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What is the European Central Bank's logic?

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We know it and can see it: the European Central Bank (ECB) "controls" the euro and the euro "controls" the euro zone. This means "controlling" the zone to bring it out of the financial crisis which is in reality a slow, difficult mutation. To win this role the ECB has had to take on a series of problems and legacies, which are much more complex than those faced by the American Federal Reserve (Fed) for example, in a situation that has also been much more difficult. There it does have some merit.

Broadly speaking the single currency which was conceived as an economic and financial wager, is fact extremely political. Bringing together countries, of various origins, to give them a single currency according to budgetary and financial criteria alone (Maastricht Criteria) after a relatively short period of preparation and follow-up, was indeed a major risk. This was all the more so since it was clearly announced that there would be no going back on the euro, in order to emphasise the commitment of all involved. In other words, leaving the euro would not just mean leaving the euro zone but, more seriously, it means leaving the dynamic of Europe, with the risk of it disappearing altogether. Beyond the stages in European integration the euro is a qualitative schism. It is a one-way ticket, undoubtedly to a wonderful, yet unprecedented destination, but which is not really defined in terms of its method – although its design is clear – as it is with all great journeys.

THE EURO ZONE: AN INHERENTLY MONETARY ZONE

This monetary zone is not "optimal" in a textbook sense of the term since it is extremely political. Ensuring that Europe no longer went to war - the best means to be wiped from the map - then ensuring that it reduced its internal differences for it to have greater influence in a world made up of large units: this was the strategic choice of the Fathers of Europe. Who, in all seriousness would want to counter that?

This choice explains that each time the political has to assume its responsibilities and settle unsolved problems from the very start. Indeed if we had waited for the so-called theoretical conditions to be achieved, the euro zone would never have been born, no more incidentally than the sterling (UK) or the dollar (USA) zones. All monetary zones are inherently political. This is why Europe also moves forward to the rhythm of its crises, notably within the euro zone, in undertaking and fulfilling its very new design. The price to pay for this has been a succession of tense situations then settlements, and their cost - a certain slowness in growth, with the ensuing political dangers and their price in terms of employment. But we have to compare this price with that of internal disintegration and tension that would have occurred in a world that is consolidating into large "blocks". We might still think that the euro zone is moving along slowly, but at least it is advancing.

The ECB operates in a crisis-prone context because it is unstable and political. At base this is beneficial to the bank. The latter is setting itself up as the jurisdiction of last-resort regulation. Firstly the member countries of the zone are clearly becoming more technical. Due to pressure from shocks and crises they are introducing systems to prepare, present as well as for the acceptance of their national budgets that are established according to a Community logic (European Semester). The focus is now on how national budgets are harmonising according to common hypotheses, how much each of

these fits into the logic of reducing their own deficits in order to reduce structural imbalances, then how all of this "comes together". In all of this, not only does the ECB watch over the hypotheses in their early stages since its own cannot be forgotten during the planning; it also creates a common economic framework for all of the economic and financial players involved, starting with the financial markets.

EITHER THE ECB IS CREDIBLE OR IT ISN'T

The ECB's credibility comes rather more from the financial markets (which we cannot believe to be benevolent) than from rules and regulations, even though the latter form the Bank's base. This is some achievement. Of course the ECB draws its strength from the law. It is independent of political decision makers and is rule-based, in other words it is beyond any partisan influence. This base is its starting point, hence its permanent reference to texts and even more to its mandate which founds both its legitimacy and its responsibility. We should remember if we are to understand this point and the issues at stake that it has already been summoned to the German Constitutional Court by the Bundesbank (!), as well as by other private German parties. They challenged its steps in support of States in difficulty. The Karlsruhe Court turned to the European Court of Justice (ECJ) which auditioned the General Prosecutor – which supported the ECB. But beyond the texts and the respect of these, the ECB's effective legitimacy is decisive. It depends on the results achieved according to the goals set, and this taking on board the difficulties to overcome.

The ECB's goal of goals is stability, in other words, to avoid crises, attenuate their effects when they occur and to stabilise steady state economic performance. To do this the ECB's clear goal is to achieve mid-term price stability. This is monetary stability: close to and below 2% mid-term. This goal means that it is in line with the Bundesbank and the "culture of stability" that this entails.

The goal of price stability is more complicated and far reaching than it might appear. It means providing economic actors with a credible mid-term 2-year vision

of prices, firstly via communications, then by action. Managing expectations can extend to five years so that the path is better benchmarked. It is gauged by assessments and by interest rates extracted from various financial products. Hence if entrepreneurs and employees are given a credible price vision they also have a vision of the average prices of their own products and therefore of wages and of margins. The channel of the ECB's price-based expectations comprises seeing and deciding whether, ultimately, businesses are committing to a policy in which wages remain below productivity, therefore whether margins will be maintained and with that investment, competitiveness and employment mid-term. In fact and implicitly the ECB speaks of midterm prices and of its mandate that comprises their stabilisation. It speaks implicitly of profit and investment – in other words of growth and employment mid-term and of major balances in the euro zone. We therefore understand the interdependence of the ECB's legal base and the way it fulfils its mission in the eyes of the market and the public which are not as different from one another as we might think. Because basically the public wants stability.

MONETARY AND FINANCIAL STABILITY

With time and the crisis another of the ECB's goals grown in importance alongside monetary stability (prices), and that is financial stability. This now means that the ECB has responsibility over the quality of the banking and financial system to resist shocks and to continue financing the economy. Before this it "took care" of monetary stability and "contributed" towards financial stability. Now these two responsibilities are almost of equal importance. The extension of its goals, its responsibilities in fact has not been easy.

In the beginning the ECB did not want any further responsibility in terms of financial stability. It feared that its independence would be diminished and especially that goals would conflict. In the case where for example it would have to raise its rates and slow the economy to counter inflation – one or several banks might be weakened and risk undermining financial stability.

In fact the situation is quite clear: price stability takes precedence, with the monetary and banking means that now go with it. This is not a theoretical position. The ECB controls the quality of the banks and in record time, of Banking Union, after a European Parliament vote. The major banks in the euro zone are followed directly in Frankfurt-am-Main, with the latter having authority to undertaken investigations into smaller establishments. They are monitored locally but under central authority. This was all introduced after a detailed assessment of the accounts of all of the banks working in the zone, after stress tests (which are going to be a regular occurrence) and living wills, in which each bank has to set down what it would do in the event of a severe shock (cessation of activity, closure etc.). During each of these stages the armed branch of financial stability, the Single Supervisory Mechanism, established in Frankfurt-am-Main in the former ECB tower works together with the branch responsible for monetary stability, the ECB, and hence under the latter's authority.

FIVE TRUTHS TO BE SAID

The first is that in the euro zone the single currency moving towards an economic policy for which there has not been enough communication or preparation: the fight to counter inflation and the quest for competitiveness with the ensuing consequences. It is clear that transferring over to a single currency no longer means devaluing national currencies, for the simple reason that they no longer exist. In each Member State of the zone the right strategy is then to follow macro-economic (budgetary) and microeconomic rules (businesses) which support competitiveness. This reduces the risks, drawing each one closer to the "best performer" - in this case, Germany. The clearest marker of this "good strategy" is to be slightly or not inflationist at all, in all events less than the others and of course less than one's main trade competitors.

The second truth, unfortunately, is that poor strategy is not paid for immediately or directly. The loss of competitiveness through prices is paid on exports, via rising external deficits. But this does not weaken the erstwhile national currency. It emerges later in terms of job losses, reduced activity, and diminished budgetary

resources. The loss of domestic competitiveness no longer implies a rapid weakening of exchange rates but now a later deterioration of unemployment, budgetary deficit, the rise of the government debt and the financing spread in relation to the "best performer". It is slower, more indirect and more perverse.

The third truth is that if mistakes are not paid for immediately we are encouraged to make even more. Indeed painless external and budgetary deficits encourage us to go further. Countries that are losing competitiveness generally try to go faster by pushing growth, not by developing their exports - which they are increasingly unable to do - but by attracting more and more real estate investors. Real estate bubbles notably in the south are to be found in countries that are struggling externally and that want to "catch-up" growth and living standards rapidly in comparison with the European average. This is what led to the Spanish, Portuguese and Greek catastrophes.

The fourth truth is that economic laws continue to operate within the single currency, even though each country is asked to take the best care of its own accounts - in other words, to reduce the budgetary deficit. We can always say that the single currency will function without the bail out of a struggling State by the others, but this does not stop economic competition laws from operating. They do this all the more so since the economic area has enlarged. Exchange risks have disappeared and the spreads of rates between States, during the whole initial period of the single currency, depending on their relative management quality, are weak or zero. Because of the way it is structured the single currency causes polarization towards the most efficient countries, the best managed and the most innovative regions. The single currency makes the gaps bigger.

The fifth truth is that any monetary union implies a transfer union. To compensate for the effects of polarisation created by the currency all countries have an inherent internal transfer system. Big towns distribute a share of their wealth to the poorer regions. Every country is both a monetary area and a transfer union. The euro zone aimed to reduce this logic by

promoting regional policies that were designed to reduce the most obvious differences – this entails major projects and access improvement programmes to reduce inequalities with a Community budget for a simultaneous development of the zone. But the means of coordination and compensation have been constantly reduced and the logic of a transfer union postponed. This has meant that many countries whose external competitiveness has been declining, have continued to bury their heads in the sand at the risk of the bubbles they have created collapsing. At base real estate bubbles are the reverse side of "normal" competitive inadequacies and monitoring and support policies in the zone. If we are not "good" at exporting then we build more housing taking advantage of low rates and extremely low monitoring levels by the national Central Banks and bank loans. We carry on until it all goes pop!

THE ECB WILL HAVE EVEN MORE AUTHORITY IN THE FUTURE

Many of these excesses have not gone unnoticed and yet the differences in situation have increased imbalances between regions and they have especially caused tension between States. The Maastricht Criteria are no longer respected and this led to the sanction of France and Germany (2002). This was avoided via a political manoeuvre at the cost of a general weakening of the monitoring and sanctions system. From this there emerged a budgetary monitoring system that was supposed to be more restrictive, but which is swift to sanction "small countries", like Portugal and Spain for example, rather than the "big" countries like France for example.

The monetary rule is more powerful than the budgetary rule and this is increasingly the case. The budgetary system – in spite of it being rule-based, as well as being increasingly precise and restrictive, and even though threats are increasingly credible, is still weaker and more subject to interpretation than the rule-based system of the Central Bank. Indeed there is no rule that obliges debt stability, which is a long term phenomenon, and difficult to monitor mid-term. However the obligation to restrict inflation can be seen quickly and easily by internal players and even more so by the financial markets. This

was the theme of Benoît Coeuré's that took place on 2nd February 2015 in Budapest (*Lamfalussy was right: independence and interdependence in a monetary union*). The ECB's mandate, which is legal at its base, is all the more respected since all monetary and financial alerts are ringing and it is working.

REASONS AND PROBLEMS IN THE LATE TRANSFER OVER TO QUANTITATIVE EASING

We might deem that the ECB launched quantitative easing (QE) rather late, in the ilk of the USA, UK and Japan. But it waited to have more technical means to act and especially more legitimacy. The euro zone is recent and differentiated. This has counted in the crisis and continues to do so. It has enabled the development of management errors – budgetary deficits, wages rising beyond productivity, bubbles and bank crises, even though price stability has been achieved across the zone! The rise of the ECB's financial stability goal will change matters in the future with banking union, bank recapitalisation, new liquidity ratios and stress tests. At base the euro zone is now better equipped to move forward and emerge from the crisis. It has increased its monetary dominance, since political crises have all been overcome to achieve this result.

But in fact this is an *ultima ratio*, according to banking and financial logic. Indeed for the ECB to be able to purchase government bonds, Mario Draghi, its president had to wait for economic recovery not to occur and for inflation to start going into the negative, since deflation was becoming a real danger. It was then legitimate for him to act in terms of his price stability mandate (inflation close and below 2% mid-term) when it turned negative! The ECJ's Prosecutor General expressed his support of this move. The ECB has acted late in comparison with the Fed, and it now has economic reasons and legal instruments to do so. However the euro zone's problems are not yet over. It generally finances itself via bank loans (to a total of 2/3), which is the opposite of the USA. The euro zone is based on banks – the dollar is based on the market: the first is intermediated, in other words indirectly – the second is direct. To help recovery with short term rates, and now with low long term rates in the euro zone, the banks, which are now stronger,

have to accept lending to entrepreneurs who want more loans whilst large and middle sized companies will go more to the markets. Credit is now reactivating in the euro zone, slowly but is lagging behind the markets.

COLCLUSION

In sum the ECB has benefited from the euro zone in this crisis as it has strengthened its scope and its centralising and therefore federal role. However it shows what remains to be done to improve this monetary zone by strengthening growth and by reducing budgetary deficits. Assuming transfer union indeed means more growth, therefore increased mobility of factors, greater flexibility and reform in business and work relations – except if careless risks are taken for its stability. This means greater corporate mobility, therefore fiscal harmonisation moving towards a financial market union. In the crisis "a more perfect union" has been created with the States which will have to become more pragmatic. The euro zone has changed us – and we are not all able admit it. Fundamentally it has even changed our approach to sovereignty.

Nothing was clearer in this regard than the speech given by Mario Draghi on 9th October 2013 at the Harvard Kennedy School. We are no longer with the "absolutists such as Jean Bodin, in the 16th century. In this case sovereignty is defined in relation to rights: the right to declare war and to negotiate peace conditions, to raise taxes, to print money and be a last resort judge. There is also a positive approach to the issue. In this instance sovereignty is related to the ability to guarantee the vital services that the population expects of its government. A sovereign who cannot effectively fulfil his mandate will only be sovereign in name ... our direction is pragmatic, oriented towards political efficacy and the provision of services that our citizens are expecting of their governments. We shall then draw the political conclusions when the time comes". This recalls that "it will be built through concrete achievements which first create a de facto solidarity" [1].

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Chairman of Betbeze Conseil, Chairman of the Foundation's Scientific Committee

1. Robert Schuman,
Declaration of 9th May 1950.

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