Peter Praet: The role of the European Central Bank - pudence and responsibility in times of crisis

Lecture by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the "Heidelberg Symposium", Heidelberg, 11 May 2017.

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Accompanying slides

The ECB's mandate, instruments, and accountability

In the wake of the economic fallout from the global financial crisis, central banks have deployed novel policy instruments on a grand scale. It was to be expected that these decisions would spark fierce debates on central bank mandates, roles and instruments. In certain quarters, central banks have come to be perceived as institutions which are eager to expand their mission and take on more powers, but reluctant to scale up – in parallel – the obligations associated with being accountable to the public. Partly in connection with this criticism, concerns were expressed about the unintended, adverse side effects that the new policy instruments might cause.[1] Overall, the debate as to whether central banks have availed themselves of the resources and powers conferred upon them by their statutes in a *responsible* way takes us right to the central topic of this Symposium.

Speaking as a central banker on the role and instruments of the ECB and on the means and ends of monetary policy here at Heidelberg University, I am, of course, reminded of Max Weber's famous lecture on politics held in 1918 about *Verantwortungs-* versus *Gesinnungsethik* (the ethics of responsibility versus the ethics of conviction[2]). Max Weber's considerations pivoted around a potential dilemma between the ethical values of the means and the ultimate ends of public policies. In the light of the difficult historical circumstances at the time, he went so far as to conjecture that achieving "good" goals may, in certain instances, require having to accept dubious means to achieve them.

Has monetary policy been exposed to such challenging choices in modern times? In Germany, after World War II, the Bundesbank was established by an act of collective will deliberately founded on a rejection of that dilemma. The culture of stability that was established in the country after the war aimed to avoid precisely that type of conflict between goals and instruments. In line with this aim, society should avoid too ample a scope for discretion and – in the end – arbitrariness being given to unelected policymakers. The positions expressed by numerous German participants in the debate about the ECB's policies can indeed be read in this light. The tendency of many of those participants to minimise the distinction – which is standard in the Anglo-Saxon debate – between "goal dependence" and "instrument independence" is probably dictated by the idea that the scope of delegation to an unelected agency should be as limited as possible.

Was the ECB well advised to take seriously the "goal dependence" principle that presides over the high-level agreements between parliaments and central banks, which assign many central banks in the world with the task of delivering a certain definition of price stability within a meaningful medium-term time frame? And, in that endeavour, did the ECB do the right thing when it claimed "instrument independence", within the confines of the Treaty stipulations, when delivering on its objective by using conventional instruments was no longer a viable option?

In attempting to answer these questions, let me take a step back.

Over the past decades, a clear consensus has emerged that price stability is the sole, or at least the primary, responsibility of a central bank. This is what we call "goal dependence": central banks did not – and should not – choose their ultimate goal. Their ultimate goal – price stability – is stipulated by legislatures which express the collective will of society. In many countries in the world the precise formulation of that assignment has been elaborated with *welfare* and *feasibility* considerations in mind. Among all the public policy goals that are most relevant to furthering the welfare of the public, central banks were given the mandate to stabilise inflation around a sufficiently low level over the medium term.

The welfare considerations are simple to explain. Price stability is the foundation of a functioning economy. Price stability ensures that the market mechanism can work properly. It supports correct market signals, contributing to an efficient use of economic resources and strengthening job creation and prosperity. It preserves the purchasing power of our money and the value of our savings. It is a common good for the whole economy.

It is worth remembering that these welfare propositions are not just abstract theory. Germany's history, in particular, has taught us that monetary disorder undermines not only economic prosperity, but also political stability. This aspect concerns not just the hyperinflation of the 1920s that has been etched so indelibly onto Germany's collective memory. In the wake of the Wall Street Crash in 1929 and the banking crisis starting in 1931, monetary mismanagement led to a precipitous collapse in money, prices, and employment.[3] Nowhere were losses in output and jobs as dire as in Germany and in the United States.[4] These economic reverberations also had traumatic consequences for the political cohesion of German society. In sum, ensuring price stability – that is, protecting societies against excess inflation and deflation – is a key contribution to collective welfare.

But how can price stability be preserved? In the course of monetary history, consensus on the role of monetary policy has fluctuated considerably. The "Great Inflation" of the 1970s, which Germany escaped thanks to its sound monetary policy framework, grew out of confusion and misperceptions about what drives inflation. Some top academic circles and central bankers entertained the notion that inflation was a structural problem and not amenable to monetary policy instruments: inflation was seen as the outcome of cost factors, such as wage negotiations or commodity price developments. The Great Inflation was only overcome once monetary policy came to be recognised as being solely responsible for price developments. Eventually, economists, irrespective of their scholarly persuasion, and policymakers alike became convinced of Milton Friedman's famous dictum that "inflation is always and everywhere a monetary phenomenon".[5] This consensus that monetary policy is solely responsible for price developments paved the way to granting sufficient independence to central banks to pursue monetary stability without political interference – and to providing central banks with effective instruments to do so.

Today central bank mandates have come to embrace the consensus that central banks are solely responsible for monetary stability. In the euro area, Article 127(1) of the Treaty (on the Functioning of the European Union) stipulates: "The primary objective of the European System of Central Banks shall be to maintain price stability."

Back in 1998, at the very beginning of monetary union, the Governing Council chose to specify its mandate in quantitative terms. In 2003 the Governing Council further clarified that, in conducting its monetary policy, it would aim at stabilising inflation over the medium term at a level below, but close to, 2%. As changes in inflation cannot be controlled over the short term, price stability is sought to be maintained over a medium-term horizon.

The definition reflects the fact that price stability does not mean zero inflation. The theory and practice of monetary policy has consistently found that a low but positive rate of inflation is critical to the functioning of the real economy. One factor in favour of tolerating low, positive inflation is the possible measurement bias in the calculation of the consumer price index as a result of insufficient compensation for the improvement in the quality of underlying goods. Low, positive inflation rates can also support the necessary adjustment of relative prices to economic shocks in the face of downward rigidities in wages and prices. Finally, the nearer the target inflation rate is to zero, the greater the risk that interest rates cannot be sufficiently cut to counter deflationary shocks.

Where does "instrument independence" come in? To achieve the goal assigned to it, monetary policy must be vested with the right instruments and with sufficient independence to choose to activate those tools – within the confines of eligibility stipulated by law – in such a way that makes the accomplishment of the goal feasible. Instrument independence is a precondition of accountability. Holding a central bank accountable for delivering its objective is meaningful only to the extent that the central bank is unconstrained – again, within the confines of the law – in its choice of the means to achieve it. Both the duty to be faithful to the mandate and the ability to pursue it effectively and independently ultimately allow the ECB to be held accountable.

Of course, "instrument independence" does not mean that central banks' choices of instruments cannot be called into question. Central banks need to explain to what extent the instruments they use are effective in meeting their objective over a certain horizon, and are not causing collateral damage that is likely to compromise the achievement of the objective further into the future. In normal times, this *obligation to explain* is relatively unproblematic. This is because we understand the transmission of the conventional instruments of monetary policy – the very short-term interest rate – fairly well. By steering the interest rates in interbank money markets, central banks in normal times are reasonably capable of influencing the broader conditions in capital markets, and affect the interest rates applied by banks when lending to the economy. Both the financial conditions prevailing in the capital markets and those prevailing in the market for bank credit, in turn, influence the investment and spending decisions of households and firms, and, ultimately, price developments. Before the crisis, this mechanism, which we also technically refer to as monetary policy transmission, worked rather smoothly.

In times of crisis, this link between short-term interest rates and price developments can be weakened dramatically. Financial fragilities in money or capital markets or in banks may render the interest rate instrument ineffective. Disinflationary developments may be strong enough to eventually remove the central bank's room to lower short-term instruments. This situation requires recourse to more complex and potentially untested instruments. It complicates the duty to explain but makes convincing explanations even more critical to the credibility and effectiveness of policy. This is why in the remainder of the speech I will give an account of the main phases of the crisis and how the various phases have called for the activation of non-standard instruments, often tailor-made to address the challenges and the risks that the crisis brought on.

Monetary policy in times of crisis

During the years of the crisis, the relationship between instruments and mandate has become much more complex, and has in fact stoked concerns about a possible dilemma between the adequacy of means and the ultimate ends.

The financial crisis evolved in three main phases, each of which required different policy responses and posed new challenges in explaining their merits.

The first phase was marked by the banking crisis, culminating in the collapse of Lehman Brothers in 2008. It prompted a systemic failure of interbank funding markets. Banks – both in the euro area and elsewhere – suddenly became very uncertain about the underlying health of other banks and stopped lending to each other. Together with other major central banks, we stepped in with forceful and coordinated interventions to provide essential liquidity to the banking sector. In the euro area, liquidity was made available in virtually unlimited amounts – against eligible collateral – and at increasingly longer tenors, which helped those banks that were being denied access to market refinancing to remain in business and keep their key intermediation function.

Without these operations, the financial system would have imploded and a far deeper contraction would have occurred. In arresting the meltdown in the money market we were able to avoid a chain of bank failures which would have precipitated a collapse in money and credit, with severe consequences for price stability. Not acting would, in fact, have amounted to deflecting responsibility for our mandate and risked accepting the kind of economic disorder experienced during the Great Depression, as mentioned in my introduction.

On that account, our balance sheet took on a more prominent role as a stabilising instrument. The novelty of deploying the central bank balance sheet as an instrument was immediately met with substantial scepticism. First, there was apprehension about moral hazard: after all, the ECB expanded credit to banks at a time when they were under scrutiny for having precipitated the crisis in the first place. Second, there were also fears about grand-scale liquidity injections ultimately paving the way for inflation.

We subsequently entered a second phase, starting in 2010, as a consequence of the loss of confidence in some sovereigns. It brought on the development of redenomination risk and thereby threatened the integrity of our currency. The sovereign debt crisis was triggered in some cases by a weak fiscal position and in others by a weak banking system. But irrespective of its initial impulse, it quickly became a two-way loop through the “bank-sovereign” nexus: banks remained dependent on fiscal authorities for solvency assistance, and the financial obligations vis-à-vis banks that this responsibility created on the part of some governments with weak fundamentals further undermined their credit standing. As the cost of borrowing for certain governments increased, banks with exposures to this debt came under intense market pressure, ultimately leading to entire national banking systems losing market access. This development, in turn, resulted in financial fragmentation and a serious disruption to the monetary transmission mechanism. In view of the implications that such dynamics could have for price stability, the ECB lowered interest rates. But these reductions were not being passed on to firms and households in a large part of the euro area. This signalled an unusual disconnect between expanding central bank liquidity and exceptionally stimulative monetary policy interest rates and contracted lending to non-financial corporations and households.

The ECB’s response to these unprecedented conditions was twofold.

First, the ECB revived the longer-term refinancing instrument that had proved particularly effective in the aftermath of the Lehman demise. Central bank liquidity was made available to banks for up to three years. This eased the pressure particularly on banks located in the countries that had been hit by the sovereign debt crisis.

Second, the announcement of Outright Monetary Transactions (OMTs) in the summer of 2012 removed the euro area break-up risk which markets – by that time – had started to price into the yields of securities issued by the governments most impaired by the sovereign debt crisis. The impact of the announcement on market sentiment was instantaneous and material to an extent few had anticipated. The steep fall in interest rates and improved monetary policy transmission in those countries most affected by the sovereign debt crisis averted a deeper recession in the euro area as a whole. Nonetheless, the sovereign debt crisis left a damaging legacy on the euro area economy and laid the groundwork for the third phase of the crisis.

In the years that followed, as a legacy of the debt crisis, banks in those vulnerable countries entered a drawn-out process of deleveraging aimed at shedding the most risky components of their balance sheets: loans to the economy. This, once more, impeded transmission of the stimulus introduced by OMTs and by the liquidity operations to the real economy. It threatened to derail the very tenuous recovery that had started in 2013 and prompted inflation rates to drift downwards – and away from levels consistent with price stability.

A third phase of the crisis started in 2014, as it became clear that the incipient recovery was too fragile and dependent on progress in transmission to warrant inaction on the part of the ECB.

Additional monetary policy measures were required to repair the bank lending channel and to halt an accelerated fall in inflation that threatened to de-stabilise long-term inflation expectations and usher in a period of self-sustained deflation.

Because the main policy interest rate, the interest rate on the deposit facility, had already been brought to zero in summer 2012, the Governing Council introduced innovative measures to provide additional stimulus. Starting in June 2014, the Governing Council brought the interest rate paid on banks' deposits of excess reserves with the Eurosystem to –0.1%. At the same time, a credit-easing package was announced which included targeted longer-term refinancing operations (TLTRO-I), a programme to purchase covered bonds issued by the banks (CBPP3, a new version of two earlier programmes with a similar scope) and a new asset-backed securities purchase programme (ABSPP). These credit-easing measures influence the economy by improving the pass-through of liquidity injected into the financial system to private sector borrowing costs.

The credit-easing measures were immediately effective in turning around the credit crunch situation prevailing in a number of countries and fostering a pronounced easing in bank lending conditions for companies and households. But, also owing to the headwinds coming from the international economy, the inflation outlook continued to deteriorate in the summer and autumn of 2014 and long-term inflation expectations started to give concrete signs of destabilisation. As a result, in January 2015 the Governing Council announced the expanded asset purchase programme (APP), which included a large-scale purchase programme targeting public securities (PSPP). The purpose of the new programme was to promote a general compression of yields across all asset classes and to generate incentives for banks to rebalance their portfolios towards assets with higher risk-adjusted returns – such as loans to firms and households.

Overall, these measures have been designed to complement each other and have proved effective and adaptable to the series of shocks which have hit the euro area economy since their introduction. Indeed, the deposit rate has been reduced further (it now stands at –0.4%). This decrease into more negative territory incentivises banks to invest the liquidity they receive as a consequence of the asset purchases into longer-maturity and higher-yielding assets. The APP has been recalibrated since its introduction and in early 2016 the Governing Council announced four additional targeted longer-term refinancing operations (TLTRO-II) to further support credit availability to euro area firms and households.

All these elements adopted in the third phase are still in place. Moreover, the ECB has adopted an integrated system of forward guidance that governs the future path of asset purchases and short-term interest rates, as well as the sequencing of these different policy tools.

Given their novelty, scope, and potential interaction with other public policies, communicating the merits of these measures proved to be much more difficult than before the crisis. A debate evolved around the premise that central bank purchases of sovereign bonds ventured into the realm of fiscal policy. After all, in the few preceding years of the crisis public debt had surged to high levels.

Is the decision to purchase public securities one which can be seen as overstepping the limits of "instrument independence"? In particular, how could the ECB avoid being pressured by political forces into alleviating debt servicing costs through continued purchases of government bonds? Would such purchases not have to be conducted above and beyond what would be appropriate for monetary policy purposes? In other words, are we back to Weber's dilemma between *Gesinnungs- und Verantwortungsethik* and are we not at risk of resolving the dilemma in an opportunistic way, achieving "good" goals by dubious means?

Public debates have pivoted precisely around such concerns. If it did occur, such overstepping of the confines that society has laid down for the central bank mandate would undermine central banks' independence and the legitimacy of their instruments and would ultimately pave the way for higher inflation. In the light of these risks, how can we be sure that the measures taken fall within the ECB's narrowly defined price stability mandate?

Conflicts with the price stability objective could indeed emerge from monetary operations that support unsustainable government finances. There is no doubt that monetary policy has had beneficial effects on government finances. The same kind of indirect support occurred when we cut our main refinancing rate to 2% in the early 2000s – a very low level at the time – and maintained that level for more than two years. But neither this episode, nor today's policy easing, is akin to the deliberately coordinated strategy of monetary financing that we observed in some countries in the 1970s.

To maintain responsibility and prudence in our actions we must dispel any doubts about the reasons behind them and their effect on price stability. Indeed, in the euro area, we have a number of extremely important safeguards in place ensuring that any central bank instrument is used solely on the basis of the central bank's narrow price stability objective, and not on any fiscal consequences thereof.

One of our most important provisions is the Treaty prohibition on monetary financing. It was key to preserving the monetary policy nature of OMTs and the public sector purchase programme (PSPP). In line with this provision, we specified that OMTs can be activated only if price stability is under threat. Moreover, the extra exposure to any single country that the Eurosystem might acquire as a consequence of OMT activation is secured by strict conditionality: as a precondition for OMT activation, the country would first have to commit to a macroeconomic adjustment programme under the European Stability Mechanism (ESM). It is worth noting that in June 2015 the European Court of Justice ruled that, given the strict modalities for their activation, OMTs fall within the scope of the ECB's mandate and include sufficient safeguards to avoid monetary financing.

A number of safeguards apply to public sector bond purchases under the PSPP too. Such purchases have a monetary policy purpose which is different from the one that applies to OMTs. They are specifically aimed at bringing inflation back to our medium-term objective in a situation in which our key interest rates are at levels that can hardly be reduced much further. The modalities for their activation are exclusively governed by the primary objective of price stability and are decided in full independence, irrespective of developments in other policy areas.

The size and duration of the PSPP are calculated to achieve progress towards the ECB's inflation objective. The effectiveness of the tool is rooted in two important features of the financial system. First, government bond yields are the benchmark indicator for pricing a large set of private debt instruments. Second, government bond markets are deep and liquid. Interventions in these markets have eased financing conditions for households and firms. Several safeguards are in place to minimise potential distortive effects on market functioning and price formation (such as the issuer limit and the issue share limit of 33%).

Turning to another area of public policy, our actions also have a notable financial stability dimension because of the implications of financial stability risks for monetary policy transmission. In the course of the crisis, the incompleteness of the European institutional architecture meant that in some instances the ECB had to act in order to maintain orderly financial conditions. Institutional developments since then have improved the conditions for financial stability. The creation of a permanent crisis-resolution framework for Member States facing financial difficulties (the European Stability Mechanism (ESM)) and the establishment of banking union, in particular the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), have been critical steps in that direction.

All our measures were designed and deployed in order to fulfil our narrowly defined price stability mandate. We did not take action to help banks or governments. We took action to help maintain the flow of credit to firms and households. We took action to provide monetary stimulus in the face of persistently weak inflation. Taking decisions using unconventional instruments has not been easy. It has always been a difficult balancing act, based on a careful assessment of the merits of all possible policy choices in view of our mandate. Not taking action would have been irresponsible and tantamount to deflecting our singular responsibility for price stability.

Conclusions

Unconventional policies have been complicated to implement and to communicate. But they have been effective in enhancing our ability to deliver on our price stability mandate. Our measures have been designed to complement each other. They have proved both effective and adaptable in the face of a series of adverse developments that have affected the euro area economy.

Going back to the type of concerns once expressed by Max Weber, I would say that we are not subject to a conflict between the values and merits of means and those of ultimate policy goals. The ECB's institutional framework continues to safeguard congruence between instruments and goals. It ensures that central bank instruments are used only in the pursuit of the central bank's narrow price stability objective, and not of other public policy goals.

Our non-standard measures have been designed in such a way that they cannot compensate for failures in other policy areas. They have made a crucial contribution to preserving the very favourable financing conditions that are supporting the economic upturn and the sustained adjustment in the inflation path towards our aim.

The euro area economy, including the public sector, currently benefits from very low interest rates. It is important for everyone to realise that our monetary policy decisions are only guided by our price stability mandate. In the light of this, fiscal authorities and borrowers in the euro area should be long-sighted enough and plan sufficiently ahead to prepare themselves for the time when it will be appropriate for us to start a gradual process of policy normalisation.

In using novel instruments to reach our goal, we have been mindful of the principle that, while "instrument independence" is critical for us to be able to deliver on our Treaty mandate, it does not excuse us from basing our choices on the law and on economic effectiveness. In this respect, we have been striving for two other important public policy virtues, also famously highlighted by Max Weber: *Augenmaß und Verantwortungsgefühl* (which I would translate as prudence and sense of responsibility). In designing our instruments, we implemented provisions and safeguards ensuring prudence. In deciding to act, in lieu of letting events march on, we took responsibility for our price stability mandate.

By ensuring price stability, monetary policy creates one of the conditions for a thriving social market economy. Monetary policy alone, however, cannot ensure prosperity. Sound economic policies are indispensable to unlocking the sources of employment and growth in Economic and Monetary Union. Member States need to live up to their joint responsibility for the stability of the euro area and step up their efforts to conduct fiscal and economic policies in a way that supports the smooth functioning of monetary union.

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[1] See Willem Buiter (2016), "Dysfunctional Central Banking; The End of Independent Central Banks or a Return to 'Narrow Central Banking' – or Both?", *Global Economics View*, Citi Research, 21 December; Otmar Issing (2016), Central Banks – From Overburdening to Decline?, *SAFE White Paper Series*, No 42; Jakob de Haan and Sylvester C.W. Eijffinger (2017), Central bank independence under threat?, *CEPR Policy Insight*, No 87.

[2] Max Weber was professor of economics at Heidelberg University from 1896–1903. His lecture was given in 1918 at the University of Munich and published in 1919. See Max Weber (1919), "Der Beruf zur Politik", in Johannes Winckelmann (ed.), *Max Weber – Soziologie – Universalgeschichtliche Analysen – Politik*, , Alfred Kröner Verlag, 1973, pp. 167–185.

[3] In Germany and Austria, the banking crisis was precipitated by the collapse of DANAT bank and Creditanstalt in 1931.

[4] See Barry Eichengreen (1992), *Golden Fetters: The Gold Standard and the Great Depression*, 1919–1939, Oxford University Press.

[5] Milton Friedman (1963), *Inflation: Causes and Consequences*, Asian Publishing House.