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Rules versus Flexibility and the Future of European Monetary Policy

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Policy Recommendations

1. In the upcoming "policy review" of the monetary policy of the European Central Bank (ECB), existing rules must be observed but applied with a degree of flexibility. The challenge is to find an adequate equilibrium between politically given rules and rules by market developments and market-oriented interventions.

2. The ECB must follow the rule of achieving price stability, but the definition of price stability needs to be more flexible.

3. There is a need for better coordination of monetary and fiscal policy, especially in times of crisis. The proposal for a "standing emergency fiscal facility", financed and managed by independent central banks, could help combine the rule of central bank independence with the need for effective macroeconomic intervention.

Abstract

European monetary policy is strongly influenced by the "battle of ideas" between a tradition of rule-based politics and of individual liability on the one hand and a policy approach of flexible cost-benefit considerations on the other hand. Regarding interest rate policy, the tendency for long-run low interest rates is basically due to economic developments, and outside the reach of central bank policy. But central bank policy may have substantial additional effects. This is the case with respect to the low interest rate policy which the European Central Bank (ECB) has been pursuing to achieve price stability. However, the present definition of price stability needs to be more flexible to avoid negative economic side effects. The most dramatic monetary policy intervention were Mario Draghi's famous words "that saved the euro." Then, the euro had been threatened because, unlike, for instance, in the U.S.A., the U.K. or Japan, for every euro area country, public debt – also in euro – is debt in a foreign currency. So, at least in theory, every euro area country is exposed to the risk of sovereign default. Thus, for the euro area, there is a potential divergence between a set of rules, designed to prevent "moral hazard" on the one hand, and a need for intervention on the other hand. Especially a severe crisis would call for closer rule-based cooperation between monetary and fiscal policy. In this context, the concept of a "standing emergency fiscal facility" is discussed.

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Introduction

One of the most interesting recent economic publications is the book "The Euro and the Battle of Ideas" by Markus Brunnermeier, Harold James and Jean-Pierre Landau. The book refers to an old philosophical discussion. The body politic must set rules to organize peaceful cooperation and trust in a society – but the question is when and how will it be necessary to change the rules or not to follow them. There is the famous saying "fiat iustitia et pereat mundus" – follow the law, follow the rules, even if the world will collapse. Some law professors tend to be proud of this attitude. I think it is cynical nonsense because, at the end of the day, politics should maximize the social utility of the population concerned. For European economic policy and especially monetary policy, this discussion is of basic relevance.

"In European economic policy, the 'battle of ideas' is a battle between a German tradition of both rule-based politics and individual liability and a French approach of flexible cost-benefit considerations and solidarity."

In European economic policy, the "battle of ideas" is a battle between a German tradition of both rule-based politics and individual liability and a French approach of flexible cost-benefit considerations and solidarity. In this battle of ideas, the ECB is described by Brunnermeier et al. (2016) as a "tragic hero," forced to make compromises between these approaches. This was easier during the massive financial crisis after 2008 – when the need for pragmatic action was obvious to almost everybody (albeit not to some German professors), but it is more difficult to reach compromises in times that may be seen as more normal.

From my own experience I may add that one should be careful about national clichés – in my view, the more relevant aspect may be the specific intellectual tradition that influences individual policymakers. Let us take, for instance, the Frenchman Jean-Claude Trichet, a technician by training, who was very close to the "German" rules-based approach, whereas Mario Draghi's thinking had been basically formed by his studies in economics at the Massachusetts Institute of Technology. Draghi thus represented rather an American pragmatic approach, his Italian background notwithstanding.

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In this paper, the question "rules versus flexibility" will be discussed with regard to some basic problems of monetary policy. In the field of monetary policy, the discussion of rules versus flexibility has already played a big role in European politics. In an upcoming "policy review," this discussion may be highly relevant with regard to the inclusion or exclusion of monetary policy approaches and thus the degree of policy effectiveness.

Interest Rate Policy

We live in a world of ultra-low interest rates today: globally, about one-quarter of outstanding public bonds shows negative rates, in Europe now 65% of government bonds. Is this the result of economic policy rules of central banks, or is this the result of inherent economic developments to which central banks have to adjust?

If we look at economic developments, two connected issues are of relevance. The first one is the decline of inflation. In this respect, Japan is a case in point, a country with two decades of ultra-low inflation. Moreover, in Western economies a weakening of the Phillips curve, the inverse relationship between changes in unemployment and in inflation rates, is evident. The second aspect is the relationship between saving – the supply of capital – and investing. Here we see what has been called a "savings glut," a worldwide oversupply of savings that tends to drive down the price of capital and thus results in a decline of what may be called the natural interest rate. I cannot go into the difficult details of the discussion of these phenomena, but I think one can safely conclude that the tendency toward long-run low interest rates is due to economic developments, and outside the reach of central bank policy.

This is the general picture. But when we look at specific developments, specific actions of central banks may be of relevance. One can safely assume that the policy of the ECB of buying bonds for a total of about 2600 billion euro did have an additional effect on interest rates – even if this effect may get smaller over time. A specific case is that of negative interest rates. Here the ECB is unique in a sense. There are other economies with negative interest rates like Switzerland, Japan or Denmark. But in these cases, negative interest rates are used as an exchange rate policy instrument. The ECB is different. It has no exchange rate goal, so negative interest rates are used as an instrument to achieve price stability in the sense of higher inflation rates. In this case, the economic reasoning is on much weaker ground in my view, and the risk is increasing that the negative side effects will outweigh the intended stability effects[1].

"The EU Treaty gives the ECB the mandate to maintain price stability. But how to define price stability?"

But here we meet another dilemma of rules versus flexibility and, in this case, it is a self-inflicted dilemma: The EU Treaty gives the ECB the mandate to maintain price stability. But how to define price stability? Like many central banks, the ECB originally set an upper limit for the inflation rate of 2% in 1998. Then, in 2003, this definition was "clarified" and changed to the present formulation of "to maintain inflation rates below, but close to, 2%" and, as an element of flexibility, "over the medium term" was added. The aim was to avoid too high rates of inflation on the one hand and deflation on the other hand. Given that it is much easier for central banks to stop inflation than to overcome deflation, the strategy of "close to 2%" was a safeguard against getting into deflation. When this decision was taken by the Governing Council of the ECB, these numbers reflected the actual developments, with inflation expectations between 1999 and 2003 oscillating between 1.7% and 1.9%. But over time the ECB developed into an inflation targeter with an inflation target, i.e. "the rule" of 1.9%."

In recent years, inflation in the euro area never reached this target and so the ECB felt obliged to follow its self-imposed rule and to engage in expansionary monetary policy, even if this has not been warranted on macroeconomic grounds.

"I consider it to be dangerous for the credibility of a central bank if it is not able to reach its self-imposed goals for a long period of time."

In addition, to influence inflation expectations, the ECB follows a policy of forward guidance. This means in effect the promise to continue expansionary monetary policy until the stability goal of the ECB is safely achieved. If we combine this with expectations of long-lasting low inflation – the markets' five-year expectation is about 1.2% – this would mean expansionary monetary policy for a very, very long time.

In my view, this is legally and technically not feasible. In other words, in this case, the macroeconomic realities would prove more powerful than the stability rule set by the ECB. This leads to a typical situation where, I think, one must adapt the rules

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1) So as a policy line I advocated for getting out of negative interest rates as soon as possible and especially for using the "good days of 2017/2018" for a more energetic normalization.

to remain credible. Because I consider it to be dangerous for the credibility of a central bank if it is not able to reach its self-imposed goals for a long period of time. This should not imply giving up the mandate for price stability as set forth in the EU Treaty, but in my view, this is a strong argument for a more realistic and flexible definition of price stability. This would mean e.g. to stick to the definition of 2% but with a range of, say, 1% to 3%, along the lines of what several other central banks are already doing today. There is no doubt that doing away with a policy of long-run low interest rates would not be welcome by parts of the financial markets – but central bank independence should mean not only independence from state intervention, but also independence from market pressure.

Saving the Euro – Looking at the Details

The most dramatic monetary policy intervention with regard to markets happened on July 26, 2012 – and it was spectacularly successful. I refer to Mario Draghi's famous "whatever it takes" phrase that is regarded as the intervention "that saved the euro."

It makes sense to look at this dramatic episode in more detail. The point of departure was a situation where, due to severe policy mismanagement, in several Southern European countries trust in public finances had dramatically declined, bond interest rates had exploded, massive capital flight had set in and markets had increasingly been dominated by "re-denomination risk," e.g. the risk of a breakup of the euro area. At the center of these developments were Greece, but especially also Italy, a founding member of the EU and currently its fourth-largest economy.

"Given all this, in 2012, it became obvious that markets got into a situation – well-known in history – of a self-fulfilling and accelerating panic. There is clear historical evidence that such a crisis can be stopped only by outside intervention."

Markets' extreme nervousness was not without reason – because the legal structure of European monetary union means that in fact legally each single euro area member country is exposed to the risk of insolvency – which is in strong contrast to the situation of the U.S. dollar or the British pound. In countries like the U.S.A., the U.K. and Japan, public debt is in their respective own currency and in extreme cases – and also in not so extreme cases – the governments of the U.S.A., the U.K. or Japan can de facto rely on the central bank to finance their public debt. In the long run, this may sometimes – not always – lead to higher rates of inflation – but markets, being primarily short-term-oriented, typically see inflation risks as less dramatic than the risk of sovereign default. The public debt of euro area countries – also debt in euro – is always foreign debt. Their currency is created by the supranational European Central Bank. In fact, one of the legal pillars of European monetary policy is Art. 123 of the TFEU that prohibits "monetary financing." This means there is – at least in theory – an inherent risk of public default. This was deliberately introduced in the EU Treaties to enforce fiscal discipline among the member countries and it is further strengthened by the "no bail-out" clause of the EU Treaty. German Chancellor Angela Merkel once described this approach as "democracy under market discipline." Given all this, in 2012, it became obvious that markets got into a situation – well-known in history – of a self-fulfilling and accelerating panic. There is clear historical evidence that such a crisis can be stopped only by outside intervention. This is like a bank run, where governments must intervene via guarantees or central banks have to act as lender of last resort – if it is in the public interest.

So, Europe was confronted with a set of rules to prevent "moral hazard" on the one hand and economic necessities for intervention on the other hand. The problem of the existing set of rules was – and still is – that they refer to the mismanagement of one specific country but ignore that in an economic and monetary union all members are closely connected via capital markets and market expectations. The default of one country may weaken creditors in other countries and the occurrence of a default of one country may weaken trust vis-à-vis other debtors – in this case vis-à-vis other Southern European countries.

"The problem of the existing set of rules was – and still is – that they refer to the mismanagement of one specific country but ignore that in an economic and monetary union all members are closely connected via capital markets and market expectations."

In 2008, it became obvious that accepting the collapse of a – globally – rather mid-sized bank, namely Lehman Brothers, led to a general breakdown of trust in the banking system and thus to a global breakdown of money markets. So, accepting Lehman's default proved to be a very costly mistake. Accepting Italy's sovereign default would have been much more costly and would have de facto meant the breakdown of the euro – as rightly anticipated by the markets – and perhaps would have led to the end of the European Union as such.

Some German professors have argued that, if there is a need to save the euro, it is up to the governments and not to the ECB to act because the ECB's sole mandate is with regard to the price stability of the euro. This, for me, is a rather strange position. First, the mandate of the ECB is more nuanced: The primary objective of the ECB (Eurosystem) is to maintain price stability. But "Without prejudice to this objective, it shall support general economic policies in the community with a view to contributing to the achievement of the objectives of the community" (Art. 105/1 TFEU). These objectives include a high level of employment and sustainable and noninflationary growth. Second, it is obvious that to deliver a stable currency, you must have a currency – this was the basic argument of Mario Draghi. This legal discussion went to the German Constitutional Court and then to the European Court of Justice, which ruled in favor of the ECB.

"With regard to macroeconomic policy, the rules of the EU Treaty, including the Stability and Growth Pact, basically make sense as long-term guidance, but there must be room to avoid costly short-term policy mistakes."

All told, the developments of the summer of 2012 have to be seen as a dramatic illustration of the dilemma between a rule-based approach and targeted policy interventions. Because this is not a black-and-white constellation. Rules may help avoid a crisis ex ante. Thus, e.g. the most important lesson from the banking crisis of 2008 was to engage in massive re-regulation of the banking sector to increase the stability of the banking sector. With regard to macroeconomic policy, the rules of the EU Treaty, including the Stability and Growth Pact, basically make sense as long-term guidance, but there must be room to avoid costly short-term policy mistakes.

In the case of Draghi's intervention, one must be aware that this intervention had indeed a spectacular immediate effect – but that in the end the euro was saved by a combination of unconventional ECB policies and new institutional arrangements, especially the creation of the European Stability Mechanism (ESM). Basically, as mentioned later, some kind of an EU fiscal element would be necessary to complement the monetary policy of the ECB in a situation of crisis. This, of course, would mean a more substantial transfer of budgetary decision making to the EU level. And here we are confronted with strong political and legal problems, especially in Germany. The German Constitutional Court once declared that the right to decide on the budget is the "crown jewel" of national parliaments.[2] Thus, the setup of the ESM being multilateral and not supranational may be another example of not fully effective rules – but all in all these combined actions had the effect of stopping the panic of the markets. So, the OMT (Outright Monetary Transactions) instru-

2) https://www.welt.de/politik/deutschland/article106631925/Verfassungsrichter-als-Verbuendete-des-Bundestags.html

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ment allowing the ECB to buy public debt if a country is subject to an ESM program, never had to be used – which demonstrates the power of signaling and of trust in the management of monetary policy.

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Conclusions

In the long run, there will, however, be a need for better coordination of monetary and fiscal policy in the event of crisis. A group of eminent economists, among them Stanley Fischer, a highly influential professor at the MIT and later Governor of the Central Bank of Israel and Vice Chairman of the Federal Reserve System (Fed), and Philipp Hildebrand, former Chairman of the Governing Board of the Swiss National Bank, recently published a paper entitled "Dealing with the next downturn." In their view, central banks have de facto run out of effective ammunition in the case of a potential new crisis. Fiscal policy in many countries is, however, also limited due to the existing high levels of public debt. A policy of "benign neglect" – of doing nothing on the economic policy front and of waiting for the markets to stabilize themselves – could lead to economically and politically catastrophic effects. The developments of the 1930s – especially also in Germany – may be a strong warning signal. On the other hand, just eliminating restrictions on monetary financing by central banks may pose grave "moral hazard" problems. So, to solve this dilemma, Fischer and his colleagues (Bartsch et al., 2019) propose to create a "standing emergency fiscal facility," financed and also managed by central banks. In the case of a severe crisis, central banks could activate this facility, but they would also have to provide ex ante adequate exit strategies. Thus, this proposal could combine the rules of central bank independence with the need for effective macroeconomic intervention.

Summing up: Economic life is influenced both by politically given rules and by market developments and market-oriented interventions. The challenge is to find an adequate equilibrium between these forces. It would be dangerous to ignore rules, but it would also be dangerous to apply rules in a dogmatic way, while ignoring basic economic developments. For central banks as public institutions, this challenge is of specific relevance because it determines the way how independence is exercised.

In general, the ECB made good use of this independence in the past – but we must be ready to meet further challenges as they are sure to arise!

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