- In doing so the central bank was increasing liquidity (money base) into the system.
 - Money base is the money created by the central bank (currency in circulation and deposits held by commercial banks at the central bank).
- One implication of QE is that it increased the balance sheet of the central bank.
- Contrast between US Fed and ECB is striking

Figure 9.4: Inflation in the US and the Eurozone 2010-17



Source: Eurostat

Figure 9.5: Balance sheets of the US Fed and the ECB, 2004-17
(trillion dollars or euros)

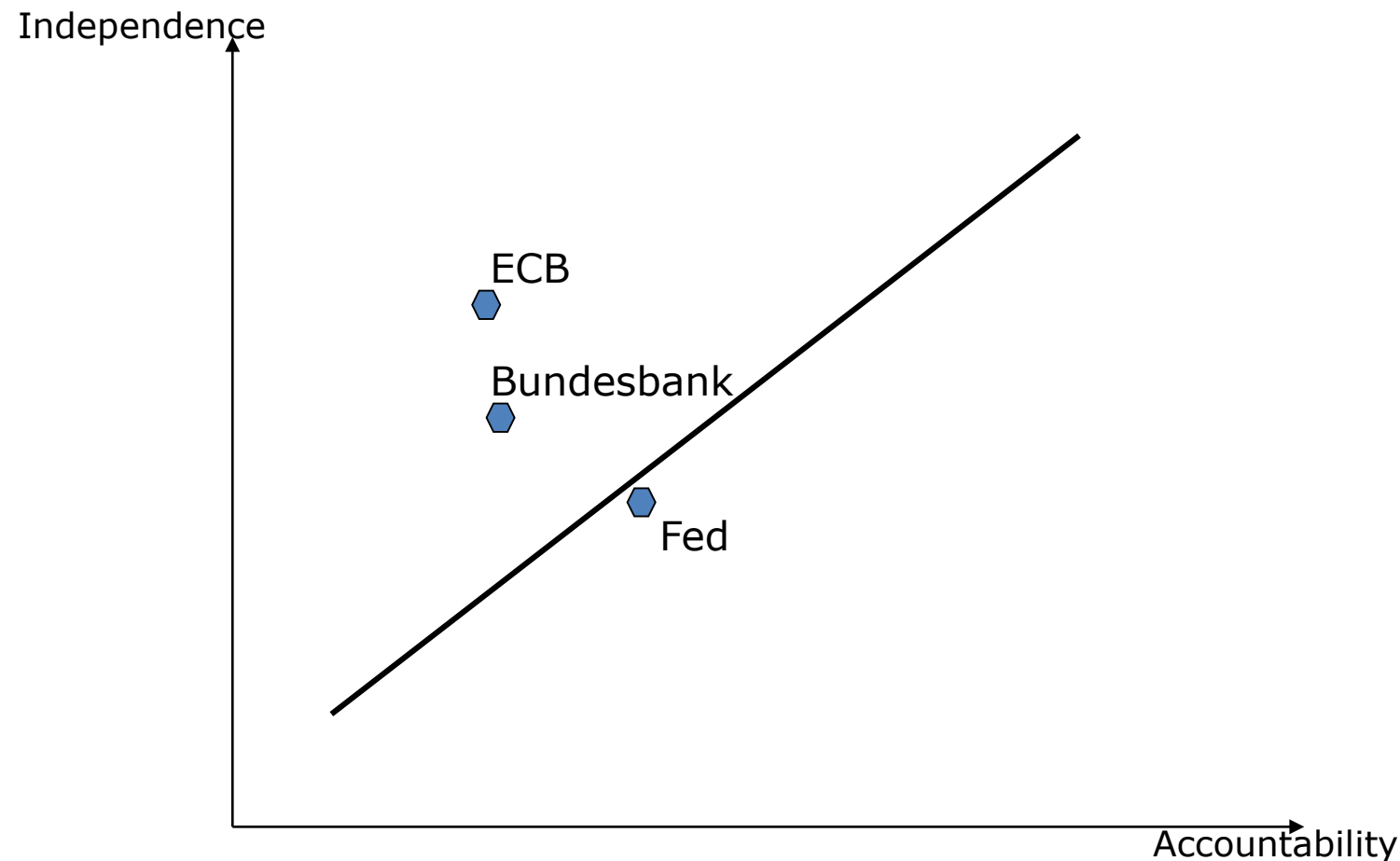


Source: ECB and US Federal Reserve

Independence and accountability

- Whenever the government delegates power to the central bank there is a corresponding need to have accountability.
 - The reason is that the government maintains its full accountability towards the voter.
 - Thus it cannot afford to delegate power without maintaining control over the use of this power.
- **Independence and accountability** are part of the same process of delegation.

Figure 8.5 Optimal relation between independence and accountability



Independence and accountability

- ECB is more independent than any other major central banks.
- The degree of accountability is weaker than in the Fed.
- This goes against the theory according to which accountability should be increased together with the degree of independence.

Independence and accountability

- Accountability is also related to the degree of precision with which central bank's objectives are specified.
 - The Treaty is vague about the other objectives besides price stability.
 - the ECB has interpreted this to mean that it has to pursue only price stability.
 - As a result, the ECB has drastically restricted the domain of responsibilities about which it can be called to account.
- Modern central banks have a wider responsibility than simply price stability.

The ECB: institutional framework

- The **Eurosystem** consists of
 - the European Central Bank (**ECB**)
 - the national central banks (**NCBs**) of member countries
- Governing bodies are
 - the **Executive Board**
 - the **Governing Council**.
- Executive Board consists of President, Vice-President, and four Directors of ECB.
- Governing Council consists of the **six members** of the Executive Board and the governors of the **nineteen** national central banks.

Executive members 2021



Where is the president of Bundesbank?



Rotation of voting rights in the Governing Council

2020

2021

NCB Governors	Month											
	1	2	3	4	5	6	7	8	9	10	11	12
President, Deutsche Bundesbank												
Governor, Banco de España												
Governor, Banque de France												
Governor, Banca d'Italia												
President, De Nederlandsche Bank												
Governor, Nationale Bank van België/Banque Nationale de Belgique												
Governor, Eesti Pank												
Governor, Central Bank of Ireland												
Governor, Bank of Greece												
Governor, Central Bank of Cyprus												
Governor, Latvijas Banka												
Chairman of the Board, Lietuvos bankas												
Governor, Banque centrale du Luxembourg												
Governor, Central Bank of Malta												
Governor, Oesterreichische Nationalbank												
Governor, Banco de Portugal												
Governor, Banka Slovenije												
Governor, Národná banka Slovenska												
Governor, Suomen Pankki - Finlands Bank												
ECB Executive Board	Month											
	1	2	3	4	5	6	7	8	9	10	11	12
President of the ECB												
Vice-President of the ECB												
Members of the Executive Board of the ECB												

	Voting rights
	No voting rights

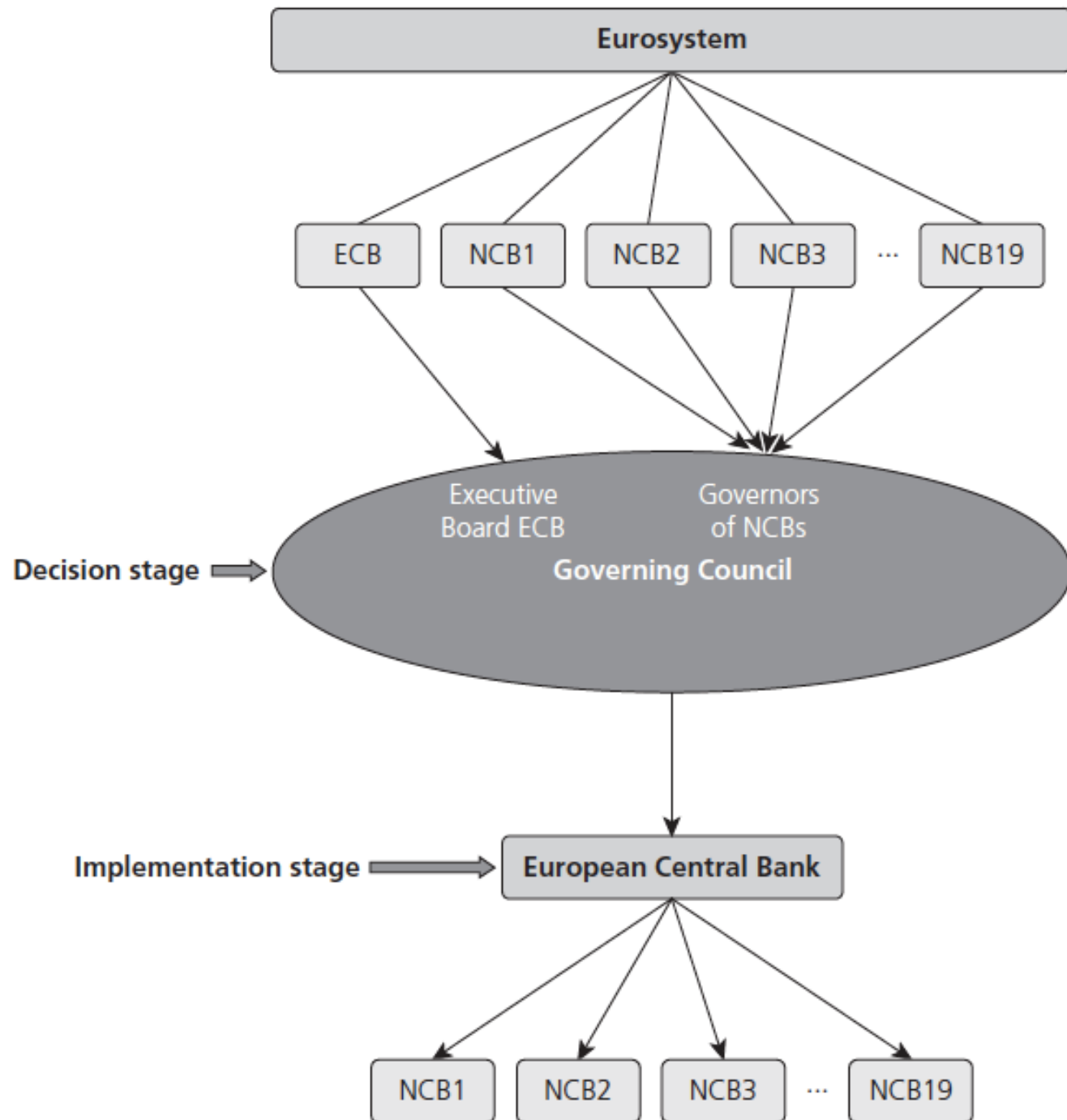
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The ECB: institutional framework

- **Governing Council is the main decision-making body of the Eurosystem.**
 - It takes decisions concerning interest rates, reserve requirements, and the provision of liquidity into the system.
 - It **meets every two weeks in Frankfurt**. During these meetings, the 25 members of the Governing Council deliberate and take the appropriate decisions.
 - Each of the members has one vote.
 - Note : with enlargement this was changed; **now rotating system**

The ECB: institutional framework

- There is **no qualified voting** in the Governing Council.
- The rationale is in the Treaty:
 - members of the Governing Council should be concerned with the interests of Euroland as a whole, and not with the interests of the country from which they originate.
 - **qualified voting would have suggested** that the members of the Governing Council represent national interests.

The ECB: institutional framework

- The Executive Board of the ECB
 - implements monetary policy decisions taken by the Governing Council.
 - gives instructions to the NCBs.
 - sets the agenda for the meetings of the Governing Council.
- Thus, Executive Board has strategic position in the decision-making process in the Governing Council.

The ECB as a lender of last resort

- ECB did not hesitate to be lender of last resort for banks
 - In 2008 with eruption of banking crisis
 - And in 2011-12 when sovereign debt crisis led to second banking crisis in Eurozone
- ECB was initially very reluctant to be lender of last resort in government bond market
- Until 2012 when Eurozone was close to collapsing
- We argued earlier that ECB should be lender of last resort in government bond market to avoid panic and fear from pushing countries into bad equilibrium

ECB has finally acted

- On September 6, 2012 ECB announced it would buy unlimited amounts of government bonds.
- Program is called “Outright Monetary Transactions” (OMT)
- In defending OMT, Mr Draghi argued that “you have large parts of the euro area in a bad equilibrium in which you may have self-fulfilling expectations that feed on themselves” . . So, there is a case for intervening . . . to “break” these expectations, which. . . do not concern only the specific countries, but the euro area as a whole. And this would justify the intervention of the central bank”

ECB has finally acted

- This was the right step: the ECB saved the Eurozone
- There is danger that its effectiveness will be reduced by politically inspired limitations:
 - Bonds with **maturity less than 3 years** will be bought
 - **Conditionality: countries in need of liquidity must accept austerity program**
- Note also that while necessary, **OMT is insufficient**
- ECB is like fire brigade: it is necessary but not sufficient in the fight against fires.

Did the ECB violate its statutes when it bought government bonds ?

- **Article 18** of the Protocol on the Statute of the European System of Central Banks and the European Central Bank :
- “the ECB and the national central banks may operate in financial markets by buying and selling (..) **claims and marketable instruments**”.
- Government bonds are marketable instruments

歐洲中央銀行體系及歐洲中央銀行條例議定書第18條 (摘自我國央行翻譯)

18.1 歐洲中央銀行及會員國中央銀行為達成歐洲中央銀行體系之目標及執行其任務，得：

- 於金融市場從事（現貨與期貨）買賣斷交易、透過附買回協議交易、**貸與或出借金融請求權與具市場性之工具**（不論以歐元或其他貨幣計價），以及貴金屬之交易；
- 與信用機構及其他市場參與者從事信用操作；**放款時並應有適足之擔保品**。

18.2 歐洲中央銀行應為**本身或會員國中央銀行建立公開市場及信用操作之一般原則**（包含宣布從事交易之條件）。

Monetary financing of government budget deficits is forbidden

- **Article 21 of Treaty**: the ECB is not allowed to provide “overdrafts or any other type of credit facilities” to public entities, **nor can the ECB purchase directly “debt instruments” from these public entities.**
- The distinction between open market operations and monetary financing is often confused.

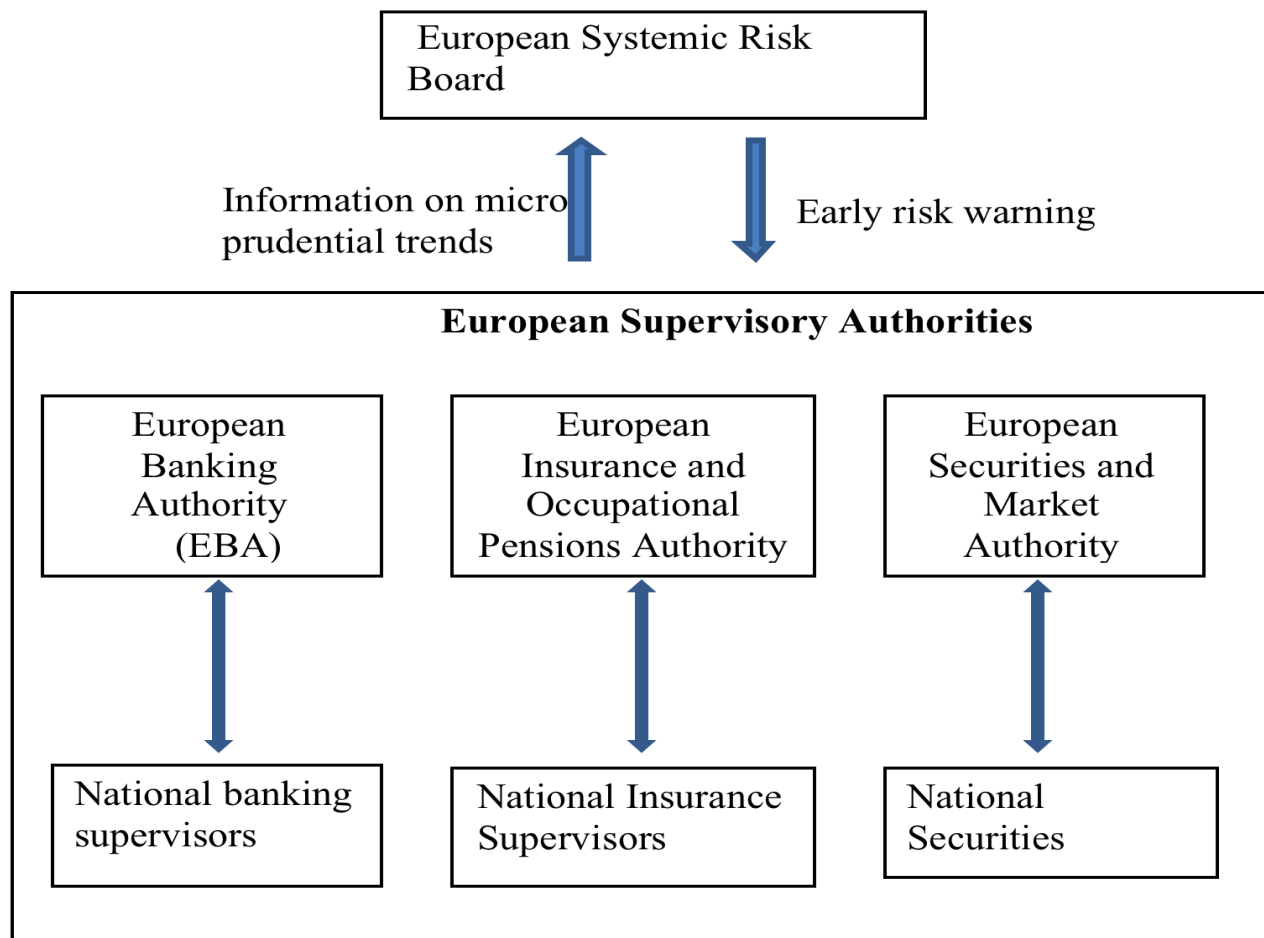
Monetary financing of government budget deficits is forbidden

- ECB is allowed to buy government bonds in the secondary markets in the context of its open market operations.
 - In doing so, the ECB does not provide credit to governments.
 - What it does is to provide liquidity to the holders of these government bonds.
 - These holders are typically financial institutions.
 - In no way can this be interpreted as a monetary financing of government budget deficits.
- This was confirmed by ECJ in 2015

The new financial regulatory and supervisory structure in the EU: towards a banking union

- The banking crisis of 2008 has been the trigger for a fundamental overhaul of the way banks and financial markets are regulated and supervised in the Eurozone and in the EU.
- The fact that regulation and supervision that existed before the crisis was mainly national was seen as having contributed to the crisis and as impeding its effective resolution.
- The need was felt to create a centralized framework of regulation and supervision.

Figure 8.9 New European Regulatory structure



Common supervisory framework

- ECB has become the common supervisor from end of 2014 on in the framework of banking union
 - Within the ECB there is a Board of Supervisors consisting of the representatives of the 19 Eurozone member states and four ECB representatives.
 - This Board has authority to supervise the “systemic” banks in the Eurozone.
 - These are the banks with a balance sheet exceeding €30 billion or 20% of the national GDP (about 200 banks).

Common supervisory framework

- This supervisory authority includes
 - the auditing of the balance sheets,
 - the imposition of fines, the recapitalization of the banks
 - their closing down when necessary.
- These are very intrusive powers that have been given to the ECB.
- The supervision of the 6000 smaller banks remains vested with the national supervisors.
- However, the ECB Board of Supervisors is empowered to issue instructions to these smaller banks if the national supervisors fail to act.

Common resolution

- Some steps were taken to cut the “deadly embrace” between sovereign and banks
- with a common resolution mechanism
 - A common fund will be set up
 - Fund only will have resources of €55 billion, which is insufficient to deal with bank crisis that is systemic in nature
- Also governance of resolution authority is too complex and will not be able to act quickly in times of crisis

Missing link: common deposit guarantee

- A crucial missing element is **a common deposit insurance system**.
 - Today every country has its own national deposit insurance mechanism.
 - If a new banking crisis erupts in a country the losses of the depositors will be compensated by the national insurance system.
 - In a large-scale crisis the national insurance systems have insufficient resources; thus it will again be national governments that have to step in.
 - In other words: the “deadly embrace” between the banks and the sovereign would is not cut.

Missing link: common deposit guarantee

- That's why a common Eurozone deposit insurance mechanism is necessary at the Eurozone level.
- This will spread the cost of compensating the deposit holders in one country over the Eurozone as a whole,
 - pretty much as this is done in the US.
- This necessitates willingness of member-countries to transfer resources to a member-country hit by banking crisis.

Conclusion

- The strong degree of independence of ECB (a positive thing) is not matched by equally strong procedure to control the performance of the ECB.
- Lack of a centralized supervision of the banking system in the Eurozone helps to explain the severity of the banking crisis that emerged in 2007-08.
- As a result of banking crisis of 2008, the European leaders have set up a **new European regulatory and supervisory structure** that should correct for the failures of the old structure.

- The ECB has acquired major responsibilities in the common supervision of the systemic banks in the Eurozone.
- This makes the need for accountability of that institution even more intense.
- Important steps have been undertaken to create a banking union in the Eurozone.
- This **banking union is far from complete**. Important steps will have to be taken to strengthen the **common resolution mechanism** and to create a **common deposit insurance system**.