Five views: What we've learned from 20 years of the European Central Bank

The European Central Bank was established 20 years ago today on 1 June 1998. To mark the anniversary, we asked five academics to give their views on the lessons learned from two decades of the ECB, and their predictions on what might lie in store for both the ECB and the euro over the next 20 years.

- **Paul De Grauwe: Lessons of the financial crisis for the ECB**
- **Waltraud Schelkle: The ECB at 20: Not like its boring older brother**
- **Sebastian Diessner: Happy 20th Birthday, ECB – here's to many more?**
- **Hjalte Lokdam: The next 20 years may see the Eurozone become a federal (economic) state**
- **Shahin Vallée: The Eurozone crisis unearthed profound flaws in the architecture of the euro area that make reviewing the design and operations of the ECB a necessity**

Paul De Grauwe: Lessons of the financial crisis for the ECB

At the end of the 1980s, the Delors Committee created the blueprint of the future central bank of the European Monetary Union. This was a time of (relative) financial stability. No major financial crisis had occurred in Western Europe since the Second World War.

This was also the time when monetarism was very popular, both in academia and among central bankers. Monetarism told the central bankers two things that they loved. First, the central bank should return to its core business, which is stabilising the purchasing power of money. Or put differently (but equivalently), stabilising the price level. Second, in order to achieve the objective of price stability, the central bank should be made politically independent.

In the past, most central banks were created, not to stabilise the price level, but to stabilise the financial system (especially the banking system). The historical experience showed that an unregulated financial system without a lender of last resort is inherently unstable. But all this was deemed to be of little importance when the ECB was created. If the ECB maintained price stability, so went the theory, all the rest would follow automatically: low inflation would ensure that the economic system is stable, and this in turn would allow efficient financial markets to deliver financial stability.

The awakening was rude. After a period of euphoria and bubbles, during which the ECB (but not only the ECB) stood on the sidelines and did little to counter speculative frenzy, the crash came in 2008. Suddenly the ECB learned that the script had to be radically changed. What did the ECB learn?

First, a central bank should care about financial stability as much as it does about price stability. Price stability is not a guarantee for financial stability. Conversely, financial instability endangers price stability. The idea that the central bank should only care about price stability had to be thrown into the garbage bin.

Second, a central bank of a monetary union should extend its lender of last resort function to the government bond markets. The ECB found out during the sovereign debt crisis of 2010-12 that the government bond markets are inherently unstable. As none of the sovereigns is backed by its own central bank, these sovereigns can easily become victims of self-fulfilling panic that leads investors to dump the government bonds deemed risky and to buy safe-haven bonds in the monetary union. This leads to massive destabilising capital flows within the union that only the ECB can stop. It took the ECB some time to understand this, but in 2012 it stepped into the fray and announced its OMT-programme that saved the Eurozone from collapse.

Third, the political independence of a central bank is fine in normal times. In crisis times when the existence of the sovereign is at stake, the independence of the central bank is limited. That is certainly the case in standalone countries, like the UK. There can be no doubt that when the UK government experiences an existential crisis the government will (and should) prevail over the central bank which will be forced to provide liquidity.

This should also be the rule in the Eurozone. But here there is a complication: there is one central bank and 19 sovereigns, none of which can impose its will on the ECB. This creates uncertainty about the willingness of the ECB to support the sovereigns in future crisis situations. And these are coming for sure. This uncertainty will continue to be a major source of fragility for the Eurozone.

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Waltraud Schelkle: The ECB at 20: Not like its boring older brother

The ECB was the brainchild of an intellectual fashion. The supranational central bank was meant to demonstrate 'the advantage of tying government's hands' by delegating policies to independent agencies. The brainchild was expected to be conservative and aloof like its boring older brother, the Bundesbank: narrowly focusing on price stability and independent by being uncooperative with fiscal authorities. In its early years, the ECB seemed to live up to these expectations of a prematurely ageing posterchild of monetary conservatism.

Yet, the ECB has grown up to be an agile, boisterous teenager. Like all youth, it is at times inconsistent and devious in its behaviour. But it has also been a necessary challenge to its conservative progenitors. How come? The Eurozone crisis forced the ECB to challenge the original understanding of independence as separation from fiscal policy on which influential German commentators publicly insisted.

During the crisis, the ECB noted that it needed cooperation from fiscal authorities or else it would have to throw a permanent lifeline of liquidity to insolvent zombie banks. The ECB thus insisted on institution building that would enshrine a new division of labour. It requested the creation of an emergency fund in return for the first bond-buying programme and a banking union in return for the announcement of Outright Monetary Transactions that put it on par with private holders of bonds should they default. These quid-pro-quos provided time for democratically elected governments to come to agreements that cannot be taken over night.

These institutions can underpin independent central banking in that they prevent the ECB's hands being constantly forced by market panic. Yet, this puts the ECB at loggerheads with the old disciplinarians. They see cooperation with governments as a slippery slope to 'politicisation'. The response of the German government has been to politicise the succession of Mario Draghi and send Bundesbank President Weidmann into the campaign. There is a precedent to this politicisation: the first two chief economists of the ECB had to be German, even though their academic credentials were decidedly underwhelming.

One lesson of the first 20 years of the ECB is that the foremost supporters of central bank independence are also its greatest threat. The confrontation with these disciplinarians made the ECB a much more interesting central bank than anybody had feared or hoped for. I believe that it will stay that way. The next 20 years will be no less interesting as German policymakers will continue to interfere. But this interference will ultimately meet with limited success. The next ECB President, be it Weidmann or not, will have to lead an institution of the future, not of an outdated past.

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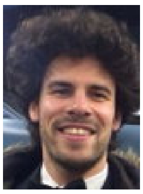

Sebastian Diessner: Happy 20th Birthday, ECB – here's to many more?

The ECB's first ten years of seemingly worry-free childhood were followed by ten more troublesome years as a teen and adolescent. When Lehman Brothers filed for bankruptcy in September 2008, the deceptively calm waters of the first decade of monetary union soon made way for a protracted financial crisis that embroiled large parts of the Eurozone.

Amid the ensuing turmoil, the ECB's more recent history will long be remembered for Mario Draghi's bold announcement to do 'whatever it takes to preserve the euro' – a surprise commitment squeezed into a speech at a London conference in the summer of 2012. The commitment itself – to not let the Eurozone be torn apart by diverging government bond spreads – is often said to have calmed panicking markets with near-magical efficacy. But once we scratch beyond the surface, we see that while bold action by the central bank was indeed essential, the credibility of Draghi's commitment was ultimately contingent on the tacit collaboration and supporting actions of powerful Eurozone governments.

The biggest lesson we have thus learned – or may still need to learn – from the past two decades is that while the immediate fate of Europe's monetary union can be safeguarded by the mighty central bankers in Frankfurt, its long-term sustainability cannot. Rather, the ECB is in need of credible and cooperative counterparts. In the first instance, this requires not merely the creation of an outright supranational fiscal authority, as is often argued, but also a readiness among monetary and fiscal authorities to cooperate: while Eurozone governments need to come round to backing the ECB where need be, the ECB should equally not let itself be driven by a mistaken understanding of central bank independence as a strict and uncompromising divorce between monetary and fiscal policy. While the line between independence and cooperation, as well as that between 'normal' and crisis times, might be difficult to draw, renewed efforts need to be undertaken to clarify the central bank's and Eurozone governments' respective responsibilities – as well as to gain a better understanding about the deep-seated uncertainties that might render such *ex ante* clarification difficult.

While the upcoming June summit of European heads of state and government is unlikely to produce anything beyond a Eurozone budget line that hardly deserves its name, the ECB might eventually run out of time to obtain meaningful support. Mounting instability in the government bond market of Italy, for instance, could well mean that the central bank's promise to do 'whatever it takes' will be called into question sooner rather than later. After the formative period of its childhood and teenage years, Eurozone governments now need to ensure that the European Central Bank benefits from an independent adulthood, but within a cooperative European family, if the monetary union is to strive for another 20 years or more.

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Hjalte Lokdam: The next 20 years may see the Eurozone become a federal (economic) state

One fairly obvious lesson of the first two decades of the ECB's existence is that the separation of responsibility for monetary and fiscal policy is unsustainable. The rules-based approach to economic policy that was created in order to support the functioning of the single monetary policy showed its weaknesses early on, with the failure to discipline France and Germany for infringing the Stability and Growth Pact. This failure was, following some of Michel Aglietta's and Charles Goodhart's writings, fundamentally linked to the question of sovereignty; while monetary sovereignty had been transferred to the ECB, Member States retained and jealously guarded their political sovereignty, particularly within the fiscal domain. The economic convergence that was 'supposed' to happen following the introduction of the euro happened neither by the Member States' own initiative nor by the invisible but firm disciplining hand of the market.

In the Eurozone crisis, the full consequences of this disjunction of sovereignty emerged and the monetary union entered an existential crisis. The ECB then stepped in and acted as if its mandate was the political stability of the Eurozone rather than the much narrower price stability mandate. In doing so, the ECB reintegrated monetary and political sovereignty and supplied the radical assurance that the markets needed at the time: there was a strong political will behind the euro.

With the Outright Monetary Transactions programme in particular, the ECB suspended market evaluations of Member States' public debts and finances and introduced the logic of *raison d'État*: against existential threats, the political community asserts itself in any way necessary to assure its own survival. In the process, some of the core normative principles (rationality of markets, rule of law) of the EMU were, at least temporarily, suspended.

But the ECB did not act entirely on its own. The Member States similarly moved to centralise and strengthen public powers to regulate not only financial markets and banks but also the economic structure of the constituent states. During the crisis, therefore, the Eurozone, in important part due to the ECB's initiative, moved towards reintegrating monetary and political sovereignty. While this process is incomplete, it points to what we might expect the Eurozone to look like in 20 years. If the euro hasn't fallen at the feet of resurgent nationalisms, we might expect the Eurozone, whether larger or smaller, to move towards centralising political responsibility for the economic affairs of the constituent states. We might, in other words, expect the Eurozone to become a federal (economic) state. Hopefully it will also be democratic.

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Shahin Vallée: The Eurozone crisis unearthed profound flaws in the architecture of the euro area that make reviewing the design and operations of the ECB a necessity

Coming out of its teenage years, the European Central Bank could be happy about its emergence from a violent teenage crisis and entry into adulthood. But the reality is somewhat more concerning. The ECB, while a beautiful construct in the abstract, still rests on a shaky economic, institutional and political structure. The issues that arise from having a *currency without a State,* described by Tommaso Padoa Schioppa as the central problem of the single currency, have become all the more visible in the last few years and have not been properly addressed.

The ECB will therefore continue to face daunting challenges over the next decades and its response and attitude in the face of financial and political adversity will be critical to the euro area and more broadly to Europe's future. There are several issues that are particularly important for the ECB in the next 20 years

First, its doctrine as a lender of last resort to both banks and governments has been tested and while it appears to have settled for an effective operational framework, there is still considerable uncertainty about the predictability of its function as a lender of last resort to banks, in particular in the use of Emergency Liquidity Assistance, which remains decentralised. Its backstop to government debt markets in the event of redenomination risk remains untested. The introduction of the Open Market Transactions programme in the summer of 2012 has played a critical role in stabilising the euro area, but it has never been used and its architecture remains subject to risks, in particular due to the fact that a financial assistance programme is required for its activation.

Second, the question of the capitalisation of the European Central Bank and the National Central Bank remains an important one because it betrays a form of discomfort for the risk that the central banks should undertake during the conduct of its monetary operations and a need for a form of fiscal or sovereign backing. The ECB has developed a shaky notion of *financial independence* that requires central banks to have sufficient levels of equity to undertake its missions. But this doctrine is intellectually flawed and applied with a great degree of inconsistency. The ECB ought to clarify that central bank equity is an accounting fiction and that unlike a commercial bank it can function with or without capital.

Third, the question of the irreversibility of the single currency has also been a critical point of tension in the conduct of the ECB operations over the last decade. Indeed, while the ECB has repeated the mantra that the euro was irreversible, it has not always behaved accordingly. Indeed, the introduction of capital controls in Cyprus or Greece, although presented as a safeguard measure for the stability of the financial system, effectively introduced a break-down of the par convertibility of money across national borders sanctioned by the ECB. Since then, two events have challenged further the notion that the euro is truly irreversible: the Brexit referendum and the realisation that Member States could vote and decide to leave the European Union; and the emergence in the euro area of political parties officially preparing for the introduction of a parallel currency and/or a euro exit.

Finally, the question of central bank independence has evolved tremendously since the concept emerged in the 1980s and 1990s. The ECB, while retaining its independence, needs to radically increase its transparency and its level of accountability. At the very least, it should release the votes of the governing council members on policy issues as the Federal Reserve does. This will become even more important now that a rotating mechanism has been introduced and given not all central bank governors are voting. In addition, it needs to release fuller sets of accounts from its policy discussions. The appointment process also needs to become more transparent and the executive board members should face a proper hearing/vetting by the European Parliament. Without prejudice to the independence of the Central Bank, the dialogue between the Commission, the Council and the Central Bank should be enhanced to ensure that while not diverting from its mandate, the ECB more actively contributes to the economic policy objectives of the union as the Treaty demands.

All in all, the Eurozone crisis unearthed profound flaws in the architecture of the euro area that make reviewing the design and operations of the ECB a necessity. So far, the intellectual and academic debate has focused on the economic, fiscal and political reality, but the monetary realm should not be neglected.

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Note: EUROPP's editors are grateful to Sebastian Diessner for his initiative in putting this article together. The article gives the views of the authors, not the position of EUROPP – European Politics and Policy or the London School of Economics. Featured image credit: Jonas M Luster(CC BY-SA 3.0)