

Fratzscher, Marcel

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## Rules versus human beings, and the mandate of the ECB

Marcel Fratzscher<sup>1</sup>

4 September 2015

### Abstract

The actions by the European Central Bank (ECB) during the global and European crises have triggered a highly controversial debate, in particular in Germany, about the costs and benefits of the chosen policy path. The paper reviews, compares and evaluates the different arguments made in favour and against ECB policies around three key dimensions – the link of the policy path to price stability, financial stability and economic policy. It argues that this debate is not only about the weighing of the benefits against the costs of monetary policy, but it is primarily about the question which mandate the ECB should pursue. This question remains unanswered.

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Keywords: mandate, price stability, financial stability, European Central Bank, Germany, unconventional policies.

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<sup>1</sup> DIW Berlin, Humboldt-University Berlin and CEPR. [mfratzscher@diw.de](mailto:mfratzscher@diw.de), Mohrenstrasse 58, 10117 Berlin, Germany. This paper is based on my keynote lecture at the CESifo Area Conference on Macro, Money & International Finance, and has been prepared for *CESifo Studies*.

***“... Men can be trusted in crisis to perform better than rules.”***

***Charles Kindleberger (1984, in “Rules versus men: lessons from a century of monetary policy”)***

## **I. Introduction**

Why do economists sometimes differ so fundamentally in their views on economic policy? Sometimes the answer lies in their nationality or geography. A good example is the discussion on the monetary policy of the ECB, an issue which divides economists by geography. How is it possible that in this age, in which information is so abundantly available and shared globally, nationality or the environment in which people operate play such a big role?

A large literature in fields such as finance shows that information at the micro level and behavioral differences are important for understanding differences in views and decisions by economic agents. But it is more puzzling when it comes to macroeconomic issues, such as monetary policy, for which relevant information is widely shared. Globally there is a strong consensus among academic economists that the policy of the European Central Bank (ECB) has been very successful, and in fact could even have been more expansionary sooner. By contrast, there is a significant majority of academic economists in Germany, who have been arguing fiercely for years that ECB policy has been wrong - too expansionary, ineffective or even with adverse effects, using inappropriate instruments, or pursuing the wrong objectives.

In no country in the world is there such an opposition to the ECB. Why do well-trained scientists in one country come to such different conclusions on ECB monetary policy? Clearly, national or personal interests may influence the way information is perceived and processed. Or economists may weigh various arguments in a fundamentally different way.

The objective of this policy paper is not to speculate on these different views. The aim is rather to inform the debate and contribute to a more rational, informed discussion on ECB monetary policy. This is not a mere academic exercise. For better or worse, economists are exerting a significant impact on public opinion. This holds true also and possibly in particular in Germany. Scientists and in particular economists are often used as expert witnesses by the media, which are inclined to try and instrumentalise economists in support of their own views and agenda.

This poses a huge challenge for the ECB. Monetary policy never functions in isolation of what other policymakers do and of what the media communicates, and thus what companies and private households perceive and believe. There has been a media storm in Germany criticizing the ECB, its policies and even its policymakers. It has gone so far that influential German media outlets have criticized the personal integrity and nationality of the ECB President. In short, the media has an important impact on the standing and hence the credibility of institutions, including the ECB. Eurobarometer surveys, for instance, show that the reputation of the ECB in Germany has been declining sharply in recent years.

Without a high degree of credibility it becomes ever more difficult for a central bank to be effective and successful. The best example is the announcement of the OMT purchase program by ECB President Draghi in late July 2012. There is a broad global consensus that this announcement was hugely successful in calming financial markets and avoiding a much deeper crisis. The ECB managed to do so with a mere announcement, without having to spend a single euro on purchasing sovereign debt through this program. This illustrates the enormous importance of credibility. A high degree of credibility is essential for monetary policy to function and to be effective. Central bank communication is sometimes, as in the case of the OMT program, even able to substitute for policy action.

The paper intends to systematically list and discuss the arguments that have been put forward in Germany in favor as well as against the ECB's expansionary policy stance, and in particular its announcement on 22 January 2015 to start a new program of quantitative easing (QE). The paper intentionally focuses on this German debate and perspective. Under the QE program, the ECB will purchase EUR 60 bn. of mostly sovereign debt of the individual euro area countries, at each country's capital key, from March 2015 till September 2016, and till the inflation path is consistent with the ECB's price stability mandate. While the purchases include also debt of European institutions, such as the ESM and EIB, most of the purchases of national debt will remain on the balance sheets of the respective national central banks (NCBs).

The paper organizes these arguments along three lines – what ECB policy means for its mandate of price stability, its impact on financial stability and the question of effectiveness, and its relation to economic policymaking in the euro area. The paper is intended to organise thoughts and give a hopefully fairly comprehensive overview of the different arguments put forward in the public discussion in Germany. The focus is primarily on this public discussion, rather than on the academic literature. We economists are too often too closely attached to our theoretical and conceptual priors in order to be sufficiently open-minded about reality.

I will argue that the risks and costs of ECB monetary policy, and in particular the QE program, are substantial. The main conclusion of this discussion is, however, that much of the criticism against the QE program is really about the question what the ECB mandate should be, and thus what the ECB should be doing, rather than how it is acting to achieve its preferred objective. In other words: many German economists opposing the ECB's expansionary policy stance essentially one of the ECB to follow a different mandate.

Many German economists hide behind legal reasoning, arguing the ECB's actions are not covered by EU Treaty. That is a very poor strategy in a discussion among economists. As much as lawyers should be careful in interpreting and defining monetary policy, economists should refrain from interpreting the law. The paper argues that the same economists who claim the ECB is breaking European law, i.e. engaging in monetary financing, are those who argue the ECB should break the law by ignoring its mandate of price stability.

The paper concludes by asking what this discussion implies about the mandate of the ECB. It is perfectly legitimate to take issue with the mandate of a central bank. The primary focus on price stability has become a panacea among central bankers over the last 25 years. Yet there is no compelling empirical

evidence that inflation targeting is always and everywhere the superior monetary policy strategy. In fact, during the global financial crisis and its aftermath, many central banks have de facto deviated strongly from or even given up their price stability mandate.

The paper is linked to a broad literature on the conduct, communication and mandate of central bank policy. Before the crisis there was a broad consensus that price stability should be the main, if not the sole, objective of monetary policy. Nowadays many central banks also give considerations to financial stability, often because they have been given responsibility for macro-prudential supervision. Some central banks have also been given a larger role in micro-prudential supervision of banks or have become responsible for this, such as in the case of the ECB.

Central banks in several industrialised countries have introduced forward guidance and unconventional monetary policies. Borio and Disyatat (2010) show that before the financial crisis monetary policy in most countries was defined exclusively in terms of a short-term interest rate and was primarily aimed at maintaining (a quantified) price stability (objective).

Nowadays, many central banks in advanced economies communicate about their future policy rates (Blinder et al. 2008). Whereas some central banks already before the financial crisis started publishing their expected path of future policy rates as part of an inflation targeting (IT) strategy, others introduced communication about future policy rates as a way to enhance the effectiveness of monetary policy by influencing expectations when policy rates are at or close to the effective lower bound, such as by promising monetary accommodation in the future once the ELB ceases to bind (Eggertsson and Woodford 2003, Filardo and Hoffman 2014).

Moreover, many central banks, have purchased assets in an effort to drive down private (long-term) borrowing rates (Gagnon et al. 2011, Fratzscher et al. 2014, Eser and Schwaab 2013). Many have also engaged in qualitative easing (Lenza et al. 2010) with the aim to change the composition of asset holdings is changed. For instance, the Bank of England's QE policy had elements of both quantitative and qualitative easing (Joyce et al. 2011).

In particular the changing mandates of central banks have profound implications for central banks. The experience with monetary policy at the zero-lower bound and the risk of deflation have rekindled the debate on the proper level of inflation to target. It has been argued that the risk of hitting the ELB is less for a higher inflation target (Blanchard et al. 2010, Buitert 2014, Walsh 2015). The mandate of many central banks now includes also maintaining financial stability (Born et al. 2012).

The paper is organized as follows. The next three sections each deal with one of the three elements of the public discussion in Germany on the ECB'S policy stance - the mandate of price stability, the impact on financial stability and effectiveness, and the link to economic policy. Section 5 then discusses the implications for the mandate of the ECB. Section 6 concludes.

## **II. The ECB's mandate of price stability**

The EU Treaty gives the European Central Bank a clear mandate—namely that of achieving price stability as its primary objective. The Treaty also stresses that beyond that, the ECB should strive to achieve economic stability. The Treaty does not say, however, how price stability is to be defined. It left that to the ECB, which before its start on 1 June 1998 adopted the definition of inflation (to be more precise, the harmonized index of consumer prices, HICP) to be below 2% over the medium term.

In its review of its strategy, which was concluded in 2003, the ECB adopted an even narrower definition of HICP inflation of “below but close to those 2%” over the medium term. Various ECB officials subsequently underlined this to mean a range of about 1.7-2.0%. A not fully specified issue is the meaning of “medium-term”. But also here ECB officials made clear that this refers to a horizon of approximately 1.5 to 2 years, i.e. a horizon at which monetary policy can influence prices and inflation. Four main arguments are being put forward in Germany by critics of the ECB regarding the objective of price stability. Each of them is discussed in turn.

### **1. “There is no deflation in the euro area.”**

This argument is wrong. A common reasoning among economists in Germany is that there is no deflation at the time of writing this article in February 2015. However, HICP headline inflation, i.e. the measure to which the ECB objective refers to, stood at -0.6% year-on-year. Core inflation, which excludes the most volatile components, in particular energy and food, was still positive at +0.6% year-on-year.

There are good reasons why the ECB has repeatedly emphasized that headline inflation is the preferred inflation gauge which it targets. First, we do not know whether changes in energy and food prices are temporary or permanent, and the best a central bank can do is to take into account that such changes are indeed permanent. Second, large changes in energy and food prices may not merely reflect the relative price change in an economy, but they often times do have an impact on core inflation via second-round effects, for instance via wage adjustments.

A second false argument, often made by some economists in Germany, is that price stability means an inflation rate of 0.0%. There are good reasons why the ECB narrowed its definition of price stability to “below but close to 2%”. An important one is that inflation can be measured only with a certain upward bias, for two reasons. One is that the weights and the HICP basket tends to underestimate the importance of those goods and services with a weaker inflation dynamics. Moreover, quality improvements can also be measured partly and with an upward bias.

Take the example of a flatscreen TV. Private households nowadays on average pay more money for flatscreen TV than they did five years ago. The HICP Basket therefore indicates that the prices for flatscreen TVs have risen, thus contributing to inflation. However, this is obviously wrong since technological progress means the TV bought today is far superior in quality compared to the one of five years ago. If one could still buy today the TV of five years ago, it surely would cost much less. Hence, instead of measuring falling prices for TVs, the HICP basket actually indicates rising or at least much less falling prices for this item. In short, both biases mean that a 0.0% inflation rate is not implying price stability but in fact falling prices.

There is a third weakness in the reasoning of those do not see deflation at HICP inflation rates of slightly above 0.0%. The HICP basket merely gives the weighted average of inflation rates across a very wide set of goods and services. This means the closer the index gets to zero, the more prices of goods and services categories are actually falling. Services inflation in early 2015 is in fact still slightly above 1%, while core goods inflation is already negative. The same argument holds across countries as for different countries in the euro area, including Germany, a rising share of goods and services have become deflationary over the past year. In many countries, in fact, more than one out of three goods and services has been experiencing falling prices.

In summary, deflation is already a reality for many companies, sectors and countries in the euro area - irrespective of whether one looks at headline inflation or core inflation. Fact is: the ECB is currently missing its mandate of price stability over the medium term by a wide margin, and is expected to keep doing so for considerable period of time.

## **2. *"The cost of deflation is negligible."***

Also this claim is patently wrong. Again, it is striking that one hears this type of argument mainly in Germany, with many economists and media trying to find examples from the 19<sup>th</sup> century illustrating country cases with high rates of growth and deflation. There are even curious attempts in Germany to make Japan's deflation look like a true success story, by arguing that per capita GDP in Japan have grown even less without deflation.

The obvious point is that one needs to look very carefully at the causes and drivers of inflation and deflation. It is hard to see any reasonable argument that deflation in the euro area today is a result of positive supply shocks, such as productivity and technological shocks, through which supply has outpaced demand. Italy's and Spain's economies have shrunk by 9%, those of Greece, Portugal and Ireland much more. Unemployment has surged, investment spending and consumption spending have collapsed. Hence it is hard to contest the argument that deflation in the euro area really is primarily due to a collapse in demand.

Deflation is costly for an economy mainly through three channels. The first one is via investment and consumption demand. A firm that has fixed cost for inputs today, such as wages and material inputs into the production process, but expects to get a lower revenues in one or two years' time due to an expected decline in the price of that product or service, but also tend to reduce investment. This also reduces the demand for labor and overall household income in the economy as well as tax revenues for the government. Such a further weakening of demand made use an even stronger decline in price expectations and in the worst case could lead to spiral of weakening private demand.

Not all deflation or deflation expectations reflect such a mechanism, in which a lack of demand and a negative output gap is the key driver. Deflation of inflation expectations may also be the result of a positive supply shock, which increases productivity and the supply side faster than private and public demand. Many German critics try to find examples reaching as far back as the 19<sup>th</sup> century to illustrates that there were periods when economies recorded high rates of economic growth and falling prices. The key issue is therefore whether today's situation in Europe is one where a large drop in demand or

positive supply shock explains the deflationary dynamics. It seems quite obvious - with the euro area economy today being smaller than into early 2008, and large economies such as Italy's and Spain's having shrunk by more than 8% - that the problem in Europe is one of insufficient demand. This is also supported by many different facts, including a sharp decline in private investment, a strong increase in unemployment and low productivity growth.

A second mechanism when deflation can be very costly is when it occurs in periods with high levels of debt. Deflation means that real rates of interest are positive and thus make it more difficult to service debt. A poor ability to service debt tends to raise bankruptcies among companies and private households. But it also makes it harder for companies to invest, thereby generate growth and profits, and ultimately help in economy pull out of recession. In fact, monetary policy attempting to smooth the business cycle to maintain price stability usually functions to achieve negative real interest rates during recessions and positive real rates during boom periods. High levels of debt are a major challenge for Europe today. It is not only that's many governments are highly indebted, but also the private sector in numerous euro area crisis countries over indebted - Spain after its property boom being the most potent example.

A third mechanism why deflation is so costly for the euro area today is that it makes necessary structural reforms much harder to implement. There is a broad agreement that there needs to be a significant relative price adjustment across euro area countries, as Germany has experienced falling real wages since the start of monetary union, while many others had experienced very strong increases before the global crisis of 2008. As normal wages are rigid downward, such an adjustment is made a lot harder in periods of deflation. This is at least one important part why the adjustment within the euro area has been taking so long and is still not completed.

But deflation does not only have an economic and financial cost to an economy, but it also has a huge cost for central bank itself. For one because deflation makes monetary policy at the zero lower bound less effective. But more importantly, a central bank that continuously misses its mandate of price stability by a wide margin will ultimately lose credibility. Credibility is the most important assets for any central. Without it, a central bank cannot be effective in guiding financial markets and economic agents, and ultimately achieve price stability. A good example is again the famous OMT announcement by the ECB the summer of 2012. The ECB managed to sterilize and car financial markets without ever having to purchase a single euro of government bonds under the OMT program. This was possible only because of the high degree of credibility of the ECB. Financial markets and investors were convinced that the ECB would be able and willing to do "whatever it takes".

### ***3. "Deflation reflects necessary relative price adjustment."***

This argument is confusing and mostly wrong. As explained above, there is no doubt that's there needs to be a significant relative price adjustment within the euro area even today. Some your area countries had experienced very rapid wage increases before 2008, while productivity, as for instance measured by unit labor costs, had grown much less. As an illustration nominal wages in the public sector in Greece had risen by about 110% between 1999 and 2008, and even real wages in the public sector have grown by almost 60% over that period. It is quite obvious to see that such dynamics poses a huge risk for a



country. The logical result was a sharp increase in public and private debt, also reflected in gigantic current account deficits, which in the case of Greece had exceeded its 15% at some point before the crisis. But also several other euro area countries had experienced a similar dynamics.

The main argument of the critics of the ECB monetary policy is that wages now have to fall in crisis countries in order for them to regain competitiveness. Why this argument is correct, it is nevertheless misleading and ignores important other elements of the required adjustment process. The first logical mistake is that normal wages don't necessarily have to fall, but it is real wages that have to decline. Hence a positive inflation dynamics can actually help the adjustment process. This does not mean that the ECB should generate higher inflation than what is warranted by its price stability mandate. But it also means there is absolutely no reason why deflation helps and adjustment process.

A second element that is missing from the reasoning is that competitiveness is about much more than simply wages and prices. The same economists who criticize ECB's expansionary monetary policy also tend to argue strongly – and correctly – in favor of more structural reforms in the crisis countries. The intention of structural reforms generally is precisely to improve the functioning of markets, competition and ultimately make firms and workers more productive. Hence the way towards competitiveness is not necessarily a reduction in wages, but at least in part should take place via structural reforms and higher productivity.

This also shows why the call for Grexit, i.e. the exit of Greece from the euro, is so contradictory. It is not that Greece has a lot of high-quality products and services for which it competes in global markets, but of which are simply too expensive. If that were the case, Greece indeed would need an internal devaluation or an exit from the common currency and a strong external devaluation. But that's simply not the case. Greece simply lacks products and services in which it has a comparative advantage and in which it competes in global markets. Reforms therefore need to focus on improving institutions and creating such products. Hence Grexit will change absolutely nothing about this problem, but will rather make it worse.

#### ***4. "ECB policy will lead to high inflation in the long-run."***

Also this concern is unfounded and wrong. Surveys show that even today high inflation is of the biggest concerns for German citizens. This is puzzling since Germany has not experienced high rates of inflation since the late 1940s and the Bundesbank had an outstanding record in maintaining stable prices and low inflation ever since its beginning. Yet this concern has to be taken seriously, also as they may influence decisions by citizens and companies. A concern is indeed that's the highly expansionary monetary policy stance of the ECB might ultimately lead to high rates of inflation as abundant liquidity might at some point find its way into the real economy.

In fact, following the Bundesbank tradition the ECB's monetary policy strategy has been attaching a considerable weight to monetary aggregates for guiding monetary policy. The ECB has had a two-pillar strategy, with one pillar of economic indicators focusing on the real side and the second on monetary aggregates. In particular, the ECB has had a reference rate of 4.5% annual growth in the M3 monetary aggregate. Although the actual M3 growth rate has been fluctuating strongly, even before the global

financial crisis, research shows that the pillar did have an influence on interest rates decisions in the past. It is also obvious, nevertheless, that there is at best a very loose connection between monetary developments and inflation. The most important reason for this is that abundant liquidity in the financial system may not necessarily translate into a high growth rate of credit to the real economy, which might then ultimately lead to excessive demand and inflation.

The concern therefore should be taken seriously that the currently abandoned liquidity, injected through low interest rates and also the QE program, might ultimately in use excessive rates of inflation when the euro area economy recovers. A timely and yet careful exit from its expansionary policy is therefore crucial for the ECB. This may not be easy to engineer and there are plenty of examples for an exit that has failed. One example is the delayed exit after the global recession of 2001-02, which meant that interest rates state too low for too long, thereby contributing to the asset price bubble in many parts of the world, including the United States and Europe. Nevertheless, technically there is no reason why the ECB should not be able to absorb axis liquidity very rapidly and effectively once the euro area economy recovers.

### **III. The impact on financial stability and other risks**

Although critics of the ECB policy are wrong in arguing that deflation either doesn't exist or is not harmful, the concerns about the risks and costs in terms of financial stability and effectiveness of ECB policy are generally much more justified. Numerous arguments have been made in terms of the financial stability risks the ECB policy may have. I tried to group them in four key arguments that should reflect most of these.

#### ***1. "The ECB QE program will be ineffective."***

Ultimately the question is whether and how the purchase of government debt under the QE program will help the ECB maintain price stability over the medium term. This is difficult to gauge as we don't know what inflation will be in two years' time. Hence the more useful guide are inflation expectations. However, inflation expectations over the next few years have continued to decline since the first indication of President Draghi at his Jackson Hole speech in August 2014. This includes the market-based measure of inflation premia five years ahead five years into the future, which he had emphasized himself repeatedly. Also server-based measures show no indication that there has been improvement in the anchoring of inflation expectations. In fact, most of these measures have been trending downwards, with inflation expectations over the next two or three years hovering around 1%.

However, this does not necessarily mean that's ECB policy, and in particular the announcement of its QE program, was not effective in influencing inflation expectations or any other relevant variable. The point is that we simply don't know the counterfactual, that is, what would've happened in the absence of the QE announcement.

Hence we need to rely on other, more indirect proxies for gauging the effect of ECB policy. A QE program is traditionally expected to influence financial markets through at least three channels. The first is the

portfolio balance channel, through which the purchase of government debt reduces the supply of safe assets, thereby forcing private investors to use the available liquidity from the sale of government bonds to the central bank for other investment. Part of this additional liquidity may end up back at the central bank in the deposit facility, although the ECB is trying to discourage this by having imposed a negative rate of interest of -0.2% as of February 2015. The hope and expectation is that at least part of that additional liquidity will be used by investors for purchasing corporate debts or extending additional credit to the private sector in the euro area economy, thereby improving credit conditions, investment and ultimately economic growth, employment and price stability.

A second channel is the signaling channel, where the QE program provides a credible and powerful signal to financial markets that policy rates will stay low for longer than previously expected, thereby pushing down the long end of the yield curve. A third channel is via inflation expectations. The QE program of the ECB is sufficiently credible, it should mean that economic agents are strengthened in their belief that the ECB will be able to maintain price stability, thereby inducing them to adjust their decisions, such as on investment and wage negotiations.

Some might be tempted to object here that the effect via the exchange rates constitutes a fourth channel. The idea is as follows: if a central bank injects additional liquidity, part of the liquidity will flow outside the economy and thus weaken the currency. Many refer to the experience of Japan and the United States in recent years, which had seen a deterioration of the currencies after QE programs. However, one should be careful in not pinning too high hopes on such a mechanism. The impact of a QE program on the exchange rate depends on a number of factors. The most effective QE program of all was probably the first one by the Federal Reserve in 2009 in 2010. There is a consensus and stronger evidence that this program actually worked to strengthen the US dollar substantially, and that it explains at least a significant portion of the strong US dollar appreciation during that period. The reason is that the first QE program by the Federal Reserve improved the prospects of financial stability and economic recovery in the United States significantly, so that it triggered significant capital inflows into the United States, thereby inducing an appreciation.

Turning back to the case of the ECB QE program, we see a significant reaction of financial markets to the various announcements of the ECB President and other officials since August 2014. Even before a single euro of government debt has been bought, at the time of writing this article, there has been a massive financial market reaction to QE announcements. Ten-year government yields such as Italy and Spain have fallen by more than 100 basis points since the summer of 2014. And also German ten-year Bund yields have declined by about 60 basis points, from slightly above 1% to less than 0.4%. Equity markets and corporate bond markets have boomed in most euro area countries. In particular the spreads between more and less risky assets within asset classes have become smaller. This suggests indeed that the ECB announcements have been ineffective in lowering risk premia and increased risk-taking by investors. Finally, the euro has depreciated quite significantly over the past year, from around 1.40 to 1.14 against the US dollar.

In short, the jury on the effectiveness of the ECB QE program is still out, and he probably won't have a clear idea until at least the program has been executed for one year or more. Nevertheless, the impact of QE announcements on financial markets suggests that the QE program has indeed been sizable. Whether

and to what extent this translated into more credit supply, better financing conditions and an improved anchoring of inflation expectations is still open.

## ***2. “ECB policy may cause bubbles and hurts financial institutions.”***

This concern is indeed largely correct. As explained above, not all the liquidity that the ECB injects into financial markets through its purchases of sovereign debt will find its way in the form of credits to the private sector or a reduction in risk premia towards more sustainable levels. It is therefore likely that the additional liquidity will reduce risk premia by more than is justified by underlying fundamentals and credit risks, and thus push-up asset prices and lead to an overvaluation of asset prices and an excessive risk-taking by financial institutions. However, it is hard to gauge and identify asset price bubbles.

Nevertheless, it is hard to see the connection of equity markets over the past year to the underlying fundamentals of many euro area economies. It is equally worrying to see ten-year government bond yields of Italy declined to less than 1.5%, which means that Italy can refinance itself much cheaply than even the United States. It is hard to see how such yields reflect the significant credit risk of the Italian state as indicated by CDS contracts, i.e. those measuring the ability of default of the government of Italy. Moreover, there are first concerns about bubbles and real estate markets in Germany, although such an overvaluation is so far limited to a few individual metropolitan areas.

This article can certainly do not justice to the sizable literature on asset price bubbles and their effects. However, a few additional points are worth emphasizing. One of them is that although the formation of asset price bubbles may be of concern to individual institutions, they may be less of a concern from the macroeconomic perspective. For instance, a bubble in equity markets in the middle of an economic crisis, as the current one in Europe, may actually help improve demand and therefore economic stability. One mechanism is via wealth effects. As equity wealth rises, part of this wealth is spent in the real economy, thereby generating real demand. Also the burst of an equity bubble poses risks to individual investors, but is less of a concern to policymakers as usually such a burst in equity markets in the past has not been linked to adverse effects on the real economy or for overall financial stability.

There are of course also the reverse cases, for which risks to individual financial institutions may cause systemic risks through the entire financial system. A lot of financial institutions, and not only banks, but also insurance companies and others, find difficult to deal with the current extended period of low interest rates. For insurance companies, for instance, it becomes difficult to find instruments that yield a sufficient return to payout guaranteed payments to their clients. For local savings banks, such as numerous German Sparkassen, it is difficult to be profitable as most of the business is based on deposit taking and lending out to small and medium-sized enterprises and households.

These are important risks that also a central bank needs to take seriously when taking decisions on monetary policy. However, it is the role of microprudential and macroprudential supervisors to deal with such financial stability risks, in addition to the central bank. Nevertheless, these concerns are important and need to be taken seriously when considering “the QE program of the ECB.

## ***3. “ECB policy hurts the small saver and increases inequality.”***

Also this concern about ECB policy is largely correct. At first, this argument may sound contradictory as the last one stressed the possibility of asset prices increasing even too much. The fact is, however, that not only wealth is distributed very unequally, but that different individuals hold very different types of wealth. The main beneficiaries of the expansionary monetary policy tend to be those that hold equity, real estate or other forms of real wealth that experienced a sharp increase in value. By contrast, those that hold most of their savings in the form of nominal assets, such as on saving account, lose out from the zero interest rate policy, as they earn less on such savings than the rate of inflation in some countries.

German savers in particular pay a high price – when it comes to the accumulation of savings and wealth - from the ECB policy. The ECB's own household and consumption network database has shown that the average (median) German individual has a lower net wealth than those in most other European economies, including many with a lower per capita income. German savers are hit harder because many fewer have property ownership and have equity wealth in their portfolio, and fewer also have gross debt. This means that the average German saver has basically all the wealth in the form of savings on her savings account, and in a negative rate of real interest, thus losing purchasing power every year.

Overall, this means that for many households and individuals in Europe the zero interest rate policy has made it much more difficult for them to build wealth for precautionary or other motives. And monetary policy is raising wealth inequality further. Although these points are corrects, we should not forget the other side, the benefits of an expansionary monetary policy also for the average citizen in Germany and other countries. The ECB monetary policy is effective and successful, it will not only deliver stable prices, but it will also support the economy, thereby raising employment and income of ordinary citizens. In short, there is a clear trade-off in that an expansionary monetary policy tends to hurts the small saver and increase inequality, yet also supports employment and income.

#### ***4. “ECB policy has an adverse external effect on other countries.”***

This claim is more incorrect than correct. The expansionary monetary policy of the ECB, as described in more detail above, has created additional liquidity, part of which may find its way abroad through capital flows, such as portfolio or bank flows. In some sense the expansionary ECB policy is therefore exported to other countries by adding liquidity and available credit in foreign economies. One particular concern is that such a policy weakens the euro exchange rate vis-à-vis other countries. This implies an appreciation of those countries against the euro area, making foreign companies less competitive in global markets. Moreover, such a policy may export deflation from the euro area to other economies via lower import prices.

An exchange rate adjustment is not necessarily unwarranted if this adjustment reflects the underlying relative economic fundamentals of two economies. In case of the euro, the depreciation from 1.40 to 1.14 to the US dollar over the past year might be considered by some indeed as evidence of such a “beggar-thy-neighbour” policy. However, many models and analyses show that the euro is not necessarily undervalued at 1.14 to the US dollar, but rather that 1.40 was a level at which the euro was probably too strong, given its economic fundamentals and outlook.

Moreover, there is an important trade-off to consider. Weaker euro may make your area companies more competitive, partly at the expense of companies abroad. Yet in economic recovery and resumption of growth and demand, coupled with improved financial stability, will help also the global economy via high overall global demand and growth. It is therefore not clear that a QE program in an individual economy causes costs rather than benefits for the global economy overall.

#### **IV. The interaction with economic policy**

A third area of relevance for monetary policy is its interaction with economic policy. In particular in Germany many critics object that the expansionary nature of the ECB policy has come at the expense of the German economy and caused a deterioration in structural and fiscal policies elsewhere.

##### ***1. “ECB policy prevents structural and fiscal reforms.”***

This is possible, but the critique is exaggerated and misguided. The concerns of the critics are understandable. By lowering interest rates and improving financing conditions, ECB policy makes it easier for governments to finance spending, and thereby may induce governments to delay a necessary fiscal consolidation. The same may hold true for structural reforms. An expansionary monetary policy may lower the “pain” and thus the pressure of governments to conduct required structural changes to the economies. Monetary policy cannot address any of these issues, neither the sustainability of fiscal policy nor structural reforms, in the long run. Monetary policy can merely “buy time”, i.e. reduce the pressure on governments to implement such reforms too quickly. The philosophy behind this is a political economy argument - reforms are more likely to be implemented in difficult times.

Why there may be some truth to these arguments and concerns, they seem to be misguided and at least partly incorrect. Take the example of the OMT announcement in the summer of 2012. There is a broad consensus that the announcement by the ECB to do “whatever it takes” pulled back the euro area economy from a much deeper crisis and possibly the financial and real depression. The question is: if ECB had not announced such an OMT program, and thus coming financial markets, would the euro area and its individual member countries be better off today? And would governments have conducted reforms more rapidly and successfully? It is unlikely that the answers to these two questions are affirmative. A deep economic depression in Europe would of made everyone worse off and would not have made it easier for governments to pursue further reforms.

There is a second major objection to this claim that ECB policies counterproductive because it’s delays economic reforms. This claim entails that the ECB should have a say on what the right structural and fiscal policies are. This poses a dilemma for the ECB. On the one hand, fiscal structure policies do have impacts on monetary policy. There is no doubt that over the past seven years, since 2008, we have moved from estate in which we had monetary dominance, i.e. where the ECB can act fairly autonomously, to one where we have financial stability dominance and possibly fiscal.

The latter means that much of the decisions by the ECB in recent years have been induced by a lack of structural reforms and fiscal consolidation in some euro area countries. The ECB is therefore lost some of

its ability to conduct monetary policy more autonomously and thereby effectively, as its success to achieve its mandate of price stability depends ever more on the actions, or the lack thereof, by other policymakers.

However, this does not necessarily mean the ECB has the right to use its monetary policy instruments to impose a particular policy course on its member governments. The ECB is certainly allowed to have and express an opinion on all economic policies that are relevant for the conduct of monetary policy. But in monetary policy stance that aims at influencing fiscal structure policies with certainty exceed the ECB's mandate. Hence, it is important to be very cautious not to push the ECB to get involved too closely in other policy fields, which would give the ECB a political role that not only goes far beyond its mandate, but which would hurt its independence and ultimately its ability to conduct monetary policy.

## **2. "ECB policy is economic policy."**

My personal view is that this critique is wrong. But this point has been one of the main complaints by the German Constitutional Court (GCC), when it recommended early in 2014 that the OMT program of the ECB to be illegal. A lot has been written on this case, and there is not enough space here to do justice to all the elements and arguments. Yet there are five key points that opponents of the OMT program criticize. A first one is that the ECB is having the objective of financing governments, rather than fulfilling its mandate of price stability, if it wants to pursue the OMT program, which states that the ECB would purchase government debt of those countries that are difficulty, but except an ESM program and fulfill the conditions successfully (though still have full market access). A second, related point is that this violates the monetary financing prohibition of the EU Treaty. Many critics see the purchase of government debt in direct violation of this prohibition. However, the treaty does allow the purchase of government debt in secondary markets, even though of course such purchases do have an impact on the conditions and yields that governments have to pay in primary markets.

A third concern is that the government purchase program, such as the OMT program but also the subsequent QE program, is fiscal policy rather than monetary policy. It is true that this policy functions directly through sovereign debt markets. The intention is indeed to lower yields and compress spreads across euro area countries to improve financing conditions and lower asymmetries across countries, thus making the ECB's policy more effective. This reduction and compression of yields is than hoped to translate into better financing conditions and the supply of credit for the private sector. But the policy of the ECB therefore functions in a more indirect way via sovereign bond markets.

A fourth and fifth concern about the ECB's OMT and QE programs is that they curtailed the budgetary rights of national parliaments and that they have distribution effects across individuals, investors and countries. By purchasing government debt, the ECB takes risks on its balance sheet, which may have an impact on its earnings or potential losses for many years if not decades to come. Moreover, there is a notion that those countries with higher public debt and the less sustainable fiscal policy benefits more from a QE program, and do so at the expense of "safer" countries, such as Germany. 80% of the sovereign debt purchases under the QE program stay on the down sheets of the national central banks, and therefore not mutualized. However, it is true that the full separation of risk is not possible as there

will always be spillovers and an influence on the conduct of the overall ECB monetary policy is one of its member governments become insolvent and default on their sovereign debt payments.

Part of these concerns is correct. Yet the critics ignore in their reasoning the true nature and functioning of all central banks. It is precisely the function of central banks to take liquidity risks on their balance sheets in bad times. And it is also that task of central banks to engage in risk-sharing, i.e. to spread risk more broadly. Both mean that central banks thereby are able to reduce the overall risks to the economy, thereby making everyone, and every member state better off.

Moreover, every single monetary policy instruments measure always and everywhere have distributional effects. In fact, the largest distributional effects of ECB policy has come from its reduction of its policy interest rates from close to 5% before the global financial crisis in 2008 to basically zero today. This has led to a massive redistribution from savers to debtors, among individuals, companies and member states. In addition, none of the ECB policies is really unique, but each and every one has been employed by other central banks worldwide. Although the situation in the euro area is special, as it comprises nineteen sovereign nations, this does not change the fact that the ECB has been using monetary policy instruments that both legal and constitute normal tools in crisis times.

### ***3. "The ECB QE program is not Germany's interest."***

This is narrowly correct, but overall wrong. It is narrowly correct in that if Germany had its own currency, then neither the zero-interest rate policy nor the QE program would be the adequate monetary policy stance at the current juncture for Germany. Germany's economy has been doing relatively well compared to the rest of the euro area since 2008 (but much worse in the decade before). With GDP growth rates of 1.6% in 2014 at around 2% projected for 2015, the German economy would not necessarily need policy rate of close to zero and a QE program that plans to purchase about EUR 200 billion of German government debt until September 2016.

Although this narrow perspective is not incorrect, the argument ignores the bigger environment in which Germany operates. This critique poses the wrong question, as Germany does not have its own currency and does not act in isolation of other euro area countries. If Germany still had its own currency, its currency value would certainly not be 1.14 to the US dollar, but possibly closer to 1.70 or 1.80 to the US dollar. Germany's current account surplus would not be at 7.5% of GDP as in 2014 (and probably much higher in the coming years), but would be substantially lower, with German exporters losing competitiveness globally and vis-à-vis other European countries. Moreover, Germany's growth would certainly be much weaker in an environment which the rest of the euro area where an even deeper economic and financial crisis. Hence, what this narrow-minded argument ignores is that Germany can and will prosper in the long run only as part of the strong Europe. What is good in terms of monetary policy for the entire euro area, can and will not be bad for Germany.

### ***4. "The Bundesbank is giving too little weight in the decision-making of the ECB."***

Possibly, but this depends on the perspective one takes. The mandate of each and every member of the Governing Council, the ECB's decision-making body, is to take a euro area-wide perspective for the monetary policy decision. This intention of the founding fathers of the ECB has clearly failed. It is no



secret and the governors of most national central banks, who all members of the Governing Council in addition to the six Executive Board members based at the ECB, quite openly declare that they have a national perspective on ECB policy.

It is sensible to have in “one member-one vote” principle for decision-making when each member truly has a euro area-wide perspective. But it makes much less sense if most take a national perspective and the motivation is driven at least partly by maximizing the benefits of minimizing the cost to the country they come from. Hence the reform of the voting scheme of the ECB is indeed an issue that needs to be clarified in the coming years.

Nevertheless, it should be emphasized that even with the bigger voting share, ECB policy probably would not have been very different from what it has been over the last seven years. The ECB has declared that all of the important decisions have either been taken by consensus or had a large majority.

## **V. Implications for the ECB mandate**

There is a striking contradiction in the reasoning of those in Germany who have been opposing both the ECB’s OMT program and its QE program. Several of these opponents reject the OMT program for its alleged violation of the ECB’s mandate of price stability. As discussed above, they argue that the OMT program is economic policy, which does not target price stability, but other objectives such as the financing of governments and the integrity of the euro. Yet these opponents reject the QE program not because it violates the ECB’s mandate of price stability, but because it pursues this mandate vigorously. The arguments in the previous sections show that there is no doubt that the ECB is missing its mandate of price stability by a wide margin.

### **The contradiction of German ECB critics**

How can this contradiction be reconciled? Every monetary policy measure faces trade-offs, has advantages and disadvantages, strengths and weaknesses. In essence, the reasoning of German opponents of both the OMT program and the QE program entails that a central bank has to carefully weigh the pros and cons of each monetary policy decision and instrument. Although these critics don’t express it in this way, they basically argue that the small improvement in price stability from the QE program does not justify the large risks and costs that the program causes. A similar reasoning holds true for the OMT program: German opponents argue that the gain in financial stability from the announcement of the program was less important than the moral hazard it induced among governments and financial institutions, and the risks to the credibility of the ECB itself.

Opponents of the OMT program and QE program therefore implicitly argue that the ECB should have broken the rules by not pursuing its mandate of price stability with its QE program. If one takes the ECB mandates by its letter, it requires the ECB indeed “to do whatever it takes” with permissible policy instruments - which according to the Treaty includes the purchase of government debt in secondary markets - to achieve its mandate of price stability, no matter how large the cost in terms of financial stability, economic stability and welfare. The ECB indeed seems to have followed such a narrow

understanding of its mandate when it raised interest rates in the summer of 2008 and in the summer of 2011, just to back down again a few months later by lowering rates. Many consider these two episodes as policy mistakes by the ECB. These were mistakes, however, only if one takes a broader perspective that includes financial and economic elements. From the narrow price stability perspective, these decisions were fully consistent at the time they were taken.

### **Rules versus discretion for central bankers**

The opposition to the ECB OMT and QE programs therefore leads us to two much more fundamental questions: one on the importance of rules versus discretion for central banks, and the second on the choice of the ECB's mandate.

Can it ever be justified for a central bank to break the rules given to it, and intentionally act in violation of its mandate? Charles Kindleberger shows in his enlightening essay "Rules versus men: lessons from a century of monetary policy" that central banks everywhere in the world repeatedly and consciously violated their rules and mandates. He argues that in many cases these violations avoided disaster and thus were in the best interest of society. This does not mean that rules are not important and helpful. It rather implies that rules that are important in good times, may be wrong and detrimental in crisis times. Hence, while rules are overall important in guiding expectations, providing stability and ultimately enhancing the credibility and the effectiveness of the policymaker, there can be a rationale to deviate from these rules in exceptional circumstances.

As crisis times can be so unpredictable and multifaceted, rules cannot be designed so as to fit such times. It therefore may be desirable for central banks to deviate from their rules during crises. Or as Charles Kindleberger puts it: "... Men can be trusted in crisis to perform better than rules." In other words, central bankers may do better in exercising discretion in crisis times than following a fixed set of rules. If central bankers exercise this discretion carefully and selectively, so Kindleberger, the credibility of the rules as well as that of the institution may actually increase rather than suffer.

Do we want an institution like the ECB to exercise such discretion? The German critics of the ECB QE program seem to be calling for precisely that. There are three options of dealing with this dilemma. The first is to widen the rules so much, that they gave a significant amount of discretion both in normal times and in crises. The dual mandate of price stability and employment of the Federal Reserve is a case in point. This duality allowed the Federal Reserve to give priority to the employment objective during the crisis and pursue a strong expansionary monetary policy stance as fully consistent with its mandate. While the Fed's dual mandate may have disadvantages in normal times – more to that below – it has the advantage of a high degree of flexibility and discretion during crisis times.

A second option is the one pursued by the Bank of England, which since May 1997 has a very narrow mandate of price stability around 2% each year. The UK experienced a period of high inflation rates approaching 5% in 2010 and 2011. Despite the Bank of England missing its target by a wide margin, it decided to pursue an even more expansionary monetary policy stance, including the adoption of a QE sovereign debt purchase program. Implicitly the Bank of England had decided that achieving its inflation target was either not feasible or not desirable over the short run. Rather than having hurt the Bank of

England's credibility, as an institution it has widely received support and respect for its decisions during that period.

Yet there is a third possibility, one that was pursued at times by the Bank of England and the Chancellor of the Exchequer as early as in the mid-19<sup>th</sup> century. At that time, the Bank of England had to follow the law that it could issue only as many banknotes as were backed by government bonds and gold. However, the Chancellor of the Exchequer issued a Letter of Indemnity, stating that the Bank of England would not be prosecuted for its violation of this law. This allowed preserving the principle, but at the same time granted an exception. This arrangement proved successful in calming financial markets during the panics of 1848, 1857 and 1866, without requiring the Bank of England to deviate much from the law. Thus, the announcement of such a tight rule coupled with an exception, and the underlying threat that the Bank of England was allowed and capable of acting decisively, was sufficient to prevent speculative attacks and bank runs during those episodes.

### **What mandate for the ECB?**

This leads to the second question: should the mandate of the ECB be changed, and if so how? There are four aspects for answering this question. The first one relates to the objectives the ECB should follow. The criticism of the ECB's QE program implies that there may be times when other objective of price stability should dominate – either because these objectives are more important, or because achieving price stability comes with an excessive cost.

There is hardly any central bank in the world that has a more ambitious objective than the ECB. While the Treaty assigns the mandate of price stability, the ECB itself has the responsibility of defining price stability. Initially been defined as inflation below 2%, it was revised in 2003 to become an inflation rate of “below but close to 2% over the medium term”, which by many is understood to be somewhere in the range between 1.6% and 2.0%. The specification “over the medium term” means that the ECB is not missing its objective if the inflation rate deviates temporarily and inflation expectations over the next one to two years remain well anchored, i.e. inflation is expected to return to this range rapidly.

The advantage of having such a narrow and specific objective is that it is highly transparent and makes the ECB accountable. It also helps ECB anchor expectations and guide financial markets and economic agents in the real economy. The drawback, however, is that in crisis times the ECB may be missing this objective, thus on the one hand threatening the credibility of the ECB if it does not manage to fulfill its mandate for an extended period of time. On the other hand, having a single mandate also means it has little leeway to pursue other objectives, such as on financial stability and economic stability, if they are not fully consistent with that of price stability.

The alternative is to pursue a wider and more flexible mandate, such as the Bundesbank with its mandate of monetary stability before 1998 or the Federal Reserve with its dual mandate today. The advantage of such a broader mandate is that it may be more consistent with the true social welfare function of society, which goes far beyond that of price stability, and an added flexibility in crisis times. Potential drawbacks are that a vague or dual mandate makes it hard to anchor expectations and guide economic agents. Moreover, as a central bank usually has only a single policy instrument in normal

times, namely the interest rate, it may simply not be capable of pursuing more than one objective at a time.

This debate on the mandate of the ECB is an important one. Inflation targeting has become the panacea of central banks worldwide since the early 1990s. But academic literature in recent years has shown that there is no significant evidence that inflation-targeting central banks are necessary more successful even achieving price stability. It has proven to be successful to adopt an inflation target when a country comes from a period of high or even hyper-inflation, and when a central bank lacks credibility. But there is no evidence that established central banks perform systematically better with an inflation target.

A second element relates to the specification of a given target. A specific target to inflation or employment helps anchor expectations and guide economic agents. However, missing the specific targets too often and by too a wide margin risk the credibility and thus the effectiveness of the monetary authority. Implicitly the German criticism of the ECB's QE program, as discussed above, was notion that the ECB is too vicious in setting itself such a narrow range of 1.6-2.0% for price stability. Some critics argue that even inflation rate of 0% should be permissible. As outlined above, there are strong arguments against such a definition of price stability. However, it is important to ask what the precise definition of price stability should be. The IMF's chief economist Olivier Blanchard had argued for the ECB to raise its inflation objective to 4% in order to have more room for cutting interest rates and avoiding the deflation we are in today.

Equally important is the time dimension. An issue that is important for the ECB today, but which is hardly discussed, is whether the ECB's determined pursuit of price stability over the short to medium-term comes at the expense of price stability in the long-run. If the critics of the ECB's QE program are right, the financial stability risks of the program may mean that it might become more difficult for the ECB to deliver on its mandate in five or ten years' time.

A third key element is the relationship between monetary policy and other fields of economic policymaking. In particular for the ECB, but also for the central banks, there has been a fundamental shift in the relationship of monetary authorities with political authorities. Overall, there has been a strong shift that implies that the de facto independence of the ECB has been curtailed significantly over the past few years. They are four dimensions along which these de facto independence - or ability to act flexibly and credibly in pursuit of the mandate - has been curtailed for the ECB.

The ECB's operational independence has become more limited. Before the global and European crises, the ECB enjoyed a high degree of monetary autonomy, in the sense that its decisions are primarily guided by factors directly affecting price stability. However, the degree of monetary autonomy of the ECB has become much smaller during the crisis and today's equilibrium is best described by one of a financial stability dominance or even fiscal dominance, and in that the ECB's actions are ever more determined by fiscal and structural policies (or the lack thereof) and financial stability considerations. This has made it much harder for the ECB to successfully achieve its mandate of price stability. In fact, the current period of deflation is hardly due to an insufficiently expansionary monetary policy, but rather the deep economic and financial crisis coupled with insufficient structural and fiscal reforms.

The ECB's political independence has been compromised. It has become popular in almost all euro area countries to blame the euro and the ECB for much of the crisis and the slow recovery. Politicians in many southern European countries blame the ECB for not acting decisively enough. By contrast, politicians in Germany and other northern European countries blame the ECB for doing too much. The ECB is not innocent in this regard. The ECB has explicitly and willingly taken a political role by accepting to be part of the Troika supervising the rescue programs for euro area countries.

The ECB is in the process of losing part of its legal independence and autonomy. The recommendation by the German Constitutional Court (GCC) that the ECB's OMT program is illegal and in violation of European law poses a considerable legal threat to the ECB and its ability to conduct monetary policy. If the position of the GCC prevails, the ECB may not be able to use certain monetary policy instruments any longer, such as the purchase of government bonds in secondary markets. It thereby would be deprived of important instruments, which ultimately would make it much harder if not impossible for the ECB to fulfill its role in particular as a lender of last resort during crisis times.

And the ECB has been losing part of its independence in an institutional sense. The disagreement among members of the Governing Council has been perceived in many countries, and in particular in Germany, as a sign of weakness and has hurt the credibility and reputation of the ECB. The perception in Germany is that the ECB takes decisions in favor of southern European countries and to the detriment of Germany. The Governing Council has failed to convey convincingly, at least in Germany, that its decisions are exclusively taken with the euro area wide perspective in mind.

This shows that the ECB's philosophy, which is based on taking decisions in a consensual manner and obliging all members of the Governing Council to take a euro area-wide perspective, has failed and needs to be fundamentally revamped. The governors of the national central banks do not accept taking a euro area wide perspective, but undoubtedly and sometimes openly vote and argue along national lines and perspectives. Hence the public perception in Germany has become overwhelmingly that its own representative from the Bundesbank has been outvoted ECB policy is acting against Germany's best interest. And it is also logical why calls in Germany have become stronger for the Bundesbank to get a bigger voting share. If governments are de facto voting according to national positions, why should the governor of Malta or of Cyprus have the same influence as the German? In fact, it is possible that the governors of the small euro area countries form a majority in the Governing Council while representing less than 20% of the euro area economy.

There are at least three ways of solving this inconsistency. A first one is a change in the constituencies (as proposed by Michael Burda), i.e. to make individual Governing Council members not responsible for representing individual member nations, but rather parts of several nations. A second option is to give a majority of votes to those Governing Council members, namely the members of the executive board of the ECB, who do not act and decide along national interests, but have a truly euro area wide perspective. This is essentially the model of the Federal Reserve. And third option is to follow the example of the Bank of England, and not to have regional or national representatives, but rather additional external expert members who have no national affiliation.

## **VI. Conclusions**

The controversy in Europe over the ECB is much more than a discussion over the best course of action to achieve the ECB's mandate of price stability. There can be no doubt that the ECB has been missing its mandate of price stability over the medium term. The criticism of the ECB, in particular in Germany, highlights a deep dissatisfaction with the narrow ECB's mandate of price stability of below but close to 2% over the medium term. The expansionary monetary policy stance of the ECB aims at returning inflation in the euro area to what is consistent with price stability. Yet it also poses significant risk to financial stability and economic stability in the euro area.

The same critics who reject both the OMT program and QE program the ECB essentially argue that the ECB should give up on its mandate of price stability, at least temporarily. The issue of the mandate of the ECB is indeed an important one that needs to be discussed and considered seriously. Pursuing a narrow price stability mandate should not be a panacea. There is no compelling evidence that alternative monetary policy mandates are less successful, in particular in crisis times. A major challenge for the ECB, and any central bank, is that a mandate that is desirable in normal times, may no longer be appropriate in crisis times. A Letter of Indemnity from the euro area governments could provide an elegant and credible option for the ECB to act more effectively.

A second challenge is a precise definition of the ECB's mandate. The arguments presented in this paper entail that a wider mandate than mere price stability gives monetary authorities more discretion in crisis times to react flexibly and credibly, and thus to be more effective. Finally, important priority for the ECB must be to regain its de facto independence, i.e. its ability to act credibly and flexibly. This requires clarification of the ECB's mandates and instruments in the Treaty as well as more responsible political decisions to tackle the underlying problems of the European crisis. But it also requires the ECB to distance itself from playing a political role by withdrawing from the Troika. And it should induce the ECB to redesign its philosophy of decision-making, which needs to take into account that many of its Governing Council members vote along national lines.

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