OMFIF Policy Meeting

New ways forward for the European Central Bank

London – 29 September 2015

Meeting notes

Overview

- The OMFIF policy meeting of 29 September, largely off-the-record – see below – brought together European economists, former and current officials and members of the OMFIF advisory board to discuss questions surrounding the ECB's new goals and instruments. This policy meeting coincided with the release of the OMFIF report on 'The future of the European Central Bank', addressing six key questions on economic and monetary union and featuring extracts from the past six years of The Bulletin.

- Speakers included Hans Eichel, former German finance minister; Jeffrey Franks, director, Europe office, International Monetary Fund; José Manuel González-Páramo, member of the executive board, BBVA, and former ECB executive board member; Paul de Grauwe, professor, European political economy, London School of Economics; Marcello Minenna, head of quantitative analysis unit, CONSOB; Edoardo Reviglio, chief economist, Cassa Depositi e Prestiti; Paul Tucker, senior fellow, Harvard Kennedy School, and former deputy governor, Bank of England; and Shahin Vallée, senior economist, Soros Fund Management. The discussion was moderated by David Marsh, OMFIF managing director.

- The meeting focused on the changing role of the European Central Bank since 2008. The ECB has taken on a range of new responsibilities to tackle market imbalances and post-crisis weaknesses. Among these are its extensive quantitative easing programme and its supervision of European banks. Participants discussed the reasons for these developments and likely trends for the future.

Discussions

1. **Hans Eichel's proposal**

- The discussion began with an on-the-record proposal by Hans Eichel, former German finance minister, to use the ECB's QE programme to provide funding for small and medium-sized businesses, increase investment in transport and communications infrastructure, and to implement the common energy market.

- Eichel argued that these proposals, in which national development banks funded by the ECB would play a key role, would represent a more targeted and effective instrument than the present liquidity-generating policies of the ECB, principally through its QE programme started in March.

- Eichel said his proposal would help stimulate demand in a way consistent with the EU's overall objectives, seen above all in the 'Juncker plan' targeted on improving investment in key sectors and overcoming Europe's weakness in growth and employment since the 2008 crisis.

- This would require the ECB moving from being purely a monetary institution towards having a fiscal role as well.

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2. The ECB's policy evolution

- Speakers emphasised the lack of European institutions for regulating euro area fiscal policy, a result of lack of political will for a much closer union. The ECB, the strongest and most credible EU institution, has become the main focus for attempts to repair EMU's structural shortcomings.

- Eichel's intervention was seen by seminar participants as a creditable attempt to overcome problems in introducing a convincing coordination of euro area fiscal policy. But the general view was that it would not wholly overcome these flaws, and would also bring the ECB into a field of fiscal redistribution and economic micromanagement where it would arguably overreach its mandate.

- The policy choices of the ECB over 15 years had been principally focused on inflation targeting, on enforcing prudence among its members, and in demanding domestic structural reforms. These choices stemmed, in part, from the influence of Bundesbank-style ECB decision-making.

- Since the onset of the euro area sovereign debt crisis from 2010 onwards, the ECB's area of decision-making has been extended further, beyond sheer exhortation, in favour of fiscal consolidation and non-inflationary policies.

- The securities market programme of 2010, the ECB's 2012 commitment to do 'whatever it takes' to save the euro, the decision on (not yet implemented) 'outright monetary transactions', and the 2015 QE programme were the result of external pressures on ECB decision-making. Chief among these were pessimistic market sentiment and the need to reassure businesses and investors of economic stability and the security of European banks and assets. Deflationary pressures have increased, with inflation falling below 2% at the beginning of 2013, and turning negative in late 2014. Despite the start of QE, euro area inflation remains worryingly below the target of 'close to but below 2%.'

- Diverse pressures have seen the ECB's role extend well beyond pure monetary policy to become the ultimate supervisory body of European banks. Europe's banking union (not yet complete in key aspects, for example, in lack of an EMU-wide deposit insurance) was generally seen as a necessary step for strengthening European banks' balance sheets, and improving market confidence.

- Attendees agreed that QE was necessary for raising inflation, improving the monetary transmission mechanism, and maintaining financial stability. These policy responses, aimed at increasing euro area liquidity, attempt to tackle supply-side issues. They do not solve recovery-hindering demand-side problems.

- The divergence between the strong growth of European countries outside the euro and the low growth of those inside shows the limits of the supply-side emphasis and underlines the deep-seated nature of EMU's structural drawbacks.

- The lack of public investment, low confidence in European economic stability, and problems of bank lending, are acting as hindrances to economic growth that QE and the banking union alone cannot fix. The 2014 Juncker investment plan aims to address these demand-side issues.

- The Juncker programme entails mobilising private investment for €315bn of European infrastructure projects, with the European Investment Bank providing €21bn of guarantees to the private sector to encourage their participation. The ECB's QE package can be seen as supplying the necessary monetary stimulus to back this programme.

- While there was general agreement at the meeting on the need for such demand-side responses, there were concerns about the proposed transition of the ECB from a monetary institution towards one with a clear orientation towards fiscal policy as well.

3. Consequences of the lack of overall coordination of fiscal policies

- The view was expressed that the ECB plays a fundamental role in euro area financial and macroeconomic stability, but that it should not become the European institution responsible for fiscal policy, infrastructure, employment-targeting and growth. Extending its mandate in such a way would risk undermining the ECB's credibility, legitimacy, and support among member states.

- Establishing the ECB as Europe's fiscal authority would require giving it extra powers, such as those over the enforcement of debt repayments and the ability to impose sanctions on members which do not invest sufficiently in infrastructure.

- The constraints of a currency union with a monetary authority but without a common fiscal authority have created European imbalances. Germany is able to export at a more competitive price due to the undervaluation of the euro relative to the strength of the Germany economy. The euro is relatively more expensive for the less productive euro members, harming their competitiveness.

- Some of these issues have been created by EMU policies constraining fiscal deficits. In the private sector, it was claimed, such rules would lead to stagnation. Some participants urged rule changes to allow member countries to have similar, looser, constraints as in the private sector.

- Euro area internal imbalances distort borrowing costs, with financing for manufacturing companies, for example, costing 20% more in Italy than in Germany, creating large competitiveness gaps.

- Improving competitiveness through devaluation is not an option in the euro area; fiscal readjustment is a principal means of rebalancing. It was argued that without a genuine single interest rate and one fiscal authority, the euro area is little more than a currency peg, with members unable to set their own monetary policies and suffering undue interest rate spreads.

- Two participants proposed widening the OMT (and the QE programme too) to realise a 2% inflation rate in all EMU participants and introduce a 'zero spread' for euro area bond market rates. However it was unclear how much support among policy-makers the 'zero spread shield' would gather.

4. Possible solutions

- Given the misgivings about the ECB extending its fiscal policy role, three alternative solutions (ranging from most to least desirable) were proposed:

  - Creation of a euro-wide fiscal authority to manage fiscal policy, similar to the ECB's role in monetary policy;
  - Better coordination of fiscal policies between member states, involving looser policies by states with more fiscal leeway with others maintaining or tightening their current policies;
  - Across-the-board loosening of fiscal policies, with all countries lowering primary budget surpluses, increasing investment spending, and lowering taxes. The ECB could raise its inflation target to 4%.

- There is a lack of political will for the closer integration among euro area members required for a fiscal authority. Question marks surround the raising of euro area finance through EMU-wide taxation, as well as the issues of goal-setting and regulation.

- Germany's rejection of risk-sharing over the QE programme and of a common deposit insurance scheme was interpreted as a fundamental signal of a serious shortage of political support for enhanced integration such as through a single fiscal authority.

5. Summary

- The demand-side aspect of Europe's economic recovery requires greater attention. QE has not done enough to stimulate demand or increase employment, which has been reduced by structural adjustment in crisis-hit countries.

- Participants acknowledged the need for euro area-wide fiscal policies to stimulate a more balanced recovery. While Eichel's proposed measures would give the ECB a greater role in this area, there was disagreement over the risks and benefits of this course.

- Participants said the ECB already had a monetary policy mandate targeting price stability. De facto, a financial stability mandate has been added through European banking union. Adding an overt fiscal role to these existing duties would represent a diversion of the ECB's powers and responsibilities that could weaken its political legitimacy.

- As an alternative, setting up a euro area-wide fiscal authority would be a more attractive solution. Yet there would be formidable problems establishing such a body and giving it the requisite powers.

- The issues under discussion will be embedded into a wider OMFIF ECB report due in March 2016.