Limits to the Independence of the ECB

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1. Introduction

Critics of the euro usually fail to recognize that many European central banks were not independent before it was created. As a consequence, inflation paths diverged among EU countries, which required that intra-European exchange rates be frequently re-aligned. Since these realignments were easily foreseen, they were accompanied by bruising speculative attacks. The euro was intended to put these disruptions to the Single Market to an end. Mission accomplished. Yet, during the crisis, the ECB has vacillated, which deepened and spread the crisis. One interpretation is that, for a while, the ECB failed to come to grip with the nature of the crisis. Another interpretation is that the ECB did not have adequate instruments. Yet another one is that the ECB felt constrained by political considerations. The present paper argues that while the independence of the ECB is formally guaranteed by the Maastricht Treaty, apparently mistaken analyses[1] and the perceived lack of instruments are a consequence of the fragility of its independence. This may be the most underestimated limit of the Eurozone construction.

The classic threat to central bank independence comes from a lopsided relationship with the government. Fiscal dominance occurs when the central bank is compelled to deviate from its preferred course of action because of fiscal policy choices. It can be compelled because it must take order from the government, precisely what formal independence rules out. It may also be compelled because the government's actions create a dangerous situation that only the central bank can defuse. This was well understood by the founding fathers of the euro and fully implemented in the Maastricht Treaty. Recognizing the threat posed by runaway budget deficits, the treaty established the principle that was formalized as the Stability and Growth Pact and by the no-bailout rule. The Eurozone crisis has shown that the pact has failed to prevent burgeoning public debts and the no-bailout rule was transgressed the first time it was tested. Repeated revisions of the pact are most unlikely to deliver a robust mechanism and restoring the credibility of the no-bailout rule is most improbable now that the Eurozone has created the ESM, which is entirely dedicated to bail failing governments out.

2. The lending in last resort function

As argued in the counterfactual exercise proposed by Eichengreen and Wyplosz (2016), when the Greek crisis erupted, the ECB could have easily let the case go to the IMF, which it vehemently opposed, at least initially. The IMF would have required a debt restructuring. This probably would have triggered some bank failures, at which point the ECB would have intervened as lender in last resort. From there on, we would have moved to the bank

[1] The classic indication of misleading action is the April 2011 increase in the policy rate, followed by another hike in June, only to be reversed in December.

reconstruction stage, sparing Greece and the Eurozone from a decade of misery that has left the country with a debt 50% higher than it initially was. Contagion could have been contained. If not, the same approach would have led to the same effects, without debt restructuring in some cases. This, of course, is not what happened. The ECB felt that it could not take the risk of a major bank crisis so soon after the Global Financial Crisis, a view shared with member governments and by the Fed. Yet the Fed had shown how to promptly and effectively deal with a huge bank crisis.

What hampered the ECB was that it could not act as a lender of last resort. This instrument is indeed still missing. Since then, the Banking Union has entrusted the ECB with bank supervision, but bank resolution remains fragmented between a European and national authorities and, crucially, that any cost is to be borne individually by member countries. Lending in last resort to banks remains a national responsibility, which creates a doom loop (Farhi and Tirole, 20xx) that may transform a bank crisis into a public debt crisis. The European Stability Mechanism (ESM) can now lend to banks but the liability remains national. Through its Emerging Liquidity Assistance facility, the ECB can also lend to banks but through the relevant National Central Bank (NCB), which perpetuates the doom loop, and only to banks deemed solvent. This is not lending in last resort to banks.

In order to avoid fiscal dominance, the ECB is also forbidden from lending directly to governments, a basic feature of central bank independence in many countries. Indirect lending is allowed, though. The ECB may buy bonds issued by member governments. If doubts emerge about the sustainability of a government's debt, however, such purchases become risky and any loss would be shared by all of its shareholders. This is why, in normal times, the ECB does not buy public bonds outright; rather, it takes them in through a repurchase arrangement, which guarantees full payback. In the presence of a debt crisis such a guarantee is shaky and, anyway, lending in last resort requires outright purchases, which are risky. When the debt crisis erupted, many countries voiced opposition to such risk pooling. As a result, the ECB has hesitated for a long time, during which the crisis grew deeper and wider. It is only when Mario Draghi, then newly appointed as President of the ECB, announced his determination to do "whatever it takes" to support national public debts that the crisis started to abate. Even so, the corresponding Outright Market Transactions (OMT) program was, and remains conditional on the relevant government agreeing to a program with the European Stability Mechanism (ESM). This is not really lending in last resort to government.

Thus, the ECB was forced to find ways to circumvent limitations to its essential function of lender in last resort to both banks and governments. In effect, it felt that it had to first receive a nod of approval from the most reluctant governments. When it finally undertook the OMT program, it was taken to court – first, the German Constitutional Court and next the European Court of Justice. Strangely enough, both courts had to decide what is the realm of monetary policy. Despite several reforms adopted in the wake of the crisis, the situation has remained unchanged. A central bank that is subject to government acquiescence and to legal proceedings is not independent.

3. Appointments to the Executive Board

Whether the ECB took so long to act decisively because it initially failed to analyze and anticipate the evolution of the crisis, or whether it took time to create the political conditions to invent and implement the required instruments, is an issue of much interest, with important

implications. In fact, both aspects came into play. A striking aspect of the crisis is that, during the crucial period 2010-12, seven of the eight members of the Executive Board were replaced, either because they had reached the limit of their terms or, in one case, because they resigned. From the outside, it is difficult not to conclude that this change in leadership resulted in a change of strategy.[2] Under this assumption, the composition of the Executive Board is of utmost importance. This is where the ECB is facing another difficulty. In all countries, members of monetary policy committees are chosen by the Minister of Finance or the Head of State. The situation is different in the Eurozone.

At the head of a monetary union between sovereign countries with occasionally divergent interests, the ECB must be able to focus on its mission. It must act with a high degree of cohesion to face down unavoidable explicit or implicit pressure from its member governments. The only way to produce cohesion is to appoint highly qualified technicians who share a common knowledge. If this is not the case, the Executive Board stands to be influenced by national interests and national politics.

According to Article 11.2 of Protocol 4 of the Treaty, "the President, the Vice-President and the other members of the Executive Board shall be appointed by the European Council, acting by a qualified majority, from among persons of recognised standing and professional experience in monetary or banking matters, on a recommendation from the Council after it has consulted the European Parliament and the Governing Council." On paper, the appointment procedure is the same in the Eurozone as in other countries. In practice, however, a tacit agreement is that the largest countries (Germany, France and Italy) have a reserved seat, often alongside Spain.[3] In these cases, each government comes up with one candidate, who is automatically accepted. For the smaller country seats, backdoor negotiations take place, involving various political deals. In all cases, both domestic and European political considerations play a large role. Over the first twenty years of the euro, the composition of the Executive Board and the appointment of the Chair, have been the consequence of apparently random choices that did not always result in adequate competence.

While this is not directly a challenge to independence, the quality and the mix of competences of the members affects the ability of the Executive Board to steer policy decisions. A key reason is that decisions are made by the Governing Council, made up by the eight members of the Executive Committee and seventeen of the NCB Governors, who are appointed at the local level. While members of the Governing Council are required to only consider the situation of the Eurozone as a whole, in many instances disagreements have surfaced along lines that reflect national interest. For example, the OMT decision seems to have faced strong reservation from several non-crisis countries that had good reason to fear that they were asked to bear risks that originated in crisis countries. The opposition was based on (valid) moral hazard considerations, a thin veil to conceal national interests. The ability of the deeply reshaped Board to make these highly sensitive decisions in 2012 is commonly attributed to the cohesion of a majority of Executive Board members, given the agenda setting power of its Chairman, who also chairs the Governing Council. Indeed, after a pre-meeting working dinner, the Governing Council deliberates for a few hours. Given its

[2] The ECB did not publish the minutes of its policy setting meeting until late 2015. It is impossible, therefore to know how the debates evolved as a consequence of the changeover of the Executive Board.

[3] Another issue is the gender composition of the Executive Board. So far, only one woman has served at any point of time but pressure is mounting, rightly so, which makes the choice of candidates even come constrained.

size (capped at 25 through a rotation system similar to the one adopted in the US for the Open Market Committee), the deliberations cannot involve in-depth analysis. This analysis is carried out within the Executive Board, sometimes apparently within a subset of its members.

This means that top quality appointments to the Executive Board are a necessary, but not sufficient, condition for the ECB to act independently in the complex environment of a monetary union among sovereign countries. The appointment procedure, however, does not guarantee that the Executive Board is composed of some the best qualified persons, leaving it open to political interferences.

4. Fiscal discipline

As indicated above, the two pillars of fiscal discipline, the Stability and Growth Pact and the no-bailout clause, have been ineffective.[4] The result has been excessive public debts in Greece and Portugal, both of which have been bailed out. In the case of Ireland and Spain, bank crises morphed into debt crises, the doom loop. In the first case, government excessive borrowing has been driven by a misinterpretation by some governments of why interest rates were lower than before joining the Eurozone, while excessive lending by the markets was justified by the expectation of a bailout (they were right). In the second case, the doom loop was created by the combination of the lack for a common resolution fund and the absence of lending in last resort by the ECB. In all cases, the building blocks of fiscal dominance were in place.

It may be argued that fiscal dominance did not result in inflation. In fact quite the contrary followed but low inflation was not specific to the Eurozone and this phenomenon remains a puzzle today. What is clear is that the ECB has been forced to adopt non-conventional monetary policies. It was not alone, but it has been subject to much wider controversies than elsewhere because national public opinions and governments were driven by national interests. As argued above, central bank independence is much more difficult to uphold in a monetary union.

5. Conclusion

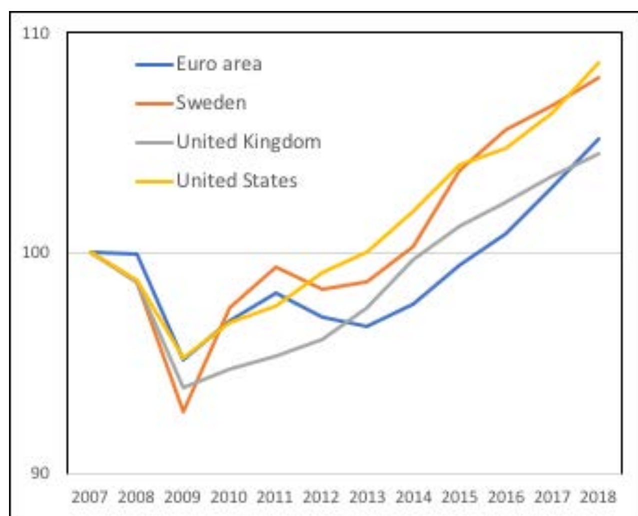
Figure 1 shows that, over the last decade, the Eurozone has underperformed relative to other countries. Following the onset of the sovereign debt crisis, it went through a double-dip recession with a much-delayed recovery. Of the four countries shown, it was the last one to return to its 2007 per capital GDP. It has caught up with the UK, but only after the 2017 Brexit referendum, and remains significantly below Sweden and the US. Of course, there many reasons behind this underperformance. Yet, the very occurrence of the debt crisis and its duration is in part related to ECB actions.

Why has the ECB been slow to adequately react? This paper argues that it did not feel able to use the lending in last resort instrument and possibly erred in its analysis, because it was concerned by sharply divergent views among its member governments. The paper also claims that these difficulties have been related to the make-up of the Executive Board and to the size

[4] This assertion is developed in Wyplosz (2013).

of the policy-setting Governing Board. Finally, the paper notes that fiscal dominance remains an issue.

Figure 1. Real GDP per capita (2007 = 1)



Source: AMECO on line, European Commission

In normal times, these limits to central bank independence matter little. Indeed, the ECB's performance over the first ten years of its existence, has been superb. It has achieved its inflation target without any clear adverse side-effects and positive side-effects, including the credibility of the inflation anchor and sustained, if disappointingly moderate economic growth. There were the years of the Great Moderation, however. In retrospect at least, the maiden flight was an easy flight. The next years have been challenging. The historic Global Financial Crisis gave way to the existential Eurozone debt crisis. This is when the limits to central bank independence started to show. Fixing these limits will not be easy.

There currently is no appetite among governments to re-think the fiscal discipline framework. Rather, their inclination is to continue fiddling with the Stability and Growth Pact. Because they well know that it is ineffective, the virtuous countries focus instead on protecting their taxpayers. One aspect is the difficulty to complete the Banking Union with a bank deposit guarantee scheme and a well-stocked resolution fund, as well as the resistance to recognize that lending in last resort is a key function of any central bank. Another likely aspect is that the upcoming renewal of membership to the ECB Executive Board will be divisive, probably with even less attention paid to its cohesion as divergent interests come to play.

If this sounds depressing, it is important to remember that it takes decades to build up institutions. It may be helpful to briefly recall the history of the Federal Reserve System. When it was created with great difficulty in 1913, the regional banks held a majority of seats on the Federal Open Market Committee (FOMC), and their presidents were fiercely protecting regional interests, mainly regional banks that controlled their own appointments. The crucial mistakes made during the Great Depression led to the Banking Act of 1935, which shifted power from the Regional Banks to the Federal Reserve Board, which has now a majority on the FOMC and created a federal guarantee for bank deposits. This was 22 years

after the creation of the Fed, following a major crisis. It took 38 years until fiscal dominance was abolished in the "divorce" agreement of 1951, following high inflation after World War II. The lesson is not only that deep institutional reforms take decades to be enacted, but also that they are triggered by serious economic turmoil. This has been the case in the Eurozone so far. It seems that the pattern is due to repeat itself, unfortunately

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