The European Central Bank between the Financial Crisis and Populisms

The authors have taken a clear, hard look at the far-reaching political consequences of the unprecedented, quasi-fiscal monetary policies adopted by the ECB to manage the impact of the Global Financial Crisis. This book is essential reading for anyone interested in better understanding the roots of the populist and sovereigntist threats to the legitimacy of the European Union institutions and the independence of the ECB.

—Dante Roscini, *Professor of Management Practice, Harvard Business School and co-Chair of the European Economic Policy Forum, Harvard University, USA*

The ECB has at times acted as the *de facto* fiscal authority of last resort for the euro area, and therefore as the existential guarantor of the European project: its economic sovereign. How that plays into politics won't be known for a while, but you should read this book to think about how unelected power has become central for hundreds of millions of people.

—Sir Paul Tucker, *Chair of the Systemic Risk Council, a fellow at Harvard Kennedy School, and author of Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State*

The relationship between populism and Central Bank independence is of fundamental importance today. This fascinating book is essential reading for those scholars and policy-makers that want to better understand this relationship not just in Europe, but across the world.

—Nauro F. Campos, *Professor of Economics, University College London (UCL), and Director, UCL Centre for Comparative Economics, London, UK*

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Foreword

The question of the legitimacy of the central bank is a relatively new one. In the old days in most countries (with the exception of Germany and Switzerland) the minister of finance was the de-facto president of the central bank. He decided about the level of the interest rate to be applied in discounting facilities and thus was responsible for monetary policies. In those days the central bank was just an instrument used by the government to pursue its economic and political objectives. As a result, the question of the legitimacy of the central bank fully coincided with the legitimacy of the government.

Two things happened to change this picture. First, the stagflation of the 1970s and the monetarist revolution changed the minds of policymakers about the role of the central bank. The central bank came to be seen as the institution responsible for price stability. This came as a reaction to the systematic use of the central bank for purposes of stabilization of the business cycle and for the funding of government deficits, both of which were seen as being responsible for the surge in inflation during the 1970s. Instead, the central bank should pursue price stability as its primary objective. All other objectives should be subordinated to that goal. In many countries, one went even further by mandating the central bank to only pursue price stability. Inflation targeting became the main operational procedure of central banks.

In order to make inflation targeting successful, it was felt that the central bank should be an independent institution. It was given the mandate to pursue price stability and was left alone in designing policies to achieve this without interference from politicians.

The creation of central banks as institutions independent from elected politicians created a dichotomy between the legitimacy of the government and the legitimacy of the central banks. These became separate concepts. The independence of the central bank also created the conditions for clashes between politicians, whose legitimacy rested on the popular vote, and the central bank, whose legitimacy was derived by the fact that the same politicians had delegated their power to bureaucrats in central banks. All this explains why a populist like Donald Trump today regularly pressures the Federal Reserve to lower interest rates.

A second major change occurred in Europe with the creation of a monetary union. Suddenly the governments of the member countries of the euro area had to issue their debt in a currency, the euro, over which they have no control. It was like issuing debt in a foreign currency. As a result, they could not give a guarantee to bondholders that these would be reimbursed at maturity. It became possible that some of these governments ran out of money, unable to roll over their debts. The knowledge that governments can run out of money can trigger self-fulfilling crises during which the fear that a government becomes illiquid leads bondholders to sell the bonds, thereby precipitating the liquidity crisis. This happened during the sovereign debt crises of 2010–2012. Thus, it was the lack of a central bank willing to step in to provide liquidity in the government bond markets of the euro area that explains the crisis of 2010–2012.

This contrasts with stand-alone countries whose governments issue debt in a currency they have full control over. These governments cannot be pushed into illiquidity by the financial markets because they will force the central bank to provide the liquidity in times of crisis. And there is no limit to the amount of liquidity a central bank can create.

It took some time for the European Central Bank (ECB) to understand this. Finally, in 2012 Mario Draghi, the president of the ECB, announced the intention of the ECB to provide an unlimited amount of liquidity in the government bond markets in times of crisis through the Outright Monetary Transactions (OMT) programme. The ECB did not want to call this a lender of last resort facility and invented the misnomer "Outright Monetary Transactions". The success was spectacular. In no time the fear and panic in the government bond markets that had created liquidity crises disappeared, without the ECB having to buy one euro in these bond markets.

Despite its success, the ECB was immediately attacked for overstepping its mandate. In other words, many observers, mainly in Germany, saw it as having become illegitimate. This also led to the creation of a populist party, the Alternative für Deutschland (AfD), that initially was an anti-euro party. The legitimacy of the ECB acquired a new dimension. This whole process is beautifully analysed in the present book and makes for a very illuminating reading. Although the European Court of Justice ruled in 2015 that the OMT programme was perfectly compatible with the mandate of the ECB, the issue of the legitimacy of the ECB and its enlarged role will not go away. This has to do with two issues underlying the OMT programme.

The first issue is that the ECB conditions the use of OMT liquidity relief on an austerity programme supervised by the ESM (European Stability Mechanism). These austerity programmes are very intrusive economically and politically. and risk subjecting the ECB to charges of dictating economic policies to popularly elected governments. In addition, there is, in fact, no need for OMT to be conditioned on austerity programmes. These OMT purchases of government bonds should only be triggered in times of liquidity crises. These do not call for austerity measures.

The second issue with the OMT programme has to do with its lack of credibility. The ECB promised in 2012 to intervene in the government bond markets in future times of crises. But what guarantee do we have that the future civil servants sitting on the Governing Council of the ECB will honour this promise? They certainly cannot be forced to do so. This contrasts with the central banks in stand-alone countries. There can be no doubt that governments of stand-alone countries will force the central bank to provide liquidity in times of crisis. In these countries, the government will then always prevail over the central bank. That is not the case in the euro area, where none of the elected politicians can force the ECB to provide liquidity relief when governments are forced into illiquidity in times of panic and fear. In the euro area, it is the ECB that prevails over elected politicians.

This creates an intense issue of legitimacy of the ECB that at some point will be attacked by politicians, and rightly so. When democratically elected governments' existence is at stake and when there is an institution populated by bureaucrats in Frankfurt that has the means to come at the rescue of these governments but refuses to do so, the political clash will be intense. The ECB will then be on the losing side.

The issues of legitimacy of the ECB are serious and have many dimensions. These different dimensions are scrutinized in a clear and incisive way by the authors of this important book. In addition, the authors link this issue of legitimacy to the popular support of the ECB. All this provides for a novel and creative analysis of the main problems of legitimacy and popular support that the ECB has faced in the past and will continue to face in the future. For anybody interested in these issues this is the best book available.

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