Yves Mersch: Necessity, proportionality and probity – central bank independence in unconventional times

Speech by Yves Mersch, Member of the Executive Board of the European Central Bank, at the conference "The ECB and its watchers XX", Frankfurt am Main, 27 March 2019.

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Introduction

The benefits of central bank independence have been established and demonstrated time and again. Inflation is costly.[1] History shows that governments lack the credibility to commit to time-consistent monetary policy, and often subordinate it to other priorities.[2] Faced with elections, governments are tempted to boost short-term growth by stoking unexpected inflation. But in the long run, this just raises inflation expectations without any benefit to growth. By delegating monetary policy to an independent, accountable central bank with a narrow mandate for price stability, democracies have found a way to reduce costly inflation without incurring output losses over the medium term.[3]

Despite this successful track record – or perhaps because of it – central bank independence has been recently questioned. In particular, it is argued that central bank independence is only justified if distributional effects are comparatively small. Critics claim that unconventional measures have large distributional effects across households, industrial sectors and even countries, and thus stray into the realms of economic and fiscal policy.

This debate has led to a wealth of academic literature being published on the ideal conditions for delegating powers and coordination between policies.[4] To be clear from the outset: it is the task of safeguarding the purchasing power of the currency that requires shelter from political influence. The same degree of independence is not necessarily justified for other policy areas entrusted to central banks that lie beyond this mandate.[5]

That is why I have repeatedly encouraged a functional approach to the concept of independence.[6]

Given my audience today, I will not discuss microprudential supervision or financial stability considerations. Instead, I will focus on practical advice on how we should act in the current environment to best achieve our primary mandate and preserve independence – independence that remains necessary to ensure long-run price stability.

In this vein, I believe there are three watchwords that should guide our actions: necessity, proportionality and probity – as several judicial reviews have confirmed.

Necessity

To put these watchwords in context, let me recall the economic conditions at the time the ECB decided to implement unconventional measures.

The euro area economy had undergone a double-dip recession. Inflation outcomes flirted with deflation, and there were signs that inflation expectations were becoming de-anchored. The transmission of monetary policy across the whole euro area was impaired. Fiscal policy offered little by way of countercyclical stabilisation. Traditional monetary policy had reached its limits, with nominal interest rates close to zero and some contemporary measures of real equilibrium interest rates below zero.

The choice for the ECB at the time was stark. We could either restrict ourselves to conventional monetary policy, and fail to fulfil our price stability mandate. Or we could implement unconventional measures, and respect our mandate.

I would argue that there was no real choice.

The Treaty affords us broad discretion in our choice of tools to honour our price stability mandate. But it offers no discretion whatsoever in the choice of whether or not we fulfil that mandate. These are the only conditions under which central bank independence is sustainable.

That is the essence of my first watchword – *necessity*. By carrying out monetary policy using a range of additional tools that were legally available to us – and used successfully by other central banks in advanced economies – the ECB supported the recovery and helped ensure a sustained adjustment in the path of inflation. We would not have managed this without unconventional measures.[7] I do not believe that central bank independence is sustainable if unelected bureaucrats refuse to take the actions necessary to honour their legal mandate.

It is true that some of these tools have been unpopular, but central banks are no strangers to unpopularity. Indeed, if acting in the best interests of long-term prosperity were always popular, monetary policy could safely be left in the hands of politicians.

Proportionality

But does necessity mean that all actions are justified when pursuing our price stability mandate?

The short answer is no.

Policymakers need to take into account not just the impact their tools have for their primary purpose, but also any potential side effects. Policy needs to maintain *proportionality* – my second watchword for today.

Proportionality is one of the basic legal principles of the architecture of the European Union. It is enshrined in the foundational Treaties and demands that the content and form of Union action should not exceed what is necessary to achieve the objectives of the Treaties. For monetary policy, proportionality implies that the ECB's actions must, first, be suitable to address the identified risks to price stability. Second, the ECB's measures must be necessary to achieve their intended objective. In other words, alternative monetary policy measures that entail more limited action would not enable the objective to be achieved as effectively and rapidly. Third, proportionality *stricto sensu* implies that the expected benefits of the ECB's actions must outweigh their costs.

These principles provide for a hierarchy of tools, where unconventional measures should be used only once conventional measures have been exhausted.

Let me address, then, the criticism that the distributional consequences of unconventional monetary policy undermine central bank independence.

It is worth recalling that monetary policy always has distributional effects.

Cutting short-term interest rates tends to reduce the income of savers and boost the income of debtors and the wealth of asset holders. It also affects incomes through the macroeconomic effects on employment and wages. In short, not only does conventional monetary policy have distributional effects, it partly works *through* causing them. In normal times, these effects are viewed as being of secondary importance to the aggregate welfare benefits of price stability. In other words, they are proportionate.

Moreover, any distributional consequences of monetary policy action need to be set against the distributional consequences of *inaction*. Sudden, unexpected deflation has distributional consequences. Ten million more people are now employed in the euro area than when unemployment peaked – this number would be much smaller had the ECB not acted, even though we only have a narrow mandate to maintain price stability that does not cover employment.

The ECB also attempted to minimise unwanted side effects by carefully designing our tools. For example, it became clear that our asset purchase programme (APP) was contributing to challenging conditions in the repo market.[8] By the end of 2016, around half of German government bonds were trading "special" – that is, at a premium to general collateral. We modified our securities lending programme, including by accepting cash as collateral, to mitigate the impact of the APP on repo markets. Today, the share of specials is generally below 10%.

In general, prevention is better than cure. That's why we established many safeguards and restrictions, particularly in our public sector purchase programme, to avoid interfering with fiscal and economic policy and providing monetary financing to governments. The stringent eligibility criteria and issue and issuer limits are examples of self-imposed restrictions which have been vetted by the European Court of Justice.[9] Independence and the prohibition of monetary financing prevent central banks from behaving as a fiscal substitute.

We have also increased transparency and enhanced accountability measures – the necessary counterparts of independence. Notably, this includes publishing the accounts of the monetary policy discussion in the Governing Council.

The takeover of banking supervision was accompanied by additional and more far-reaching accountability obligations, such as the Interinstitutional Agreement with the European Parliament and a number of memoranda of understanding with other institutions. A separation principle was established; and supervision does not have broad regulatory powers like in monetary policy.

So while our unconventional measures undoubtedly have side effects, the essential point is that these side effects are not manifestly disproportionate to the primary objective of the measures – contributing to price stability. But we have to continuously monitor the ongoing *appropriateness* of our measures in order to preserve the balance between costs and benefits. And while the growing number of new tools and activities has moved the actions of the central bank closer to other policy realms, the boundary was never crossed – as confirmed by the European Court of Justice. Therefore, the use of such measures during the crisis does not represent a break with the framework that justifies central bank independence.

But we continue to assess the impact of our measures, and of negative interest rates in particular, on areas such as bank profitability, and to consider whether our mix of policy measures remains suitable and proportionate.

Probity

My final watchword refers not to how policymakers conduct policy, but to their personal conduct. At a time of increased external pressure on central banks, it is important that policymakers act with *probity*.

The Treaty affords significant personal independence to members of the ECB's Governing Council. These provisions play a vital role in our unique institutional framework, since monetary policy must be appropriate for euro area-wide conditions, which may be different from the conditions in a policymaker's home country. By providing strong protections for sitting Governing Council members, the Treaty aims to isolate them from political pressure.

These protections also come with an obligation to act in a responsible manner at all times. Inappropriate behaviour by policymakers can damage the reputation of central banks and be used by politicians to build a narrative against independence. This is why we publish the calendars of the members of the Executive Board, as well as their speaking points when talking behind closed doors. In the long run, we can only remain isolated from political pressure if we separate ourselves from political debate.

Conclusion

The multiple crises of recent years have forced the ECB to venture into unknown territory to fulfil its primary mandate.

Undesirable but unavoidable side effects of monetary policy measures and the expansion of our activities into the vicinity of other policy areas have led to attacks on the ECB's independence. Although the highest Court confirmed that the unconventional measures taken by the ECB were legal, the subjective – albeit erroneous – impression of a breach of mandate has been enough to trigger increased political pressure.

The best protection against – unjustified – attacks on the independence of monetary policy is therefore a narrower mandate combined with a high degree of transparency and the strict interpretation of legal limits. In this respect, a broader mandate in some jurisdictions warrants a clear distinction between government tasks and ancillary central bank tasks. As to supervision operational autonomy is of the essence but of a nature that is functionally determined. Monetary policy independence extends indeed to a broader regulation power and a role as "guardian of the Treaty".

For monetary policy this does not mean, however, that we will inevitably and over-hastily return to the limited set of instruments and the balance sheet size of the pre-crisis period. Regulatory changes and the enduring fragmentation of European financial markets may in the future require some adjustments to our operational framework for monetary policy within our well-established strategy. However, whatever a future monetary policy framework may look like, it must be based exclusively on the price stability mandate and set up within legal limits.

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1 Costs of inflation include the sub-optimal allocation of goods and activities, so-called shoe leather costs, distortions to the tax system and costs associated with the de-anchoring of inflation expectations. For a summary, see ECB (2011), *The monetary policy of the ECB*.

2 See Kydland, F. and Prescott, E. (1977), "Rules Rather than Discretion: The Inconsistency of Optimal Plans", *Journal of Political Economy*, Vol. 85, No 3, pp. 473–491; and Barro, R. and Gordon, D. (1983), "Rules, discretion and reputation in a model of monetary policy", *Journal of Monetary Economics*, Vol. 12, No 1, pp. 101–121.

3 See, among many others: Alesina, A. and Summers, L. (1993), "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence", *Journal of Money, Credit and Banking*, Vol. 25, No 2, pp. 151–162; Cukierman, A., Webb, S. and Neyapti, B. (1992), "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes", *The World Bank Economic Review*, Vol. 6, No 3, pp. 353–398; and Berger, H., de Haan, J. and Eijffinger, S. (2001), "Central Bank Independence: An Update of Theory and Evidence", *Journal of Economic Surveys*, Vol. 15, No 1, pp. 3-40.

4 See, for example, Tucker, P. (2018), "Pristine and Parsimonious Policy: Can Central Banks Ever Get Back to It and Why They Should Try", in Hartmann, P., Huang, H. and Schoenmaker, D. (eds.), *The Changing Fortunes of Central Banking*, Cambridge University Press. See also Summers, L. (2017), "Central Bank Independence", Bank of England: 'Independence – 20 years on' Conference.

5 There appear to be almost no limits to the ideas for new fields of activity to entrust to central banks, as our long list of opinions on the subject shows. See, for example, the ECB opinions mentioned in the ECB's 2018 Convergence Report, pp. 30–32.

6 Mersch, Y. (2017), "Central bank independence revisited", keynote address at the Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States.

7 There is a wide range of empirical evidence demonstrating the effectiveness of unconventional measures

across a range of countries. See, for example: Joyce, M., Lasaosa, A., Stevens, I. and Tong, M. (2011), “The Financial Market Impact of Quantitative Easing in the United Kingdom”, *International Journal of Central Banking*, Vol. 7, No 3, pp. 113–161; Wu J. and Xia, F. (2016), “Measuring the Macroeconomic Impact of Monetary Policy at the Zero Lower Bound”, *Journal of Money, Credit and Banking*, Vol. 48, No 2-3, pp. 253–291; and Eser, F. and Schwaab, B. (2016), “Evaluating the impact of unconventional monetary policy measures: Empirical evidence from the ECB’s Securities Markets Programme”, *Journal of Financial Economics*, Vol. 119, No 1, pp. 147–167.

8 See Hammermann, F., Leonard, K., Nardelli, S. and von Landesberger, J. (2019), “Taking stock of the Eurosystem’s asset purchase programme after the end of net asset purchases”, *Economic Bulletin*, ECB, Issue 2.

9 See Judgment of 11 December 2018 in case C-493/17 (*Weiss and Others*).