



*Reconciling Governance and Model:  
a Five-Fold Narrative for Europe*

# Which future for the ECB?

Presented by

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**(joint work with Giovannini and Gros)**



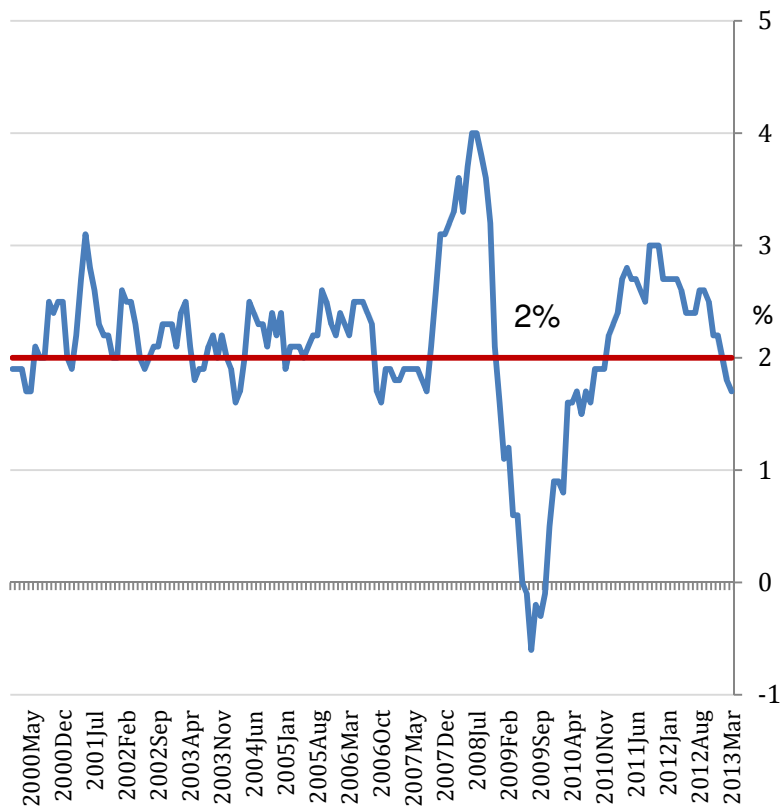
Brussels 25 April, 2013

# Outline

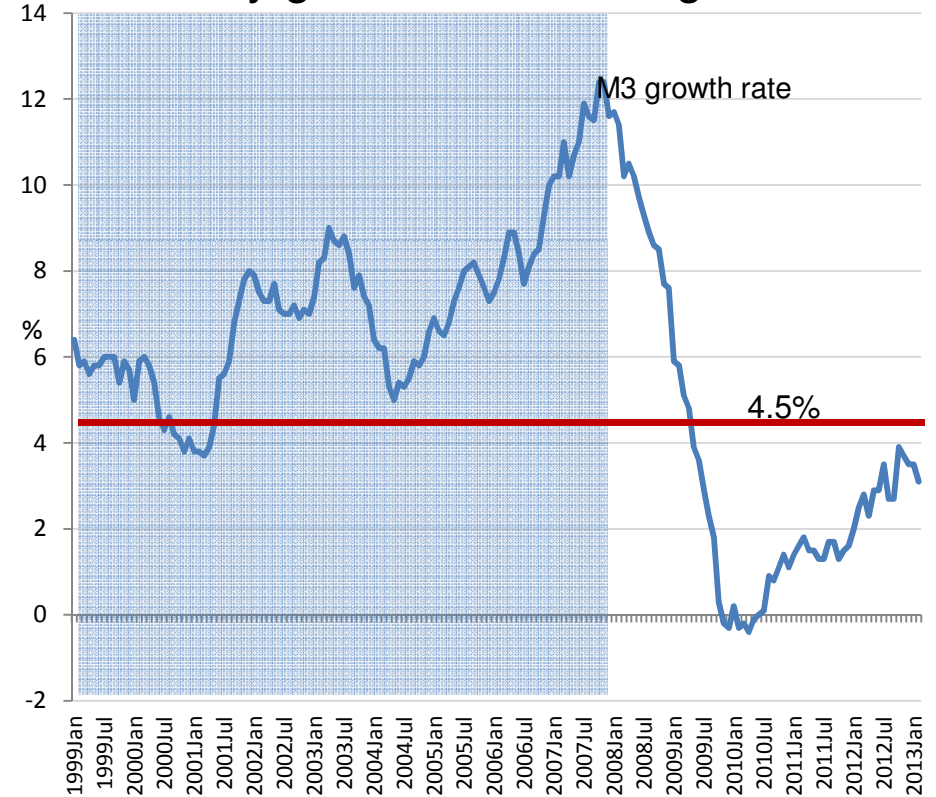
- The ECB original design and the inflation targeting context
- The eruption of the global financial crisis:
  - unconventional monetary policy across the world
- 2010:
  - blurring borders between fiscal and monetary policy, undermining independence?
  - The euro area crisis: persisting crisis management mode
- The challenges ahead for the ECB:
  - Banking union: supervision and monetary policy
  - Exit strategy
  - Looming long-term risks: ‘Japanization’ of the EA economy?
- Which ECB? overloaded!

# The illusion of the easy task of targeting inflation

Inflation: Centered target



Money growth: missed target



Source: ECB

# The global financial crisis: unconventional monetary policy across the world

First response (2007-end 2009) similar to the other major Central Banks of western economies:

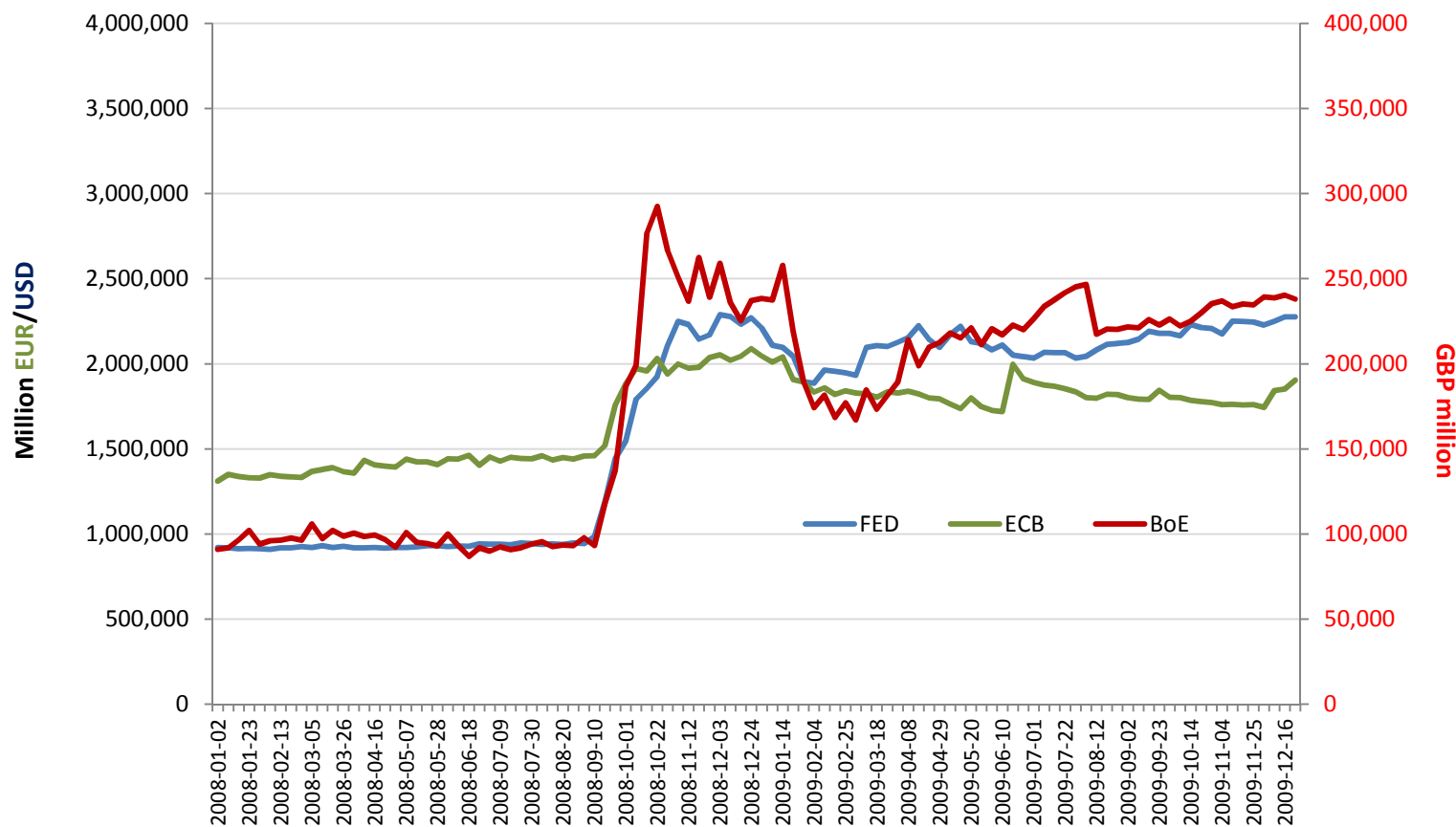
- cut interest rates & unconventional policy measures for injecting liquidity (duration of refi & eligibility)

But differences in terms of assets purchase:

- UK quantitative easing (200GBP)
- US intervention in specific market segments (1 trillion USD);
- ECB CBPP (€60bn)
- ECB focus on banking system: enhanced credit support program
- Result..

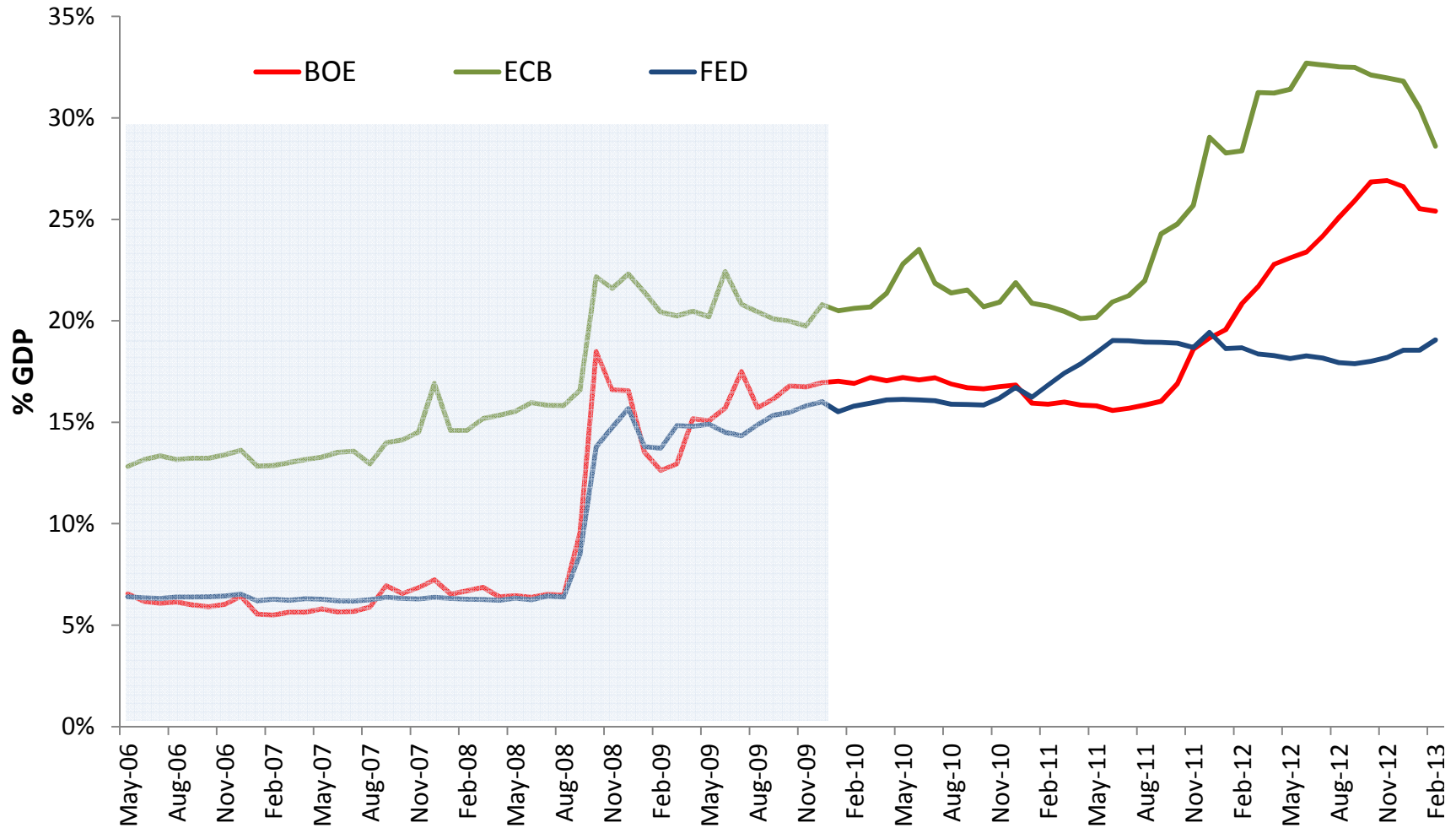
# Similar expansion of the balance sheets (I)

## Total Assets/Liabilities



Source: ECB, FED and BoE data

# Similar expansion of the balance sheets (II)



Source: ECB, FED and BoE data

## Is inflation targeting at risk?

Not in terms of outcome

- Actual and expected goods price inflation under control

BUT

- Exclusive and narrow focus on inflation assessed as insufficient and even misleading
- Financial stability priority at least temporary
  - Which trade-off?
  - Emerging trends to central bank independence?

# The euro area crisis (I): credit easing

## The second stage of the crisis (2010-):

- Unique to the EA: Different degree of financial stress and risk perception in the financial markets
- UK, US: concerns about economic cycles:
  - more intense stimulus through monetary policy (Pure QE with no credit risk)
- EA debt crisis: no monetary policy but crisis management
  - Limited assets purchase unlike US (USD 2.3) and UK (GBP375 bn)
    - » SMP: restore the proper functioning of the monetary policy transmission mechanisms (about 200 bn);
  - ECB preference for direct support to banks: credit easing
    - » ELA
    - » LTRO: central counterparty of EA banking system, segmented along national lines (bearing credit risk)
  - OMT, for the moment just on paper

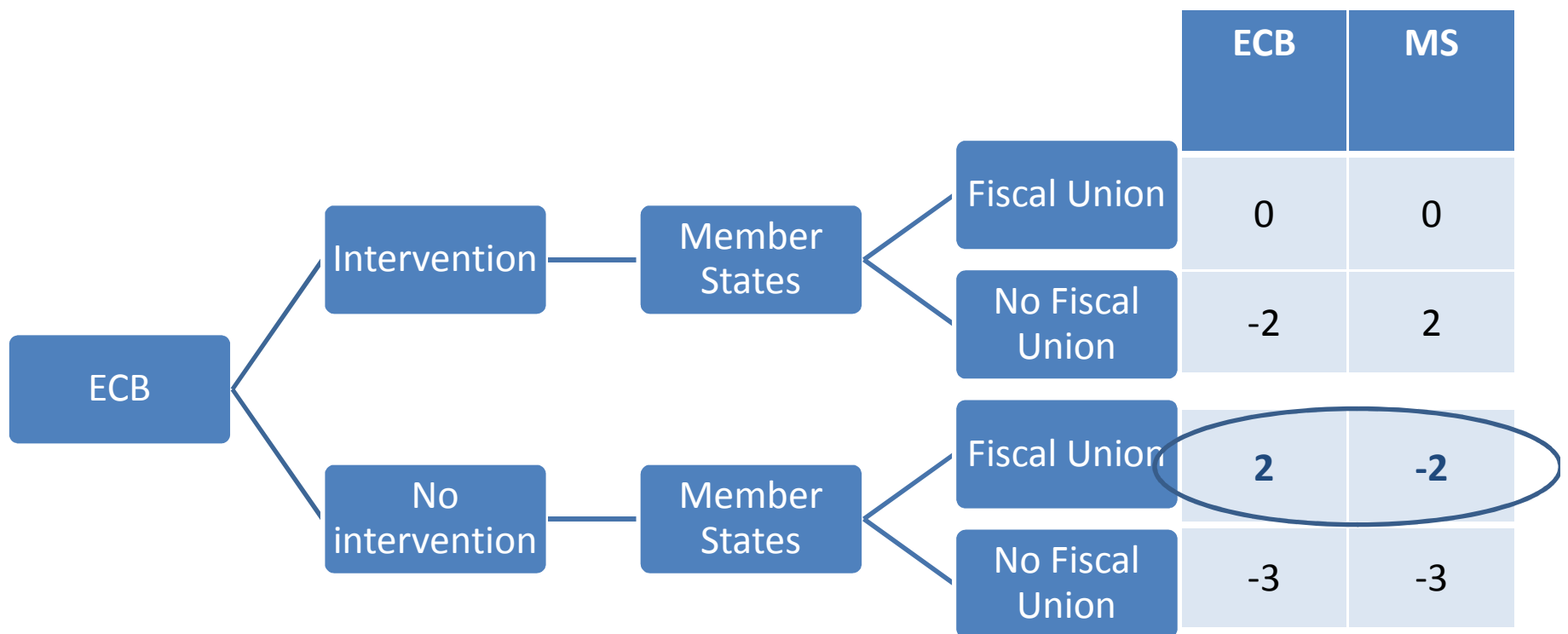


## The euro area crisis (II): risks to CB's Independence?

Inflation targeting is insufficient to guarantee financial stability:

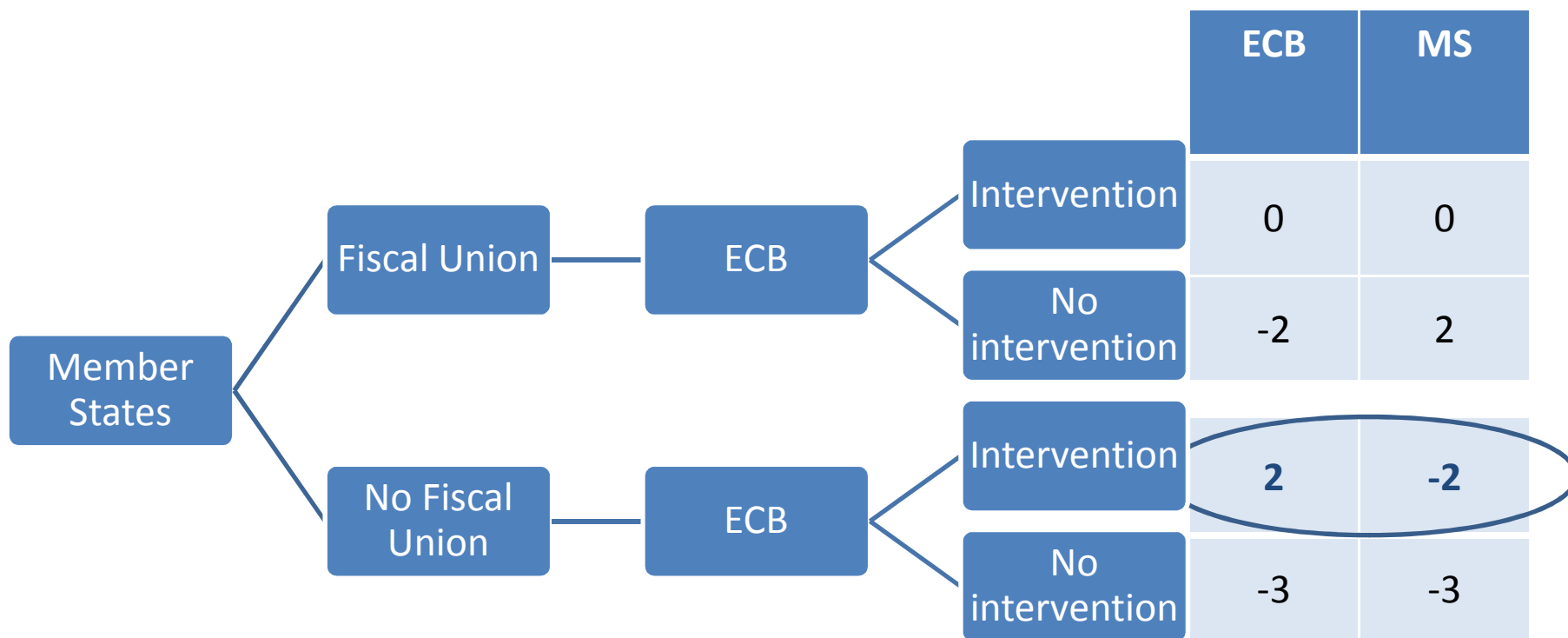
- Risk of collapse of the EMU: a call for a ECB as lender-of-last-resort
  - Blurring the distinction between fiscal & monetary policy
- ECB tried to avoid it but it did acted as LLR
- Looming risk undermining independence & credibility in pursuing price stability
- A game theory approach with two players with two strategies each:
  - Fiscal authorities (MS): greater fiscal union and status quo
  - ECB : massive intervention in debt markets (obviating the need for greater fiscal union in the short term) and no intervention

# A sequential approach: ECB first mover



Equilibrium: FISCAL UNION (MS) / STATUS QUO(ECB) -> ECB

# A sequential approach: MS first mover



Equilibrium: STATUS QUO (MS) / ACTIVE INTERVENTION (ECB)

## **The euro area crisis (III): risks to CB's Independence?**

Interpreting OMT with conditionality:

– ECB to force the achievement of the cooperative outcome (Bothe ECB and MS act):

- Remove sequence approach
- Avoid the bad outcome

# ECB's challenges ahead (i): Monetary policy & banking supervision under one roof

## Institutional challenge:

- Primary mandate remains monetary policy and price stability
- Risk of conflict of interest: refi to banks is huge, keep lending to avoid losses
- Bank failure is a highly fiscal & political (national) issue:
  - Lack of democratic accountability
  - Loss of political independence

## Operational challenge:

- Monetary policy:
  - relatively infrequent decisions about one variable;
  - implemented uniformly throughout the system by the NCBs;
  - fiscal implications, but diffused among Member States.
- Banking supervision:
  - It requires hands-on management;
  - Few decisions during normal times, frequent major decisions in times of crisis

## ECB's challenges ahead (ii): Looming LT risk: 'Japanization' of the EA economy?

- 'Disturbing' similarities with Japan of two decades ago are emerging:
  - ageing population;
  - large debt burdens;
  - Bank fragility
  - Small (in relative terms) open economy with current account surplus
  - weak internal demand.
- ECB may be called to face huge pressures, which could undermine its independence:
  - Need of preserving rooms for monetary manoeuvres;
  - Need of fixing current institutional fallacies in EU design.

# Conclusions

- The eruption of the crisis in 2007 has complicated enormously the job of central bankers
- The old paradigm of inflation targeting needs, at least, to be adapted (augmented?)
- Prolonged weak economic performance: temptation for m.p. to stimulate the economy
- Can CB keep the promise of:
  - Maintaining Price stability
  - Ensuring Financial stability (Supervision + LLR)
  - Stimulating the economy
  - Remaining politically independent



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