The ECB Needs *to* Rediscover Itself

BY JÜRGEN STARK, THOMAS MAYER, AND GUNTHER SCHNABL

And return to its conceptual and legal foundations.

The doubts of the German Federal Constitutional Court about the conformity of the Public Sector Purchase Program of the European Central Bank with its mandate (published in a ruling on May 5, 2020) have sparked a new controversy about the independence, mandate, and power of the ECB.

The German Federal Constitutional Court argued that for "safeguarding the principle of democracy, it is imperative that the bases for the division of competences in the European Union be respected." The Federal Constitutional Court (2020) criticized the European System of Central Banks for not carrying out a sufficient "proportionality test" of the PSPP, that is, it had not sufficiently weighed the unintended side effects of the program (on public debt, personal savings, pension and retirement schemes, real estate prices, and the keeping afloat of economically unviable companies) against the monetary policy objective that the program aims to achieve and is capable of achieving. The Court obliged the German federal government and the German parliament, the Bundestag, to ensure within three months that the ECB conducted a proportionality assessment, communicated their legal view to European Central Bank, or took other steps to ensure that conformity with the European Treaties was restored.

The ECB has signaled on many occasions that it regards itself obliged only to the European Court of Justice and not to national

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constitutional courts. Thus, the dispute is about both the ECB's understanding of the design of monetary policy and its accountability. It reopens the question of the central bank model of the European Monetary Union, which seemed settled in the Maastricht Treaty in favor of the blueprint provided by the Deutsche Bundesbank.

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STATUS AND MANDATE

The Deutsche Bundesbank, and its predecessor, the "Bank deutscher Länder" under the influence of the United States and United Kingdom after World War II, were politically independent prior to monetary union and committed to the objective of price stability. Pursuing a consistent policy for price stability in the medium term, it delivered low inflation and a strong currency for Germany. By contrast, in France, Italy, and many other southern European countries, the central banks were subordinate to the ministries of finance. Interest rate changes were decided politically, with central banks obliged to implement these decisions. As a result, inflation rates were higher than in Germany, and the southern European currencies depreciated against the D-mark.

With the creation of the European Monetary Union by the Maastricht Treaty of 1992, important and proven principles based on the model of the Bundesbank were established. They included the independence of the ECB and the national central banks, as well as a narrow mandate to maintain price stability as the primary objective of monetary policy. The ECB was endowed with an even higher degree of independence from political influence than the old Bundesbank, since its status was enshrined in international law.

Furthermore, limits were imposed on the Member States with regard to public budget deficits and debt. Within the framework of European rules, fiscal policies remained the responsibility of the Member States. Other constitutive elements were the prohibition of monetary financing of government expenditures (Article 123 of the Treaty on the Functioning of the European Union) and the ban of the European Union or single Member States on assuming liabilities of individual member states—known as the "no bailout" clause (Article 125, TFEU). Economic policy remained largely a national responsibility, unless competences were explicitly transferred to the European Union in whole or in part in Article 3 and Article 4, TFEU (which stipulate the principles of transfers).

The independence of the ECB is thus limited exclusively to the mandate of price stability. This status applies neither to banking supervision nor to the role of the ECB in ensuring financial stability and the other areas of economic policy. Neither the ECB nor the ECJ are superior to national law in every area of economic policy. If European institutions such as the ECB exceed their specific powers given to them to shape policy, they empower themselves and violate the legal constraints imposed on them. They act *ultra vires,* as the Federal Constitutional Court has again emphasized.

The ECB's two-pillar monetary policy strategy developed in 1998 included central elements of the Bundesbank's approach. The definition of price stability and the medium-term orientation of policy were based on the Bundesbank's implicit objective of an inflation rate of 2 percent. The monetary analysis was given a prominent role. With good reason, the Bundesbank saw the pursuit of price stability as an art rather than an exact science in which judgement always took precedence over economic engineering. Due to the heterogeneity of the new currency area, the money supply target was not fully transferred to the ECB and supplemented by economic analysis. Monetary policy conclusions were drawn from both analyses of short- and medium-term inflation risks in an exercise of "cross-checking."

A strategy review in 2003 initially did not result in any fundamental practical changes. The definition of price stability as an inflation rate below 2 percent was confirmed. However, it was added that the medium-term objective should be an inflation rate below, but close to 2 percent. The reference value for the annual change in money supply M3 was abandoned and, in line with the temporal orientation of the two pillars, the short-term economic analysis took first place, the monetary analysis second.

PARADIGM SHIFT AND BREAKING TABOOS

In contrast to the ECB Governing Council's understanding in 2003, the outcome of the strategy review was later reinterpreted as a change in strategy towards short-term inflation targeting. The declaration of intent to aim for an inflation rate below but close to 2 percent over the medium term became a self-imposed short-term point target

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of 1.9 percent. The ECB thus carried out a paradigm shift. The “two-pillar strategy” now played a role in name only. Since in inflation targeting the deviation of output from the long-term trend is an intermediate target for inflation control, short-term output stabilization became an intermediate monetary policy objective through the back door. Since then, the ECB has intervened directly in national economic policies.

Shock moments such as financial crises make major changes possible. The ECB’s sharp interest rate cuts at the beginning of the century in response to the bursting of the dotcom bubble favored real estate bubbles, rapidly rising government spending, and excessive consumption in some southern euro states and Ireland. The subsequent outbreak of the European financial and debt crisis in 2010 then paved the way for direct purchases of government bonds. Before this, the ECB’s monetary policy had been based on refinancing operations, in which the ECB had only held securities with repurchase agreements from commercial banks for a limited period of time.

In May 2010, the majority of the Governing Council of the ECB gave in to pressure from European leaders to participate in the rescue of Greece with the new Securities Markets Programme. Thus, the taboo of monetary financing of public expenditure was broken and the ECB’s independence from political influence was compromised.

With his promise to do “whatever it takes” to defend the euro at the height of the European sovereign debt crisis in July 2012—and the later announcement of a new purchase program for public securities—ECB President Mario Draghi reduced risk premiums on the bonds of southern euro countries, which had threatened their solvency. Thus, SMP was followed in September 2012 by the Outright Monetary Transaction Programme as a conditioned “bail-out promise” by the ECB to euro area crisis countries. Although the program has not been activated until today, the ECB, as a potential “lender of last resort,” not only took over a risky explicit solvency guarantee for the euro states with this step. It also penetrated deeply into the remit of national fiscal policies, which would have been legally responsible for rescuing the euro.

In 2014, interest rates were cut into negative territory on the allegation of deflationary dangers, and in March 2015, when the economy was growing robustly, a new comprehensive Public Sector Purchase Programme followed. ECB representatives repeatedly described the program as “within the mandate” of the ECB, based on their interpretation that an inflation rate well below the 2 percent benchmark ought to be lifted towards 2 percent by all means in the near future. At the same time, this policy provided a cover for the ECB’s intentions to reduce the insolvency risks of financially unsound member states. By December 2018, the Eurosystem had bought government bonds worth around €2.1 trillion in this endeavor.

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ECB interventions and negative interest rates caused considerable market distortions and a massive redistribution of income and wealth from savers and creditors to governments and debtors. As a consequence of another instrument, dubbed (targeted) long-term refinancing operations—(T)LTROs—incomes were also redistributed between euro states, because the extension of (T)LTROs was strongly distributed in favor of southern European countries, since April 2020 with a negative interest rate of up to -1 percent. The TARGET2 interbank payment system developed into an implicit credit mechanism for problem countries in the southern euro area. None of these actions had any democratic legitimacy.

In a hesitant preparation for the overdue exit from ultra-loose monetary policy, PSPP initially ended in December 2018. However, when the euro area economy slowed again, bond purchases in the amount of €20 billion per month were

Conflicting Titles

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—J. Stark, T. Mayer, and G. Schnabl

resumed in November 2019. In March 2020, they were increased by a further €120 billion until the end of 2020. The zero interest rate policy was continued.

With the outbreak of the coronavirus crisis and the recession due to the economic shutdown, the ECB launched the Pandemic Emergency Purchase Programme with a total of €1,350 billion on top of PSPP. With public debt growing very strongly in all euro states, the ECB's intention is to keep the borrowing costs of European monetary union member states low and to prevent looming insolvencies of important euro area countries. The total volume of government bond purchases under PSPP and PEPP is expected to exceed €3,000 billion by the end of 2020. Considering these magnitudes, the—prohibited—financing of public expenditures, arranged by the Governing Council of the ECB, is obvious to any unprejudiced observer.

MULTIFUNCTIONAL ECB

Since its establishment, the ECB has taken on additional tasks that go way beyond its legal mandate. In 2014, it was given the task of directly supervising the major banks in the euro area. The conflict of interest is obvious. On the one hand, the ECB is a monetary policy institution and, on the other, it is a banking supervisor. The depression of interest rates for monetary policy purposes is weakening the balance sheets of banks, which should worry the banking supervisor. In the event, banks become ever-more dependent on the ECB.

By buying corporate bonds on a large scale since 2016 in the Corporate Sector Purchase Programme, the ECB is pursuing an industrial policy benefitting large European companies. For example, the bonds of Siemens, Daimler, BMW, Deutsche Bahn, SNCF, Renault, Enel, and Telefonica all are on the ECB's buying list. Unsurprisingly, large companies have become strong supporters of the ECB's monetary policy. With Christine Lagarde taking office as president, an enhanced role of the ECB in environmental and climate policy was brought up for discussion, duly supported by green parties, environmental associations, and the European Commission, which before the Covid-19 pandemic wanted to spend immense public funds on "green policies."

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The ECJ granted the ECB *carte blanche* for its self-empowerment in the case of both OMT and PSPP. Plaintiffs have accused the ECJ of having followed the ECB's reasoning without a thorough assessment of their arguments along the lines of the German Federal Constitutional Court. The latter has now contradicted the ECJ on the PSPP and ruled that the German Bundesbank could be banned from participating in this program, if the ECB cannot justify the consistency with its mandate. Withdrawal of the Bundesbank could be seen as a precursor to the break-up of the eurozone.

In early July, the German government and a majority of parties in the German parliament have signaled that they regard documents provided by the ECB, which aim to demonstrate the "proportionality" of its Public Sector Purchase Programme, as enough to fulfil the requirements imposed by the Federal Constitutional Court. This may resolve the conflict formally. Yet the fundamental problems of the separation of competences between supranational and national courts remain just as open as the transgression of competences of European institutions. Inspired by the decision of the Federal Constitutional Court of May 5, new lawsuits, notably on the Pandemic Emergency Purchase Program, are expected. This can be prevented in two ways.

POSSIBLE SOLUTIONS

First, the Treaty on the Functioning of the European Union could be altered. This would, however, not be an easy task. Treaty amendments require ratification by the parliaments of all EU member states or even referendums. Yet several initiatives seem to already anticipate such a step. The agreement between French President Emmanuel Macron and German Chancellor Angela Merkel on joint EU borrowing to finance a "Reconstruction Fund" for Europe points in the direction of a common European fiscal policy. The debt limits have been breached already so often and so far that they have become completely discredited. With the Covid-19 crisis they will become untenable.

Moreover, with the PSPP extension and the ECB's announcement that it will no longer adhere to the 33 percent ownership limit of government bond issues and, in principle, to the capital key in the PEPP, the assumption that the ECB does not finance government expenditure is no longer credible. The TARGET2 payment system has developed into an implicit international credit mechanism, where loans are extended automatically without limit. Thus, owing to the ECB's understanding of monetary policy, the "transfer and liability union," which the European treaties were intended to prevent, has become reality. Hence, a Treaty change seems overdue.

At the same time, however, the ECB's "cheap" money policy is emasculating savings and inflating stock and property prices to the disadvantage of the younger generation and the middle class in Europe. Bursting financial market bubbles lead to drastic crises, which trigger low-interest therapies that turn companies into "zombies." As a result, productivity gains fall or turn negative, putting persistent pressure on wages. Zero and negative interest rates damage banks and deprive them of their function to ensure an efficient allocation of capital in the euro area. As a result, the open market economy with free competition enshrined in Article 127 of the TFEU is undermined without the objective of price stability being achieved.

Hence, without amending the EU treaties and the German constitution—or perhaps even without a new German constitution if the Bundestag's right of final decision in budgetary matters is to be transferred to the European level—only the second way remains: The restoration of the ECB to its original conceptual and legal basis. This would include a commitment to a qualitative definition of price stability which takes into account—directly or indirectly—the impact of the common monetary policy on asset prices. A further development of the ECB's original two-pillar strategy is principally better suited for this purpose than a monetary policy strategy that separates the short-term pursuit of a narrow inflation target from macroprudential analysis.

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The evaluation of the achievement of the target would again have to be based on an extended monetary analysis, as already considered at the ECB some years ago. The monetary analysis would have to include the macroprudential analysis currently conducted separately in the banking and financial sector. Both analyses would result in a balanced assessment of the state and prospects for the stability of the purchasing power of money.

Finally, the European Central Bank would have to stop direct purchases of government bonds and reduce its holdings, as called for by the Federal Constitutional Court. Although this would entail short-term risks and adjustment costs, it would secure the future of the common currency and the young generation in Europe in the long term.

In the blueprint of monetary union, only the issue of money was lifted to the supra-national level, both conceptually and legally. Most other areas of economic policy, and especially fiscal policy, remained at the national level and separate from monetary policy. The ECB was given price stability as its only objective and was prohibited from financing the state. However, because governments did not comply with the obligations of the Stability and Growth Pact, the ECB was forced into the role of lender of last resort for the states. Because the ECB narrowed its mandate to achieve a short-term inflation target, it encroached on the general economic policy reserved for the states, created risks to financial stability, and had an unjustifiable impact on the distribution of wealth within and between euro area countries. It is to the credit of the German Federal Constitutional Court to have addressed this transgression of competences.

If the European monetary union is not to become a legal vacuum, the ECB must return to its conceptual and legal foundations. This requires a broad-based monetary policy strategy that takes account of prices on all markets, includes financial risks in its considerations, and, above all, understands that monetary policy is an art and not an economic engineering science. ◆