Challenges for the ECB in Times of Deflation

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International Labour Office
Geneva

Employment Policy Department

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Preface

The primary goal of the ILO is to work with member States towards achieving full and productive employment and decent work for all. This goal is elaborated in the ILO Declaration 2008 on *Social Justice for a Fair Globalization*,[1] which has been widely adopted by the international community. Comprehensive and integrated perspectives to achieve this goal are embedded in the Employment Policy Convention of 1964 (No. 122), the *Global Employment Agenda* (2003) and – in response to the 2008 global economic crisis – the *Global Jobs Pact* (2009) and the conclusions of the *Recurrent Discussion Reports on Employment* (2010 and 2014).

The Employment Policy Department (EMPLOYMENT) is engaged in global advocacy and in supporting member States in placing more and better jobs at the center of economic and social policies and growth and development strategies. Policy research and knowledge generation and dissemination are essential components of the Employment Policy Department's activities. The resulting publications include books, country policy reviews, policy and research briefs, and working papers. [2]

The *Employment Policy Working Paper* series is designed to disseminate the main findings of research on a broad range of topics undertaken by the branches of the Department. The working papers are intended to encourage the exchange of ideas and to stimulate debate. The views expressed within them are the responsibility of the authors and do not necessarily represent those of the ILO.

Azita Berar Awad
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[1] See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf
[2] See http://www.ilo.org/employment.

Foreword

This paper highlights how European Monetary Union (EMU) governance, as designed by the Maastricht Treaty and subsequent modifications, is unfit to deliver sound and effective macroeconomic management that is conducive to sustained and sustainable economic prosperity for all Europeans. This is especially evident at times of crisis. The paper argues that monetary and fiscal policy in the EMU design leave very little room for manoeuvre. This is consistent with the prescriptions of a prevailing consensus that focus mainly on the supply side of the economy and blames the crisis on the fiscal profligacy of the peripheral member states of the EMU. This has engendered pro-cyclical fiscal policies. The paper also argues that the inertial or pro-cyclical behaviour of fiscal authorities projected a reluctant European Central bank (ECB) to eventually take decisive (and controversial) ECB action. Without such action, however belated, the Eurozone would probably not exist today.

The paper then points out that the ECB and European policy makers at large still adhere to the prevailing consensus. The consequence is that the policy response to the crisis is always too little and too late. The paper concludes that without reform of the Eurozone's macroeconomic governance, it is difficult to foresee a permanent resolution of current woes. It suggests adopting a modified 'golden rule' of public finances – which gives primacy to protecting growth promoting investment during fiscal adjustments - and considering the introduction of a dual (or even triple) mandate for the ECB.

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Abstract

This paper assesses the performance of the European Central Bank (ECB) during the crisis that started in 2008. The ECB statute is consistent with a view of the economy that was predominant in the 1990s, a view that postulates a very limited role for discretional policies in managing the business cycle. The ECB had therefore to stretch its mandate on several occasions during the crisis to avoid severe outcomes. It was unable to avoid a slow but inexorable slide of the Eurozone towards deflation and a liquidity trap. To restore robust growth, fiscal policy should be used, and institutions should be redesigned away from the Washington Consensus framework that shaped the Maastricht Treaty. Better rules for fiscal governance and a widening of the ECB mandate are proposed.

1. Introduction

The global financial crisis that began in 2008 seems to be slowly fading away, as the world economy continues to recover from the worst shock since the 1930s. Recovery is fragile and uneven, as was aptly recalled by the latest IMF *World Economic Outlook* (IMF, 2014). In particular, emerging economies (with the possible exception of China) may face difficult times ahead because their potential growth has been impacted by the crisis (and also by increased geopolitical risks). Yet, even if revised downwards, the IMF global growth forecast for the years ahead is acceptable.

The first phase of the crisis has been extensively discussed. Suffice it here to recall the salient facts: the unravelling of a small speculative sector of the US credit sector, the market for subprime loans, generated a cascading effect on the rest of the global financial system. Contagion was mostly due to the deregulation which allowed the proliferation of increasingly opaque financial instruments, spreading toxic assets in the portfolios of often unaware owners, and leading at the same time to excessive risk-taking and debt. When the US housing bubble burst, financial institutions worldwide, and also households and firms, rushed to sell their assets. This deleveraging process led to a credit crunch and to a drastic reduction in investment and consumption. The financial crisis therefore spilled over into the real economy.

The policy response followed the typical textbook recipes that have been known since Keynes wrote the *General Theory* in 1936: the prompt intervention of central banks through massive credit to financial institutions prevented the meltdown of the financial sector. This injection, nevertheless, was ineffective in restarting the economy. In the process of deleveraging, banks, businesses and households shrank their balance sheets, thus reducing liquidity (see Adrian and Shin, 2010) at a faster pace than credit was increased by central banks. It did not, therefore, translate into demand for goods and services. This *liquidity trap*, familiar to historians, made monetary policy lose traction, as was clear by the end of 2008. In line with Keynes' prescriptions, fiscal policy then took the centre stage; in the Spring of 2009, most advanced and emerging economies implemented massive stimulus plans to support demand and put the economy on a recovery path, even if at the price of a generalized deterioration of public finances.

The European economy, in particular the Eurozone countries, began to diverge from the other advanced economies when, in the fall of 2009, Greece disclosed frauds in the management of public finances that had been going on for the previous decade. The Greek crisis revealed imbalances that went well beyond irresponsibility in the management of the public finances at the Eurozone periphery (Saraceno, 2013a). Since then, while the rest of the world economy is heading towards a recovery, fragile certainly, but irreversible, the Eurozone has been mired in a deepening crisis, which may still endanger the very existence of the single currency.

The scope of this paper is to assess the response to the crisis, looking both at the policies followed, and at the rules and institutions that European Monetary Union (EMU) has in place to ensure its good governance. The focus will be on monetary policy that, most probably against the will of ECB presidents Trichet and Draghi, came to be at the forefront of the fight against the crisis. In a nutshell, it argues that the ECB has been the only institution fighting against the breakup of the Eurozone, but mostly for the wrong reasons, i.e. the inertia and wrongheaded fiscal policy of Member States. It then argues that this dysfunctional behaviour of European policy makers is the fruit of a European version of the Washington Consensus, that has shaped institutions and, even more importantly, the mind-set of those policy makers.

The structure of the paper is as follows: Section 2 is devoted to an analysis of the Eurozone's slow slide into deflation during 2014. The following section builds on previous work (Fitoussi and Saraceno, 2013) to describe the theoretical underpinnings of the so-called Berlin-Brussels-Frankfurt (BBF) consensus. Section 4 then addresses the behaviour of the ECB during the crisis, showing how it went as far as the treaties allowed, and sometimes beyond, to fight speculation and the threat of exit by peripheral countries. Section 5 deals with what needs to be done to lift the EMU economy out of the crisis. The paper argues that in a liquidity trap there is only so much a central bank can do, and that the answer lies in a more active fiscal policy; this in turn would require modifying the current fiscal framework. The section concludes by asking whether a dual mandate, or even a triple mandate including fiscal stability, would better equip the ECB to fight recessions and foster economic growth.

2. 2014 – Annus Horribilis

The Summer of 2013 was a period of widespread optimism among European policy makers. Speculation was defused, European peripheral countries were no longer in danger of leaving the euro, and their economies seemed to be going better. Partisans of austerity (see, for example, German Finance Minister Wolfgang Schäuble, 2013) claimed vindication of their view that austerity and structural reforms, however painful in the short run, were necessary to improve the fundamentals of troubled economies, so as to take advantage of the recovery later on. The short-term pain of austerity and recession was justified as the price to pay to obtain the long-term gain of improved competitiveness and exports, together with convergence towards the benchmark represented by virtuous and successful countries like Germany. It was already clear at the time that this representation did not correspond to reality; first, because the Eurozone kept diverging (Saraceno, 2013b); and, second, because growth was driven mostly by export growth, and was therefore intrinsically fragile. There are two reasons why an export-led model is fragile: The first is the well-known fallacy of composition: not everybody can export at the same time, which means that by definition the German model cannot be generalized, and its success rests on other countries absorbing its excess savings. The second reason, more political, is that by betting on an export-led growth model, Germany and Europe will be forced to rely on somebody else's growth to ensure their prosperity. This is of course a source of economic fragility, but also of irrelevance in the political arena, where influence goes hand in hand with economic power. Embracing the German economic model, Europe would condemn itself to a secondary role in the world arena.

2014, *Annus Horribilis* of the Eurozone, has confirmed that there was no reason to be optimistic. Data from the European Commission (Figure 1) show that real GDP for the Eurozone will still be below its pre-crisis level in 2014, and is forecast to return above it only in 2016. In the meantime the United States is well above its pre-crisis peak (+8%). Even the more successful EMU economies like Germany are barely above the level of 2008 (+3%), and their growth in the next two years is forecast to be rather disappointing. Two large economies, Italy and Spain, are around 8% below the peak.

The persistent weakness of the Eurozone economy has slowly pushed the area towards deflation (Figure 2). At the beginning of 2013, the Eurozone inflation rate was around the target level of 2%. Since then, however, it has decreased almost continuously. The flash estimates for December 2014 officially mark, with a rate of -0.2%, the entry of the EMU into deflation. Considering in addition the turmoil caused by the recent change of government in Greece, there is little doubt that the Eurozone remains today the sick man of the world economy. The possibility of a triple dip, a third recession in 2015, cannot be ruled out, but even without that, the Eurozone is entering its eighth year of negative or stagnant growth; unemployment is at record high levels, and is not forecast to decrease for two more years at least (Figure3). The risk of a lost decade is becoming a reality. This calls for a comparison with the Japanese experience of the 1990s. Figure shows real GDP evolution in Japan and in the EMU starting from 1992 (red line) and 2008 (blue line) respectively. 28 quarters into the crisis, Japan's GDP was 8 points larger than EMU's GDP today. As it could be objected that this is unfair to the EMU because Japan in the 1990s never did experience a slump comparable to the one of 2008 in Europe, the yellow line plots Eurozone GDP starting from early 2009. Even taking into account the rebound, the Eurozone today does not match the performance of Japan in the 1990s. The conclusion, as Paul Krugman (2014) aptly puts it, is that the Eurozone should stop looking at Japan as a worst case scenario, but rather as a role model[1].

Today the ECB is facing a situation that was not believed possible when its governance was designed with the Maastricht Treaty. The Treaty was designed to prevent free riding by Member States, and excessive inflation. Long periods of depressed growth were not believed to be possible any more in Europe or in the United States. This led to a design, grounded in a particular doctrine, which is today showing all of its limitations.

3. The ECB mandate and the Berlin-Brussels Consensus

The institutions for European economic governance were designed under the Maastricht Treaty, signed by the EU Member States in 1992. The Treaty contained the five criteria to be fulfilled by countries wishing to adopt the euro[2], and the statute of the ECB. As Member States in the Eurozone remain in charge of their fiscal policy, the other major building block of European economic governance is the Stability and Growth Pact (SGP), introduced by the Amsterdam Treaty in 1997. The SGP organizes fiscal surveillance of countries belonging to the single currency around a preventive arm (broadly speaking a system of peer pressure, see Fitoussi and Saraceno, 2008), and a system of sanctions for countries not respecting the fiscal rule of a balanced budget over the business cycle.

It is well known that the Maastricht Treaty also assigns to the ECB a strict inflation mandate: "The primary objective of the ESCB (Eurosystem) shall be to maintain price stability" (art. 127), and “Without prejudice to the objective of price stability, it shall support the general economic policies in the Community” (art. 2). It is worth noticing that the ECB is given considerable independence by the Treaty in the definition of price stability that the ECB’s Governing Council defines as a "year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below, but close to 2%". In the United States, instead, the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act) amended the Federal Reserve Act in establishing a *dual objective* for monetary policy of price stability and full employment. These different institutional arrangements are no accident, but reflect the intellectual environment in which they emerged. The Humphrey Hawkins Act dates from a period in which Keynesian dominance in academic and policy circles posited a role for macroeconomic policy. As a consequence, monetary policy could, and should, include full employment among its objectives. The Maastricht Treaty, on the other hand, centred European economic governance on the rejection of active macroeconomic policies: the ECB only has a mandate for price stability, and has considerable autonomy in pursuing it. Furthermore, the SGP forces countries to rely solely on automatic stabilizers to cushion economic fluctuations. This “Berlin-Brussels-Frankfurt Consensus” (Fitoussi and Saraceno, 2013) is an evolution from the

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[1] Wolfgang Munchau (2014) argued recently that the length of the crisis, and the incapacity of European policy makers to endow the Eurozone with well-functioning governance endanger the single currency more today than at the height of the crisis.

[2] The five criteria, aimed at guaranteeing nominal convergence before the adoption of the single currency, are: (1) Inflation close to the average between the lowest inflation rates in the zone; (2) long-term interest rates close to the average between the lowest interest rates in the zone; (3) two years at least in the exchange rate mechanism, without realignments; (4) public deficit lower than 3% of GDP; (5) public debt lower than 60% of GDP, or approaching that level at a sufficiently fast pace. By the decision date of June 1998, 11 countries fulfilled the criteria, with Greece joining shortly afterwards. As of January 2015, the Eurozone has 19 members.

original Washington Consensus (Williamson, 1990), a fuzzy concept used here to label any set of policies that follow three basic principles: first, the quest for macroeconomic stability (balanced budgets, price stability, and, for developing countries, exchange rate stability); second, supply-side structural reforms aimed at increasing competition and openness; and third, ignoring any possible trade-off between present and future growth. The Washington Consensus inspired development policies for more than two decades with mixed results (Gore, 2000; Rodrik, 2006). Furthermore, Fitoussi and Saraceno (2013) argue that today it is shaping policies and institutions in Europe. As a side note, it is interesting to notice how the proponents of the consensus have evolved. In the early 2000s Fitoussi and Saraceno talked about a "Brussels-Frankfurt-Washington" consensus, that later evolved into a "Berlin-Washington" consensus. In the current paper, the expression "Berlin-Brussels-Frankfurt" (BBF) consensus was chosen, as the IMF has lately been distancing itself from the Consensus policy prescriptions (IEO, 2014). The discussion below shows that there may be grounds for believing that the ECB itself, showing unprecedented activism in managing the crisis, is also distancing itself from the Consensus. As this paper argues, however, this activism can be explained by the paralysis of other institutions (the Commission and Member States), and not by a change of paradigm in the Governing Council analyses. "Frankfurt" is therefore retained in the Consensus label.

While its proponents change, the Consensus *per se* is rather stable, having its theoretical foundations in the neoclassical Walrasian theory. In a nutshell, the theory postulates the centrality of markets populated by rational agents who, if left free to operate without distortions, tend to converge spontaneously to "optimal" equilibria, characterized by full employment of resources and the maximization of a representative agent’s welfare (the so-called Pareto efficiency). Price and wage flexibility, then, ensures that demand adapts to full employment supply (a principle known as Say’s Law). The emphasis of the theory is then on supply-side measures capable of increasing the capacity of the economy to produce. Barring exceptional circumstances, this view considers aggregate demand management useless, if not actually harmful. Credible reforms would boost profits and productivity expectations, thus leading to increased demand and growth. And even if supply-side policies, reducing wages and social protection, were to have a negative impact on private demand, this would be more than offset by the export-led growth induced by gains in competitiveness.

A crucial corollary of the Walrasian framework is that money, whose intrinsic utility is zero, is only demanded for transaction purposes. It stems from this corollary that, at least in the long run, money is *neutral,* i.e. it has no impact on the real sector, and only affects prices and inflation. In the short run, the existence of rigidities may suggest that monetary policy has real effects, as is for example the case for New-Keynesian models (see, for example, Woodford, 2003). However, long-run neutrality dictates that even in these cases, the best central banks can do is to keep strict inflation targets, thus anchoring private sector expectations and minimizing deviations from the optimal path of the economy. Rules, be they fiscal or monetary, are justified by the same token: they avoid policy-induced uncertainty, minimize the risk of biases in government action, and provide a stable environment for investment and growth.

The existence of a Pareto superior equilibrium to which the market economy spontaneously tends once the appropriate conditions are met has very strong policy implications: the only role for economic policy is to make sure that barriers to free competition (monopolies, asymmetric information, rigidities) are removed through “structural reforms”, so that markets are able to converge to the optimal equilibrium path. Policy is not supposed to make choices, but only to clear the ground of obstacles to the free unfolding of market forces, leading to a state that, by definition, represents the best of all possible worlds. This is why, for the Consensus, technocrats are actually preferable to politicians; not only because they are supposedly more competent, but also and especially because they are free from the vested interests and political bias that could lead to distortions in market incentives. In addition, they are less bound than politicians by the "fetters and constraints" of democracy.

The BBF Consensus, embedded in European institutions and practices since the early 1990s, led European governments to give up active management of the business cycle, and to engage in a non-cooperative strategy through fiscal and social competition. Even before the global financial crisis hit the world economy, the inertia of European policy makers in comparison with their homologues across the ocean was striking. Compare the indicators of monetary and fiscal policy activism. Table 1, updated from Fitoussi and Saraceno (2011), shows that in the pre-crisis period short-term rates in the US and in the Eurozone have been on average very similar (only 40 basis points of difference). This is not informative *per se*, because the interest rate level has to be determined in regard to inflation and output gap objectives, which may have been different in the two zones. What is in fact striking is the much higher variability of interest rates in the United States, with the standard deviation double that of the EMU, and a spread between the maximum and the minimum value which is also significantly larger.

Table 1: Short-term interest rates descriptive statistics: 1999-2007

	Fed Funds	ECB Repo
Mean	3.53	3.09
s.d.	1.82	0.90
Max	6.5	4.75
Min	1	2

Source: Datastream

The same conclusions hold if we look at a similar table for fiscal policy. Table 2 reports the descriptive statistics of the fiscal impulse[3] for the largest European economies, the UK, US and Japan.

Table 2: Fiscal impulse descriptive statistics: 1999-2007

	GER	ITA	ESP	FRA	EMU4*	UK	USA	JAP
Mean	-0.15	0.04	-0.30	0.23	-0.03	0.51	0.44	-0.73
s.d.	1.80	1.20	0.65	0.58	0.90	2.69	1.28	1.86
Max	4.39	2.72	1.03	1.23	2.27	5.25	2.88	1.51
Min	-2.08	-1.29	-1.09	-0.43	-0.70	-4.76	-0.92	-3.64

Source: Datastream

*EMU4 (Germany, France, Italy, Spain) is weighed with GDP

Even if the US experienced higher growth on average (the average growth rate of the US over the period was 2.9% and in EMU4 it was 2.1%), from the table it emerges clearly that the US had a more expansionary stance. More importantly, as with monetary policy, the United States showed significantly higher fiscal activism over the period than EMU4 (an interesting exception being Germany). The higher reactivity of American fiscal authorities is not surprising considering that the US have a lower level of social protection and of automatic stabilization, which calls for a more active role of macroeconomic policies

[3] The fiscal impulse is computed as the negative of year-on-year changes in cyclically adjusted government net lending. It measures the discretionary fiscal stance of the country, a positive number denoting an expansionary period.

to limit the effects of harmful fluctuations of income (Creel and Saraceno, 2010). But there is more than that. Even if the European fiscal rules (the SGP and now the Fiscal Compact) never led to actual sanctions in spite of the numerous infringements, their very existence was capable of constraining governments' action through peer pressure and a general reprobation attached to fiscal (and monetary) activism (Fitoussi and Saraceno, 2008).

To summarize, the BBF Consensus is built around the hypothesis of market efficiency and has been enshrined in European institutions since the Maastricht Treaty. Discretionary policies are limited to a bare minimum, while rules and government by technocrats are preferred to remove the obstacles to the Pareto optimal equilibrium of the economy. EU institutions and practices resulted in inertial macroeconomic policies in Europe, even before the crisis hit in 2007.

It is much harder to accept government by technocrats or by rules, however, if one believes, in the Keynesian tradition, that economic processes are inevitably characterized by failures and imperfections, whether of markets or of policy makers. If the platonic idea of a superior Walrasian equilibrium is abandoned, we are forced to accept the existence of a plurality of possible trajectories for the economy, resulting from the interaction of markets, institutions and public policies. This multiplicity of equilibrium paths, not necessarily ranked in terms of welfare, forces policy makers to choose a particular trajectory and therefore, among other things, one of the many possible distributions of resources between the different actors involved in the economic process.

The crisis that began in 2007 confronted policy makers with hard choices. European institutions, and in particular the ECB, were not suited to the task. They had been designed at a time of "Great Moderation", when it was believed that policy would at worst have to smooth the business cycle. The next section shows how this created tensions and inefficiencies in the management of the crisis that go a long way towards explaining the persistent weakness of the European economy seven years into the crisis.

4. ECB action during the crisis

The reaction of central banks to the near-collapse of interbank markets in 2007-2008 was bold, coordinated, and overall successful. Central banks flooded markets with liquidity, and eased credit conditions; this happened through conventional and non-conventional interventions, and with different macroeconomic effects. While the Fed proceeded with both aggressive rate cuts (3.75 points from August 2007 to October 2008) and injections of liquidity, the ECB privileged the latter measures, and started cutting rates only in October 2008, (after an increase in July 2008, weeks before the Lehman Brothers collapse). The two strategies were equally successful in terms of providing liquidity to the interbank markets and to combat the tendency of short-run rates to increase. However, they had different effects on long-term rates (European rates remained substantially higher than their US equivalent), and hence on the macroeconomic environment. Central banks also put in place non-conventional interventions, with the specific objective of ensuring sufficient liquidity in the interbank market, and *de facto* substituting commercial banks in that market. Open market operations were reinforced, notably by expanding the range of assets demanded as collateral, and including assets whose market value was difficult to determine. Furthermore, central banks increased their exposure, by engaging in longer term loans to the banking sector.

As successful as it had been in avoiding a financial meltdown in the early stages of the crisis, monetary policy was not able to restore confidence. The massive injections of liquidity into the system were hoarded or invested in safe public bonds by banks in an attempt (vain, given the sharp reduction in stock market prices) to restore more sensible prudential ratios. The liquidity trap came out of the pages of the economic history books, and confidently installed itself in the American and European economies. Monetary policy ran out of steam, at least as the main tool of policy intervention.

Consistent with standard textbook prescriptions, centre stage was taken by fiscal policy, and in the winter of 2009 most advanced and emerging economies adopted and implemented fiscal stimulus plans. While these were probably not large enough to lift the economy out of the crisis, their impact was felt and the freefall was stopped. During 2009 the ECB, like other central banks, maintained an accommodating stance, but remained in the background.

The ECB's low profile was bound not to last, however, because with the explosion of the Eurozone sovereign debt crisis, monetary policy returned to the forefront. Consistent with the BBF Consensus, the crisis of Eurozone peripheral countries was interpreted by European governments and institutions as a fiscal morality tale (see, for example, Sinn, 2014). In exchange for financial assistance from the EU and the IMF, countries in distress had to implement draconian structural reforms and austerity plans monitored by a Troika composed of the ECB, the European Commission and the IMF. Austerity was not limited to the periphery, however, as core countries joined in the fiscal consolidation effort that was seen to be the recipe for growth. In spite of the good health of its public finances, Germany engaged in a (so far successful) effort to balance its budget by 2015. Austerity and structural reforms have plunged the Eurozone into a double-dip recession, followed by a weak, mostly export-led recovery in 2013 and a new slide towards deflation in 2014.

Disappointing growth and turmoil in sovereign debt markets put enormous strain on the Eurozone, threatening the very survival of the single currency. The incapacity of European governments to work together in a bold and coordinated response to both speculation and faltering growth forced the ECB to rush in to avert disaster. Interestingly enough, the path followed by the US was not very different. The political gridlock in the US forced President Obama to reverse the fiscal stance faster than he should have done, and the Fed had to step in with its quantitative easing programme to provide support to the economy. But the similarities stop there. First, the United States has a federal structure, so that transfers between states, such as unemployment benefits and tax receipts, contribute to rebalancing asymmetric business cycles. Second, the US stimulus had been significantly larger than the one implemented by EU countries. Furthermore, while the ECB was and still is constrained by the no bail-out clause that prevents it from directly purchasing sovereign bonds in the primary market, the Fed has no such limitation. This means that while the Fed could act as a buyer of last resort and buy government debt, thus making default virtually impossible (and keeping yields very low as a consequence), the ECB could not perform this important role of insurer. Eurozone countries in trouble, therefore, also had and have to fear speculation on their debt.

Since 2010, ECB action has been marked by three major interventions, all of them made necessary by exceptional circumstances. The first is the Long-Term Refinancing Operations (LTRO) programme, launched in late 2011. Then, in 2012, the famous "whatever it takes" speech by Mario Draghi in London (July 26), followed in September by the Outright Monetary Transactions (OMTs) programme. Finally, more recently, Mario Draghi's (2014) Jackson Hole speech, followed by the EMU version of quantitative easing.

The first remarkable ECB intervention was the LTRO programme, launched in two instalments in late 2011 and in February 2012. The plan, prepared by Jean-Claude Trichet, but implemented on the watch of the new President Mario Draghi, was designed to respond to the persistent weakness of the Eurozone interbank market. The ECB provides liquidity to banks through its main refinancing operations, whose maturities in normal times rarely exceeded 30 days. With the crisis, long-term operations acquired importance. Loan duration was gradually increased until December 2011, when the ECB launched a large 36 month lending programme (amounting to a thousand billion euros) at a 1% rate. Most of the allotted funds were borrowed by financial institutions, and the ECB balance sheet inflated accordingly (see Figure). The quality of the balance sheet was questioned in many quarters (see the discussion in Wyplosz, 2012), in that the ECB further extended the range of collateral to be posted to the ECB. In particular, the ECB waived the credit rating requirement for Greek, Portuguese and Irish sovereign debt. In accepting to "pollute" the banks' balance sheet with toxic assets, the new President Mario Draghi marked a difference with his predecessor in that he recognized that a central bank's role is to ensure stability of the financial system as much as it is to guarantee price stability.

The programme was successful, especially with the Eurozone peripheral banks in Ireland, Italy, Spain and Greece which obtained the lion's share of the funding. But it did not manage to end the credit crunch and to restart growth. A large portion of the financing provided to Eurozone banks through the LTRO was used to buy periphery sovereign debt. The LTRO therefore had the unintended consequence of further strengthening the vicious circle of banks and sovereign debt: large holdings of sovereign debt exposed banks to the risk of default; this led to increased fragility and put a strain on the public finances, thus increasing the risk of default and closing the vicious circle[4].

As Figure 5 shows, the LTRO programme did not succeed in calming the turmoil in the market for sovereign debt. During the summer of 2012, Italian and Spanish yields came under increasing strain, and discussion about a possible default and exit from the single currency started to spread, even if rejected by public officials.

In a defining moment of his tenure as President of the ECB, Mario Draghi delivered a speech in London in which he famously said "*But there is another message I want to tell you. Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.*" (Draghi, 2012). This bold statement, which calmed the markets overnight, was taken as a commitment for the ECB to step into the market for sovereign bonds and, if necessary, to stretch its mandate[5] by acting as a lender/buyer of last resort for countries in trouble. This interpretation proved correct when, in September 2012, the ECB Governing Council almost unanimously approved the Outright Monetary Transactions (OMT) programme.

Under the OMT programme the ECB commits to buy unlimited amounts of sovereign bonds of countries in trouble that request assistance, thus *de facto* transforming itself into a lender of last resort. In exchange for ECB protection, countries need to engage in a programme of fiscal austerity and structural reforms to be monitored by the Troika, similar to those required of countries that required financial assistance from the EU. In other words, with the OMT programme the ECB offered insurance in exchange for reforms and austerity. It was a deal that would entail the loss of a good deal of sovereignty. It is not by chance that Spain has always refused to apply for the programme in spite of heavy pressure, and so far no country has ever used it. Yet, the programme marked a turning point in the European crisis. While the BBF Consensus macroeconomic framework remained unchanged (and it was actually reinforced by the emphasis on conditionality), the mere possibility of accessing ECB protection through the OMT programme shielded the peripheral countries from speculative attacks. A look at Figure 5 shows that since late 2012 spreads with German Bunds constantly decreased, and are today at perfectly sustainable levels.

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[4] The Eurozone banking union, that is taking shape at this moment, was meant to provide a supranational backstop for financial institutions, and a common supervisory board. The banking union being implemented falls short, especially on the first account (for details see Ubide, 2013).

[5] In fact, Mario Draghi forcefully denied that the ECB was stepping out of its mandate, arguing that a collapse of the euro, and the ensuing turmoil in financial markets would have undermined the very price stability that the ECB is meant to pursue.

Interestingly, at the time, the OMT programme was wrongly interpreted in some quarters as a clumsy attempt to implement quantitative easing in the Eurozone. In fact, it was clear from the beginning that, as with any insurance scheme, its success would be measured precisely by the fact that the ECB would not have to intervene in bond markets (Saraceno, 2012). As Figure shows, as spreads started closing, financial institutions started paying back LTRO debt, and the ECB balance sheet shrank (its size is today at July 2011 levels, just before the LTRO was launched).

The LTRO and the OMT concurred to calm down financial markets in a durable way. Since the Autumn of 2012, the frequent turbulence (political and economic) that hit the Eurozone never triggered the type of financial turmoil experienced between 2009 and 2012. In this sense, the ECB's policies, implemented in a context of inertial (when not countercyclical) fiscal policy, were successful. The two programmes did not succeed, however, in restarting growth in the Eurozone. The stabilization of financial markets led the ECB to slowly shift its focus from financial stability to macroeconomic performance.

2014, the *Annus Horribilis,* prompted another major shift of perspective for the ECB and for its President that triggered conflicts inside and outside the ECB[6]. In June, facing deteriorating expectations about future inflation, the ECB Governing Council abandons its caution, and explicitly admitted that the Eurozone inflation rate was too close to zero. This opened the way for a new round of liquidity injections, aimed at bringing the balance sheet back to 2012 levels (see Figure). The programme started in September 2014 with the purchase of Covered Bonds and then Asset Backed Securities[7]. The results of this "European Quantitative Easing" programme, still unfolding at the time of writing (January 2015), are mixed (Jones, 2014). While in some regions of the periphery, credit constraints on firms and households are still biting, in the Eurozone as a whole the persistent weakness of aggregate demand has an impact on demand for credit, and the large amount of liquidity available is not being used by financial institutions which are having a hard time finding borrowers. The impact of the programme on the economy is likely to be disappointing, and in January 2015 the ECB made a further major step forward, announcing the purchase of sovereign bonds outside the OMT programme to bring the size of its balance sheet roughly to the 2012 level. This further deepened the divide between hawks and doves within the Governing Council (Davies, 2014). Even if apparently sovereign risk mostly remains in the hands of national central banks, the programme is an important step forward, as it breaks the taboo on direct central bank intervening in sovereign bond markets. There are reasons to believe that the sovereign bond purchase will have mixed results, rather like the private bonds purchase launched in the Autumn of 2014. It is, in fact, evident that the economy never really lifted itself out of the liquidity trap. The troubles in the financial sector hid the increasingly depressed state of household and corporate expectations, which had an impact on the willingness to spend and to borrow. As constraints on credit supply are slowly lifted, financial institutions and the ECB find themselves facing insufficient credit demand.

Furthermore, and potentially even more disturbing, the renewed activism of the ECB does not seem to stem from a change of thinking. The speech Draghi delivered at the Jackson Hole Central Bankers Symposium in August 2014 (Draghi, 2014a) has shaped a new consensus among European policy makers, based on three propositions:

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[6] To carry out the policy changes he had in mind, Mario Draghi had to twist some arms in the ECB Governing Council. This resulted in unprecedented tensions (see Reuters, 2014). In the meantime, a judgment on the constitutionality of the OMT programme is pending in the European Court of Justice at the request of the German Constitutional Court. In January 2015, a preliminary ruling gave comfort to Mario Draghi, declaring the OMT legal "in principle". The final ruling is expected in the late Spring 2015.

[7] An asset-backed security (ABS) is a corporate security (usually issued by a financial institution) whose value is derived from and collateralized (or "backed") by a specified pool of underlying assets that typically are too illiquid to be sold separately.

1. Europe suffers from deficient aggregate demand. The impact of austerity on the economy had been underestimated (on this the ECB is cautious, while the IMF is much more explicit: see IEO, 2014), and the ongoing stagnation has depressed private spending as well.
2. Monetary policy has lost traction, and while it needs to remain accommodating, it will not by itself be able to lift the economy out of the crisis.
3. Finally, the length of the crisis has imposed a toll on the productive capacity of the economy, its potential growth rate, and its capacity to grow in the long run. Therefore, investment is central to stimulating the economy in the short run and to sustaining potential growth in the medium term.

The third point is particularly important, because the ECB President for the first time explicitly mentioned that fiscal policy should be used, within the limits set by the treaties, to support aggregate demand. What is interesting, however, is that while the diagnosis has changed, the policy prescriptions have not. The old narrative argued that the crisis was due to fiscal profligacy and insufficient flexibility in the economy. From the diagnosis followed the treatment: austerity and structural reforms to restore confidence, competitiveness, and private spending. Today we have a different diagnosis: the economy is in a liquidity trap, and spending stagnates because of insufficient expected demand. Yet, the recipe remains the same:

"Let me add however that the success of our measures critically depends on a number of factors outside of the realm of monetary policy. Courageous structural reforms and improvements in the competitiveness of the corporate sector are key to improving business environment. This would foster the urgently needed investment and create greater demand for credit. Structural reforms thus crucially complement the ECB's accommodative monetary policy stance and further empower the effective transmission of monetary policy. As I have indicated now at several occasions, no monetary – and also no fiscal – stimulus can ever have a meaningful effect without such structural reforms. The crisis will only be over when full confidence returns in the real economy and in particular in the capacity and willingness of firms to take risks, to invest, and to create jobs. This depends on a variety of factors, including our monetary policy but also, and even most importantly, the implementation of structural reforms, upholding the credibility of the fiscal framework, and the strengthening of euro area governance." (Draghi, 2014b)

To sum up, The Jackson Hole speech was only half a revolution. The focus remains on structural reforms, and only a limited role is envisaged for monetary and fiscal policy. The ECB is undoubtedly playing a leading role in the crisis, and it has been successfully steered by its President into uncharted waters (sometimes stretching its mandate). There are reasons for this, as it had to fill the void created by austerity and by the disappointing results of structural reforms. But it did so reluctantly, only to avert disaster and the implosion of the Eurozone; most importantly, it never challenged its adherence to the BBF Consensus. At a recent speech in Helsinki Mario Draghi (2014c) outlined his vision for the future of Europe calling for a closer Economic Union to complement the single currency by deciding and implementing coordinated reforms and fiscal discipline. Governments would in other words have to transfer sovereignty to the European level in order to better implement the BBF Consensus prescriptions. The problem is that it is hard to believe that more of the same, even if better coordinated and implemented, would yield the success that has eluded the Eurozone so far. The next section explores possible alternative scenarios.

5. Towards effective macroeconomic governance: The ECB mandate and a modified golden rule for the Eurozone

Faced with mounting deflationary pressures, European policy makers rely on the "QE European Edition" that the ECB is putting in place. While necessary and welcome, as observed above, such loosening may not allow the Eurozone to embark on a robust growth path. We know since Keynes, (1936) that in a liquidity trap monetary policy loses traction. Today, a depressed economy, stagnant income, high unemployment, uncertainty about the future, all help to compress private spending and demand for credit across the Eurozone, while they increase the appetite for liquidity. At the end of 2013, private spending on consumption and investment was 7% lower than in 2008 (a figure that reached a staggering 18% for peripheral countries). Granted, radical ECB moves, like announcing a higher inflation target, could have an impact on expectations and trigger increased spending; but these are not politically feasible. It is not improbable, therefore, that a "simple" quantitative easing programme may amount to pushing on a string. The ECB had already accomplished half a miracle, stretching its mandate to become *de facto* a lender of last resort, and defusing speculation. It cannot be asked to do much more than this.

But what to do in a liquidity trap? Luckily, Keynes comes to the rescue. In the *General Theory* he argues that whenever monetary policy loses traction, the stage should be taken by fiscal policy, as developed and emerging economies successfully did in 2009. Eurozone economies should stop relying on the ECB and embark on a global fiscal expansion, finally reversing the pro-cyclical fiscal stance that has dominated since 2010. This fiscal expansion should be centred around the increased investment that resurfaced in the debate on European economic policy, so as to become the cornerstone of the programme presented by new Commission President Juncker.

Public investment deficiency is now chronic. Less visible and politically sensitive than current expenditure, for twenty years it has been the adjustment variable for European governments seeking to meet the Maastricht criteria and to control their deficits (Figure 6). Since the crisis hit, private investment has also collapsed, and is still held well below its long-term trend by depressed demand and negative expectations (including in the Eurozone core; see DIW, 2013).

In this context the Juncker plan (European Commission, 2014) is welcome news even if, as is too often the case in Europe, it is too little and too late. The plan foresees the creation of a European Fund for Strategic Investments endowed with €21bn from the European budget (€16bn, mostly reallocation of existing funds) and from the European Investment Bank (€5bn). This is meant to lever conspicuous private funds (in a ratio of 15 to 1) to attain the objective of €315bn, mobilized over three years. EU countries may contribute to the Fund, but the contribution is not compulsory. As the allocation of funds will not be proportional to the contribution to the fund, there is a chance that governments will not rush to contribute.

Two aspects of the plan raise issues. First, the size: the predicted ratio of private to public spending necessary to reach the 315 billion is 15 to 1. This is enormous, as typical public-private partnerships rarely attain a ratio of 3 to 1. But even in the far from realistic assumption that the plan could create a positive dynamic and mobilize private resources to the announced 315 billion, this amounts to just over 2% of GDP for the three years 2015-2017 (approximately 0.7% annually). The plan is too little, far too little, to put the continent back on track. The second, and even more problematic, issue is the contingent nature of the plan. Its size and time horizon, as well as the lack of involvement of national governments, seem ill suited to reversing the unsatisfactory trend of the last three decades and to bring about long-term investment levels compatible with structurally higher growth. To sum up, the Juncker plan suffers from the lack of a real expenditure capacity at the Union level, and it is therefore forced to build a complex architecture that will either fall short of the target it has set, or become dangerously over-leveraged.

In an ideal world, the crisis and deflation would be dealt with by means of a vast European investment programme, financed by the European budget and through Eurobonds. Infrastructure projects, green growth and the digital economy are just some of the areas for which the optimal scale of investment is European, and for which a coordinated long-term plan would be necessary. A “Marshall Plan 2.0”, in other words, capable of giving the economy the stimulus that has been missing in the past seven years (Chowdhury and Islam, 2014). The increasing mistrust among European countries exhausted by the crisis, together with the fierce opposition of Germany and other northern countries to any suggestion of debt mutualisation, make this strategy virtually impossible.

The solution must therefore be found at national level, without giving up European-wide coordination, which would guarantee effective and fiscally sustainable investment programmes. Derviş and Saraceno (2014) recently proposed that the EMU should adopt a fiscal rule similar to the one implemented in the UK by Chancellor of the Exchequer Gordon Brown in the 1990s, and applied until 2009[8]. The new rule would require countries to balance their current budget, while financing public capital accumulation with debt. Investment expenditure, in other words, would be excluded from deficit calculation, a principle that also emerges, timidly, in the Juncker plan. Such a rule would stabilize the ratio of debt to GDP, it would focus efforts of public consolidation on less productive items of public spending, and would ensure inter-generational equity (future generations would be called to partially finance the stock of public capital bequeathed to them). Last, but not least, especially in the current situation, putting in place such a rule would not require treaty changes.

The golden rule is not a new idea, and in the past it has been criticized on the ground that it introduces a bias in favour of physical capital and penalizes certain expenditure on areas such as education and healthcare that, while classified as current, are crucial for future growth. This criticism, however, can be turned around and transformed into a strength. Derviş and Saraceno propose that at regular intervals, for example every seven years, in connection with the European budget negotiation, the Commission, the Council and the Parliament reach agreement on the future priorities of the Union, and make a list of areas or expenditure items exempted from deficit calculation for the subsequent years. Joint programmes between neighbouring countries could be encouraged by providing co-financing by the European Investment Bank. The modified golden rule would in fact yield a return, on a European scale, to industrial policy, a political and democratic determination of the EU’s long-term growth objectives. The entrepreneurial State, through public investment, could once again become the centre piece of a large-scale European industrial policy, capable of implementing physical as well as intangible investment. Pending a real federal budget, the bulk of investments would remain the responsibility of national governments, in deference to the principle of subsidiarity. But the modified golden rule would coordinate and guide them towards the development and well-being of the Union as a whole.

However, the reform of EMU macroeconomic governance should not be confined to fiscal policy. As indicated above, the EMU institutional setup led to excessive inertia by the ECB before and during the crisis (Table 1). It was also discussed at length how the ECB had to stretch its mandate and adopt cumbersome communication strategies (see footnote 5) to reconcile its activism with the strict price stability objective it was supposed to pursue.

[8] For more information see the references in Creel et al., (2009) and, for a critical view, Balassone and Franco, (2000).

The dual mandate of the Fed in the US, on the other hand, allowed a much more effective and transparent action, suited to the exceptional period we are experiencing. The crisis further showed that at times of economic distress, anchoring the private sector's expectations is vastly insufficient to restore growth and employment.

In fact, the case for strict inflation targeting appears weak once it is admitted, contrary to the tenets of the BBF Consensus, that monetary policy may have an impact on economic activity, which requires policy makers to arbitrate between sometimes conflicting objectives. Furthermore, the inflation mandate has had an impact on ECB action, regarding both its reactivity (in particular during the crisis) and the transparency of its communication strategy, a crucial element of central banking effectiveness. However, there are at least two other arguments that can be made in favour of adopting a Fed-like dual mandate.

The first is a simple assignment problem. Following Mundell, (1961), the task of monetary authorities should be to react to common shocks. The optimal monetary policy response to idiosyncratic shocks is to "do nothing" (Lane, 2000), leaving the task to national fiscal policies that remain decentralised. The strict inflation target, and the absence of a federal government capable of implementing EMU-wide fiscal policies, leaves one of the objectives of macroeconomic policy, the reaction to common shocks, without an instrument. Either fiscal policy (through a real European budget) or monetary policy (through a dual mandate) should be assigned to that objective. Standard textbook analysis actually suggests that a combination of the two would be the most effective.

The second argument is not confined to monetary unions. As the debate between hawks and doves shows in the US, a dual mandate does not necessarily mean insufficient attention to price stability. The dual mandate was in place when Chairman Paul Volcker conducted a bold anti-inflationary monetary policy in the early 1980s. And just three years ago, in the midst of the financial crisis, Chicago Fed President Charles Evans complained that too much attention was being paid to inflation and public deficits, and concluded that "*if 5% inflation would have our hair on fire, so should 9% unemployment.*" (Evans, 2011). In other words, nothing prevents central banks from fighting inflation in the framework of a dual mandate; but they cannot fight unemployment within inflation targeting. One institutional arrangement may encompass the other through the appropriate choice of weights, but the converse is not true. Once again, the fundamental justification of exclusive focus on price stability can only lie in the acceptance of a neoclassical platonic world in which macroeconomic policy is ineffective, and hence governments need to make no choice.

The crisis has highlighted another deficiency of the BBF consensus, namely its neglect of financial stability as an objective of monetary policy. This neglect is based on conventional wisdom, first explicitly stated by Schwartz (1995), that a monetary regime that produces aggregate price stability will, as a by-product, tend to promote stability of the financial system (Borio and Lowe, 2002, p. 27). Price instability would lead to uncertainty, shortened investment horizons, changes in the value of collateral. All of this would encourage speculation and favour financial instability. The consequences for policy are therefore straightforward. Following, for example, Bernanke and Gertler (2001), central banks have been neglecting to set targets for asset prices unless these threatened price stability. The conventional wisdom had already been questioned before the crisis. Leijonhufvud (2007) argues, for example, that price stability could lead, via low interest rates, to excessive risk taking and a higher probability of financial crises. The crisis itself, coming after two decades of subdued inflation, challenged the conventional view. This has only led, so far, to marginal changes in the policy prescription. The benchmark model adopted by the banking profession has been amended in order to introduce financial stability, but that is nevertheless assumed to be positively correlated with price stability (Woodford, 2012). Thus, monetary policy should at best only adopt a flexible inflation target, or simply better coordinate with the bodies in charge of financial regulation and supervision (Blanchard et al., 2010). Yet, the assumption of a positive correlation between inflation and asset prices seems empirically unwarranted (Blot et al., 2015; Cukierman, 2013).

With the banking union, the ECB is given a supervisory role that formalizes its involvement in the management of the Eurozone financial sector. Furthermore, as has been discussed at length, the Central Bank has been active well beyond the inflation targeting mandate that the Treaties assign to the institution in Frankfurt. It is clear that today it is exploring uncharted waters, and making choices that involve trade-offs. ECB Vice-President Vítor Constâncio implicitly acknowledged the widened scope for central bank action in a recent speech on the prospects for the banking union (Constâncio, 2014), while arguing that financial stability should not be a concern for ECB action. More interestingly, the ECB Vice-President acknowledged the trade-off faced by the ECB between low inflation and the risks of asset price inflation brought about by central bank activism.

The time has therefore come to rethink the ECB mandate, and to adapt it to the tasks that it already pursues *de facto*. Blot et al., (2014) argue that the treaties should be amended to account explicitly for the triple task of financial stability, macroeconomic stability and, of course, price stability. This would avoid schizophrenic communication, enhance transparency and democratic control over ECB action, and deliver more effective monetary policy, especially at times of crisis.

6. Conclusion

This paper has highlighted how EMU governance as designed by the Maastricht Treaty and subsequent modifications, is unfit to deliver sound and effective macroeconomic management. This is especially evident at times of crisis. The paper has argued that:

1. Monetary and fiscal policy in the EMU design leave very little room for manoeuvre consistent with the prescriptions of the BBF Consensus that focus mainly on the supply side of the economy
2. The dominant narrative on the EMU crisis, consistent with the BBF Consensus, blames the crisis on the fiscal profligacy of peripheral countries. This has led to procyclical fiscal policies
3. The inertial or procyclical behaviour of fiscal authorities, projected a reluctant ECB to the front of the scene. Without decisive (and controversial) ECB action, the Eurozone would probably not exist today.
4. Yet, the ECB, and European policy makers at large, still adhere to the BBF Consensus. The consequence is that the crisis keeps being one step ahead of the policy response, that is, always too little and too late.
5. The conclusion is that without reform of the Eurozone's macroeconomic governance, it is difficult to foresee a permanent resolution of current woes. The paper suggests adopting a modified golden rule of public finances, and considering the introduction of a dual (or even triple) mandate for the ECB

Eurozone governance reform unfortunately did not challenge the BBF Consensus. On the contrary, the fiscal compact, the evolving banking union project, the Juncker plan, all combine to strengthen the idea that coordination and burden sharing, as well as active macroeconomic management as can be observed in large countries like the United States, Japan or even China, remains a chimera for the European Union, and in particular for the Eurozone.

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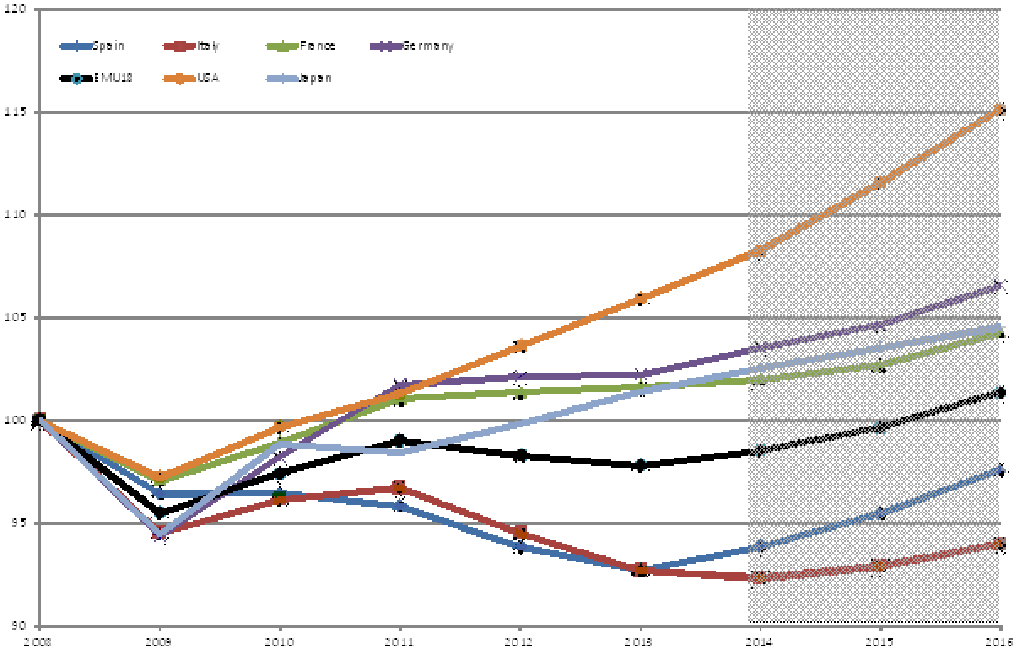
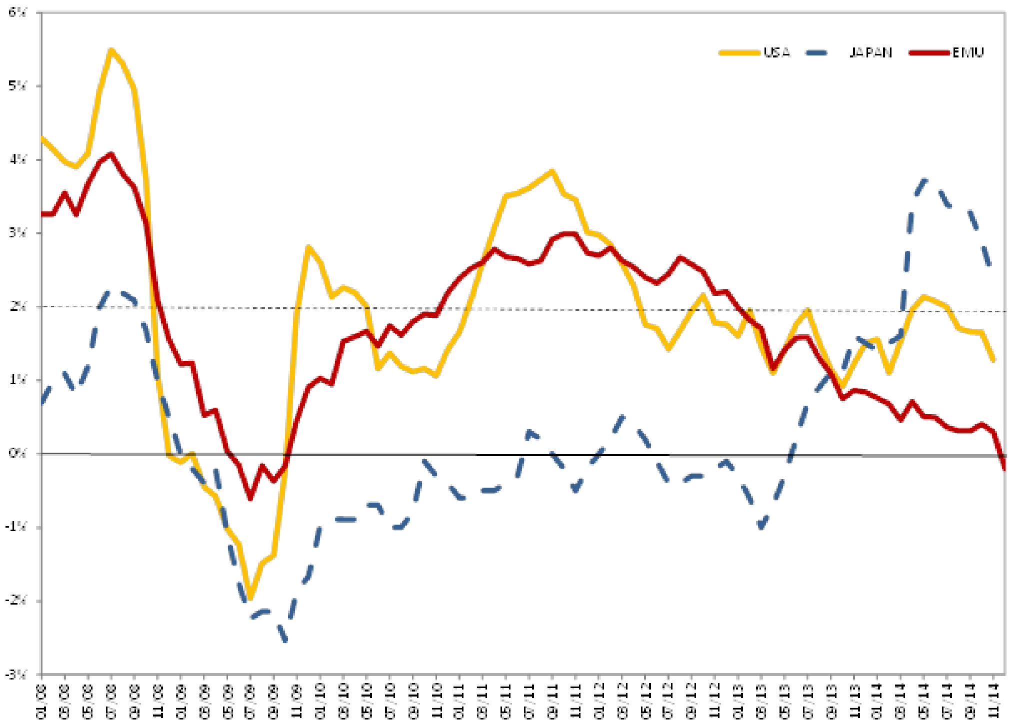
Annex – Figures

Figure 1: Real GDP – 2008=100



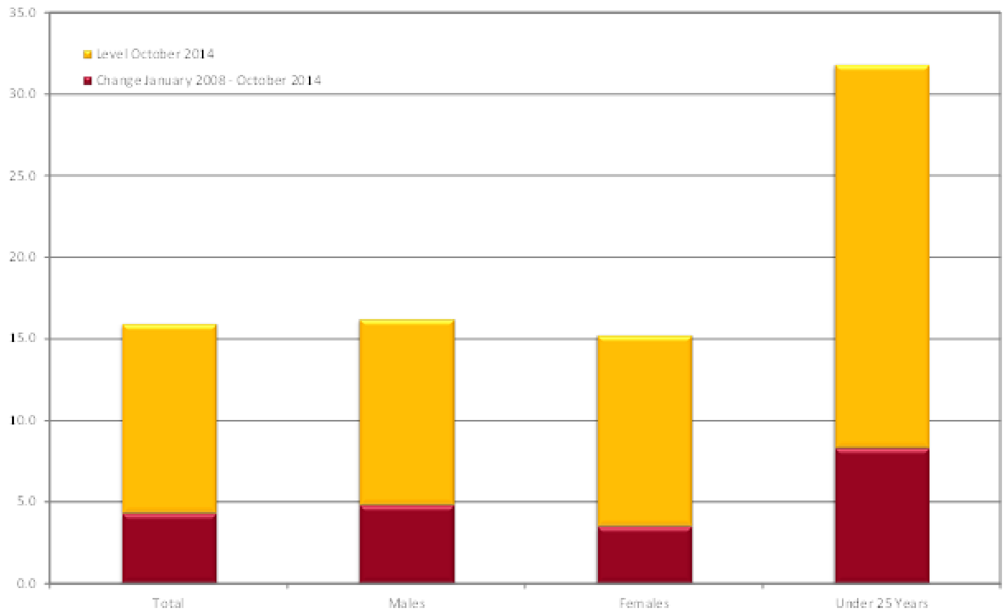
Source: European Commission AMECO Database.
Shaded area is forecast

Figure 2: Yearly Inflation Rates



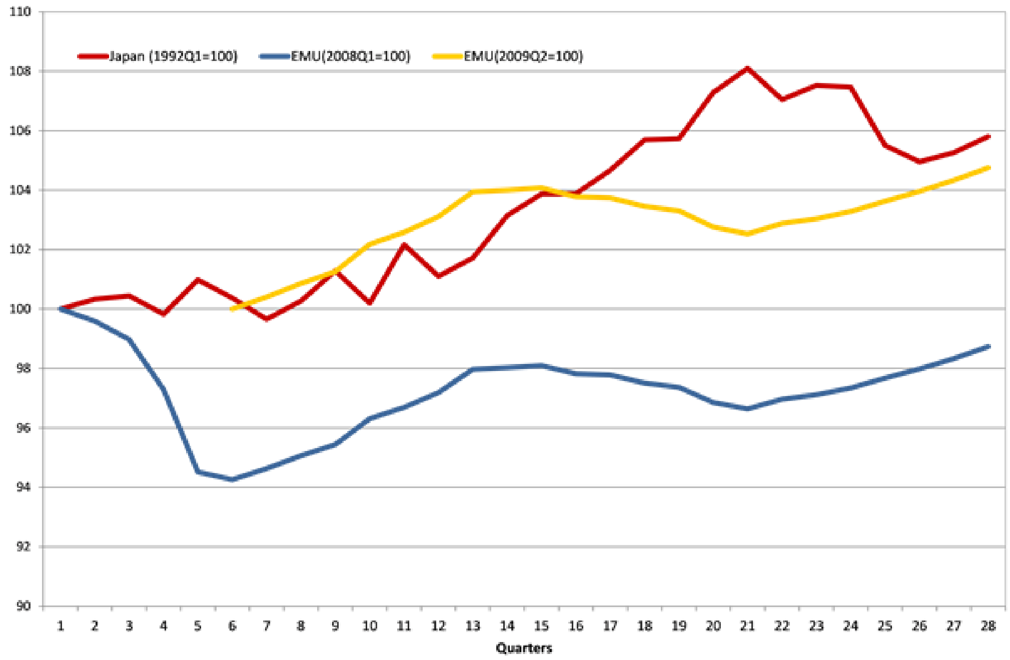
Source: Datastream

Figure 3: Unemployment According to ILO Definition



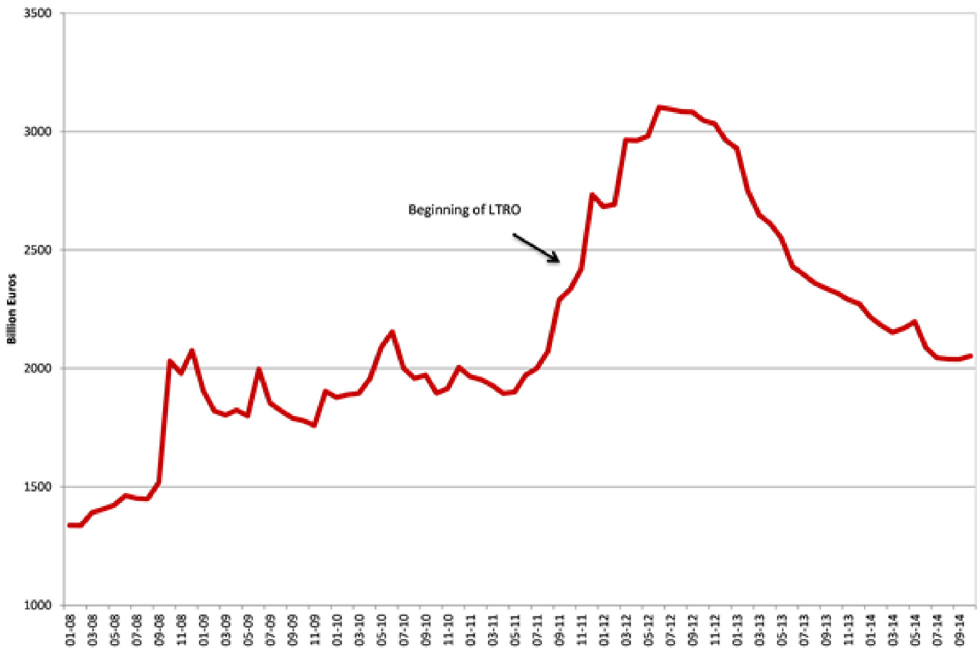
Source: Eurostat

Figure 4: Lost Decades: GDP in Japan and the EMU



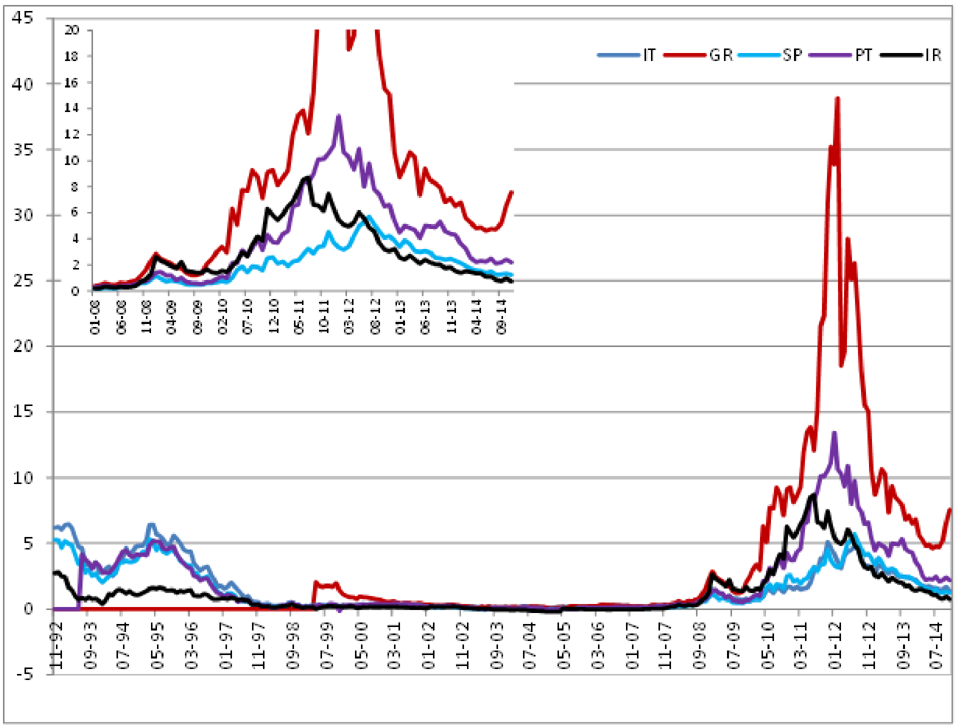
Source: OECD Economic Outlook

Figure 5: ECB Balance Sheet - Assets



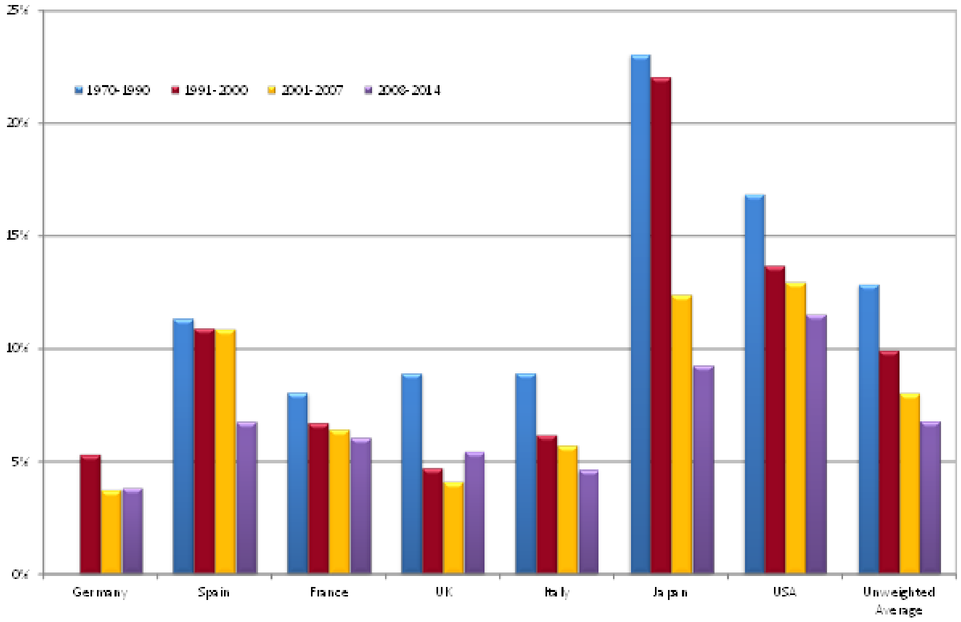
Source: ECB - Fred

Figure 6 : Ten Year Government Bond Yields – Spreads with Germany



Source: Datastream

Figure 7: Public Investment as a Percentage of Total Public Expenditure (Excluding Interest)



Source: OECD Economic Outlook

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