

European Expert Meeting

The role of the European Central Bank in the Financial Crash  
and the Crisis of the Euro-Zone

Berlin, April 12<sup>th</sup> 2011

**ECB monetary policy prior to and in the face of the crisis**

Marica Frangakis

Nicos Poulantzas Institute

Athens, April 2011

## Introduction

*“Whether or not the inevitable ‘blame game’ is worthwhile or justified, the experience of financial crisis, panic in September 2008 to March 2009 and nearly widespread financial collapse, has been so unnerving and shaking that there are likely to be far-reaching changes to the operation and regulation/supervision of the financial system in general and to the role and functions of the central bank in particular.” (Goodhart, 2010:8)<sup>1</sup>*

In one succinct, albeit long, sentence, Charles Goodhart, a former advisor to the Bank of England, has expressed a view that is gaining ground in international financial fora<sup>2</sup>. Are we at the dawn of a new era in central banking? Will the emphasis of policy shift from price stability to financial stability? If so, how will it be implemented? What are the implications for economic policy?

These are just a few of the questions emerging in relation to central banking, as a result of the financial crisis and the tensions generated by the ensuing sovereign debt crisis. The ECB is of course not immune to such considerations, although, as we shall argue, it is unlikely to take the lead in establishing the parameters of a new era.

The present paper is structured as follows:

- Section 1 reviews briefly the historical phases of central banking;
- Section 2 examines the institutional framework of the ECB;
- Section 3 analyses the ECB monetary policy prior to the crisis;
- Section 4 discusses the monetary measures taken by the ECB in the face of the crisis;
- Section 5 presents the prudential supervision arrangements of the EU and the adjustments made to them following the crisis;
- Section 6 summarizes and concludes.

### 1. A historical reminder

Goodhart (2010; *ibid*) distinguishes three eras in the evolution of central banking: (i) the Victorian era from 1840s to 1914; (ii) the government control era, from 1930s to end-1960s; and (iii) the ‘triumph of the markets’ from 1980s to 2007. The periods intervening between the different eras and the change in paradigm each signals are considered to be transitory periods, or ‘confused interregnums’.

In the Victorian era, it was assumed that government debt was not related to any economic activity. Therefore, its use as a policy instrument was to be avoided<sup>3</sup>. Such a non-activist view limited the scope of both fiscal and monetary policy. It took the interwar years and a Great Depression for this view to be displaced.

---

<sup>1</sup> Charles Goodhart, 2010, *The changing role of central banks*, BIS Working Papers No 326, Nov. 2010

<sup>2</sup> As evidenced e.g. by the international conference organized by the BIS on “The future of central banking under post-crisis mandates” (24-25/6/2010) and the IMF on “Macro and Growth Policies in the Wake of the Crisis” (7-8/3/2011).

<sup>3</sup> Wars are of course exempted!

In the next era, especially after World War II, the scope of economic policy was broadened and central banking became an integral part of overall policy. At that time, the functions of a central bank consisted of (a) providing advice on policy; (b) administering the system of policy controls and (c) overseeing the management of financial markets, especially the gilt-edged market, the money market and the foreign exchange market.

As the international financial system came under increasing pressure, the Bretton Woods Agreement collapsed (1972-1973), ushering in a new era in economic policy, in general and in central banking, in particular. The day was won by monetarism, the theoretical backbone of neoliberalism.

The central bank paradigm of the third era was characterized by two main features: (a) a near exclusive concern with price stability, over other areas of policy; and (b) institutional independence of the central bank from the political authorities and the assumed 'political business cycle'. Furthermore, the neoliberal view specified the means to achieve the prescribed goals of policy. These are indirect, market-based instruments, such as the short-term interest rate, which became the primary tool of monetary policy after the 1980s.

As Epstein (2006) has pointed out, the fact that formal or informal inflation-targeting is promoted by the IMF, as one of the conditions for providing loans and technical assistance, explains why a large number of especially poorer countries shifted to this type of paradigm in the 1990s and 2000s<sup>4</sup>. So commonly accepted was the neoliberal model of central banking during this period, that it came to be considered as "somehow 'modern', even optimal and therefore worthy of emulation throughout the globe" (Epstein, 2006a:13)<sup>5</sup>.

However, this view took a severe blow in 2007 and 2008, as what appeared to be a liquidity crisis of the financial sector rapidly turned into an insolvency crisis of major proportions. As noted by a BIS official, "The near collapse of the financial system happened not only in the back yards, but in our front yards, too" (Cecchetti, 2010:1)<sup>6</sup>. This does not mean that monetarism in central banking has been displaced. Only that it is being seriously questioned, which may indeed herald the start of yet another era in central banking; a more interventionist, policy-integrated era.

## **2. The institutional framework of the ECB**

The European Central Bank (ECB) was set up in the late 1990s (on 1/6/1998), at a time when 'the inflation-targeting/independence from government' model of central banking was at its height. Thus, it is an example of this model in extremis. As it has been pointed out, "The ECB appears to be the ultimate 'narrow' central bank; it literally has a mandate for price stability and a very small role in ensuring financial stability, confined to the ensuring of the

---

<sup>4</sup> Gerald Epstein, 2006, *Too much, too soon: IMF conditionality and inflation targeting*, Bretton Woods Project, September 2006

<sup>5</sup> Gerald Epstein, 2006a, *Central Banks as Agents of Economic Development*, UNU-WIDER, Research Paper No. 2006/54

<sup>6</sup> Stephen G. Cecchetti, 2010, *Introductory Remarks*, BIS Papers No. 55, January 2011

smooth functioning of the TARGET payments system, not the financial system” (Schinasi, 2003:3)<sup>7, 8</sup>.

Further, the independence constitutionally granted to the ECB is the most explicit both in writing and in practice, by comparison to other central banks, such as the Federal Reserve, the Bank of England, etc, as noted by Alexander Lamfalussy<sup>9</sup>.

It is generally accepted that the Deutsche Bundesbank was the model used for designing the ECB, both in terms of its statute and in terms of its practice. In particular, it has been argued that this was necessary in order to satisfy German public opinion that the Bundesbank was not being given up for an institution that would be controlled by politicians (Forder, 2006)<sup>10, 11</sup>. On the other hand, it should be noted that the Bundesbank had a central role in banking supervision, insofar as it was responsible for collecting all the necessary information required for banking supervision, which it provided to the Federal Supervisory Office, the legal supervisor (Schinasi, *ibid*). The ECB has had no such role in the past. The latest developments in this area introduce certain changes, which we shall discuss in Section 5, the impact of which is not however clear.

- **Legal provisions**

In order to comprehend the narrow character of the ECB, it is necessary to examine the pertinent key provisions of the Treaty of the EU, as well as of the ECB Statute<sup>12</sup>. In particular, we shall look into the following aspects of the ECB: (i) its mandate; (ii) its tasks; (iii) its independence and (iv) its democratic accountability or lack of it.

- (i) *Mandate* – Price stability constitutes the core of EU monetary policy and of the ECB objectives. More specifically, in the Treaty for the Functioning of the EU this is mentioned (a) as one of the goals of the EU itself, taking precedence over other goals, which may be pursued only ‘without prejudice to price stability’ (art. 3.2 and 119.2); (b) as ‘the primary objective’ of monetary policy and as such, one of the means to achieve the Union’s goals (art. 119.2); and (c) as the central objective of the ECB and of the national central banks, which together constitute the European System of Central Banks (ESCB) (art. 127.1 and 282.2).

By contrast, the goal of financial stability is neither included in the goals of the EU, nor is it a task assigned specifically to the ECB. One can only presume that European leaders ruled out the possibility of a crisis, perhaps in the euphoria of introducing

---

<sup>7</sup> Garry J. Schinasi, *Responsibility of Central Banks for Stability in Financial Markets*, IMF Working Paper, WP/03/121, June 2003

<sup>8</sup> TARGET : Trans-European Automated Real-time Gross settlement Express Transfer system

<sup>9</sup> Alexander Lamfalussy, *Keynote Speech*, BIS Papers No. 55, January 2011

<sup>10</sup> James Forder, 2006, *Monetary Policy* in ‘A Handbook of Alternative Monetary Economics’, Edward Elgar

<sup>11</sup> See also John Grahl, 1997, *After Maastricht: A guide to European Monetary Union*, Lawrence and Wishart, London for an extensive discussion of the setting up of the ECB.

<sup>12</sup> Official Journal of the EU, C115 VOL 51, 9-5-2008

the new single European currency, even though this neglect made such a possibility greater than otherwise!

- (ii) *Tasks* - According to article 127.2 of the Treaty and article 3 of the ECB Statute, “The basic tasks to be carried out through the ESCB shall be: to define and implement the monetary policy of the Union; to conduct foreign – exchange operations consistent with the provisions of Article 219; to hold and manage the official foreign reserves of the Member States; to promote the smooth operation of payment systems”. The proviso of article 219 concerns *exchange rate policy* which remains in the authority of the Council. This may alter or abandon the central rates of the euro within the exchange-rate system, as well as formulate the general orientations for exchange-rate policy in relation to third currencies, ‘after consulting with the ECB’ (art. 219.1 and 219.2).

Furthermore, the ECB has the exclusive right to authorize the issue of euro banknotes (art. 128.1).

Lastly, there is a clear prohibition for the ECB and the national central banks of the member-states, to lend to any public authorities, whether on the European or the national level. In particular, “Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States ... in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be *prohibited*, as shall the purchase *directly* from them by the European Central Bank or national central banks of debt instruments” (art. 124.1 of the Treaty and art 21.1 of the Statute). In this sense, the function of the ECB as a Lender of Last Resort – the essence of central banking – is curtailed.

- (i) *Independence* – According to article 130 of the Treaty, “When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, *neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body*. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks”. Furthermore, according to article 282.3 of the Treaty, “The European Central Bank ... shall be *independent in the exercise of its powers and in the management of its finances*. Union institutions, bodies, offices and agencies and the governments of the Member States shall respect that independence”.

Thus, the ECB has by design both functional and operational independence from the European and national authorities. This is in keeping with the monetarist tenet that ‘markets know best’. Together with the mandate and the tasks described above, it concludes the panoply of monetarist characteristics, with which the ECB was endowed at its very inception!

- (ii) *Accountability* – The independence of a central bank from the political authorities is the corollary of a lack of democratic accountability. In the case of the ECB, this is

further compounded by the fact that its relation with the European Parliament, the only EU representative body, is limited to the submission of annual reports and its participating in the EP committees ‘at the request of the EP or on its own initiative’ (art. 284.3 of the Treaty and art. 15.3 of the Statute).

### 3. ECB monetary policy before the crisis<sup>13</sup>

Our examination of the ECB’s institutional characteristics, as these arise from the relevant legal provisions of the Treaty of the Union and the Bank’s Statute, makes it clear that its main, if not exclusive, area of activity is monetary policy. In this section, we shall review the main aspects of the ECB monetary policy before the crisis (in ‘normal’ times, as the Bank would have it), i.e. over the period 1999-2007. In particular, we shall analyse (i) the rationale and goals of the policy; (ii) the monetary transmission mechanism; (iii) the main tools employed; and (iv) the pre-crisis monetary policy record.

(i) *Rationale and goals* – This is put forward by the ECB in pure monetarist terms. Thus, the market view of money as a ‘medium of exchange’ prevails, by comparison to its other uses, namely, as a ‘unit of account’ and a ‘store of value’. Similarly, the ECB upholds the notion of the ‘neutrality of money’, albeit in a long-run perspective (ECB, 2004: 41-42). Not surprisingly, inflation is thus viewed as a monetary phenomenon, to be dealt with by purely monetary tools. In this way, not only is the ECB’s monetary policy narrowly defined – exhibiting a practical allergy to inflation – but also, narrowly implemented.

The ECB’s quantitative definition of price stability was set in 1998 by its Governing Council, as follows: “Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term” (ECB, 2004:50-51). In 2003, it was further established that the ECB aims to maintain inflation below but close to 2% over the medium term.

It should be noted that until 2003, the ECB also employed a reference value for monetary growth (M3) set in 1998 at 4.5% p.a.<sup>14</sup>. In 2003, it was announced that the Bank would “no longer review the reference value for M3 on an annual basis because experience has shown that the underlying medium-term trend assumptions cannot be expected to change frequently” (ECB, 2004:64). Thus, the M3 reference value was quietly dropped.

(ii) *Monetary transmission mechanism (MTM)* – Before the crisis, the MTM of the ECB relied on the interest rate channel, as shown in Chart 1 below.

As we can see, the interest rate channel is supposed to work its way through the economy both directly, through the money market and the other financial

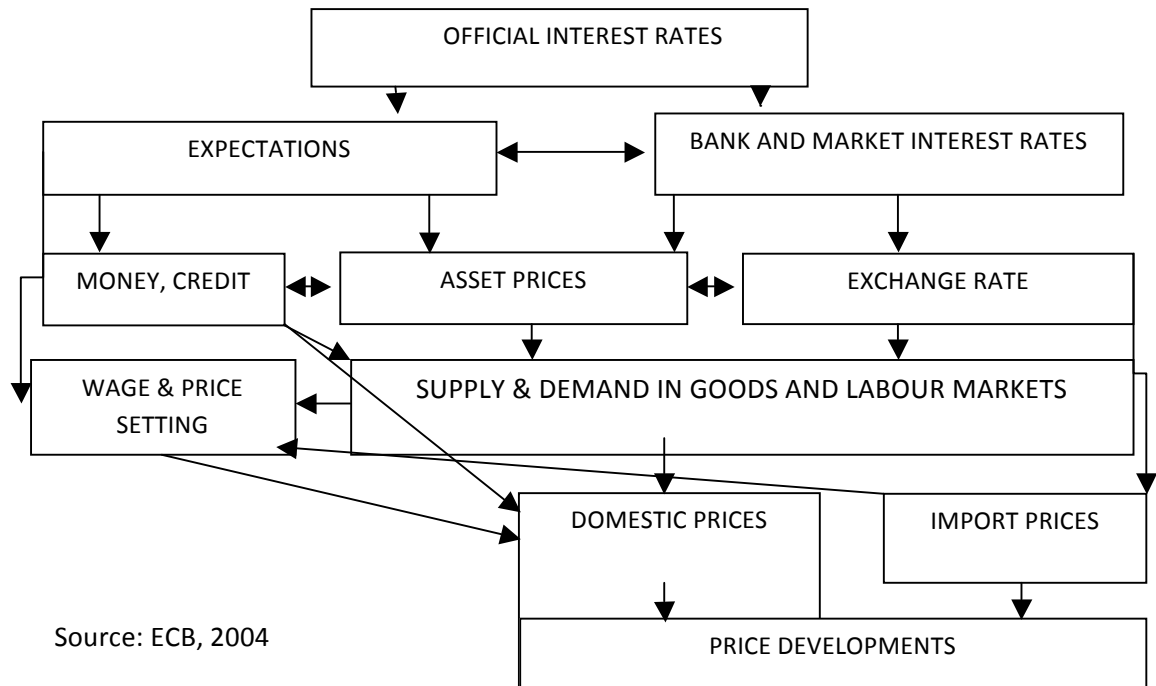
---

<sup>13</sup> Main references for this section include: ECB, 2004, The monetary policy of the ECB; ECB, 2006, History, Role and Functions by Hanspeter K. Scheller, 2<sup>nd</sup> Revised Edition; ECB, 2008, 10<sup>th</sup> Anniversary of the ECB, Monthly Bulletin; ECB, 2011, General Documentation on Eurosystem monetary policy instruments and procedures, February

<sup>14</sup> M3 comprises M1 (currency in circulation +overnight deposits)+ M2 (M1+deposits with a maturity of up to 2 years and deposits redeemable at a period of notice of up to 3 months)+marketable instruments issued by the monetary financial institutions, including money market funds and repurchase agreements.

markets and indirectly, through the formulation of expectations, which are of course assumed to be rational, in accordance with the monetarist paradigm.

**Chart 1 – The ECB monetary transmission mechanism from interest rates to prices**



Source: ECB, 2004

It is worth noting that the interest rate channel is intended to influence demand through changes in supply. In addition, changes in asset prices ... affect the supply and demand decisions of households and firms... as a consequence, the level of domestic demand for goods and services relative to domestic supply will change' (ECB, 2004:45-46). In addition, the Bank's credibility is assumed to be crucial to its anchoring inflation expectations, where 'credibility' demands that the Bank does not easily change its course of action, even in the face of adversity, such as that experienced in 2008.

- (iii) *Tools* – These are set out in the following articles of the Statute of the ECB: 18, on 'open market and credit operations; 19, on 'minimum reserves'; 20, allowing the Governing Council of the ECB to decide on the use of other operational tools with a majority of two-thirds of the votes cast; 21, prohibiting any lending to public authorities; 22, on 'clearing and payment systems and 23, on 'external operations'. Table 1 below presents an overview of the monetary policy operations of the Eurosystem<sup>15</sup>.

<sup>15</sup> The Eurosystem consists of the ECB and the national central banks of the member-states that belong to the euro area, as opposed to the European System of Central Banks (ESCB), which includes the ECB and the national banks of all member states.

Table 1 Eurosystem monetary policy tools					
Monetary policy operations	Types of transactions		Maturity	Frequency	Procedure
	Provision of liquidity	Absorption of liquidity			
<b>1. Open market operations (OMOs)</b>					
Main refinancing operations (MROs)	Reverse transactions		One week	Weekly	Standard tenders
Longer-term refinancing operations (LTROs)	Reverse transactions		Three months	Monthly	Standard tenders
Fine-tuning operations	Reverse transactions Foreign Exchange swaps	Reverse transactions Collection of fixed term deposits Foreign Exchange swaps	Non-standardised	Non-regular	Quick tenders Bilateral procedures
	Outright purchases	Outright sales		Non-regular	Bilateral procedures
Structural operations	Reverse transactions	Issuance of debt certificates	Standardised Non-standardised	Regular Non-regular	Standard tenders
	Outright purchases	Outright sales		Non-regular	Bilateral procedures
<b>2. Standing facilities</b>					
Marginal lending facility	Reverse transactions		Overnight	Access at the discretion of counterparties	
Deposit facility		Deposits	Overnight	Access at the discretion of counterparties	

Source: ECB, 2006

Through its monetary operations, the ECB aims at providing regular refinancing to credit institutions and facilities that allow them to deal with end-of-day balances and to cushion transitory fluctuations. Of the two groups of monetary policy tools, the most important one is *open market operations* (OMOs), executed on the initiative of the Bank, usually in the money market, in which the maturity of transactions is generally less than one year. Until 2008, the *main refinancing operations* (MROs) constituted the key policy instrument.

Through the MROs, the Eurosystem lends money to *counterparties* against collateral, on the basis of certain eligibility criteria. It is worth noting that in June 2003, out of a total of 6,776 credit institutions in the euro area, 2,243 fulfilled the criteria for participation in open market operations, 2,749 the criteria for accessing the marginal facility and 3,188 for accessing the deposit facility. In actual fact, in the first half of 2003, the number of counterparties participating in MROs amounted to 252 and those participating in LTROs to 136



on average. During the crisis, the number of counterparties increased tremendously, as a result of a relaxation of the eligibility criteria.

With regard to *collateral*, the Eurosystem accepts instruments issued by both private and public debtors. Such collateral consists of two categories of assets, 'tier one', which includes marketable debt instruments, fulfilling uniform euro area-wide eligibility criteria specified by the ECB, and 'tier two' – additional assets of particular importance for national financial markets, set by the national central banks.

Lending through OMOs is in the form of *reverse transactions*, whereby a central bank buys assets under a repurchase agreement or grants a loan against assets given as a collateral<sup>16</sup>. Although such transactions provide funds for a limited period of time, extensive use of these was made, with considerable relaxation of the pertinent criteria during the crisis.

In addition to OMOs, the Eurosystem also offers two standing facilities to its counterparties, as shown in Table 1 above. More specifically, the *marginal lending facility* provides overnight loans from the central bank against collateral at a predetermined interest rate, which is higher than the market rate. The *deposit facility*, by contrast, allows banks to make overnight deposits with the central bank at a predetermined interest rate, which is lower than the market rate. The interest rates on the two standing facilities form a 'corridor', within which lies the ECB main refinancing operations rate<sup>17</sup>. The three rates are the ECB key interest rates. The difference between the MRO rate and that of the two standing facilities amounts to approx. +/-1%.

In addition to OMOs, the ECB requires credit institutions to hold compulsory deposits on accounts with the national central banks, known as '*required*' or '*minimum reserves*'. These are set for each institution on the basis of a ratio (set at 2%) applied to the short-term liabilities on its balance sheet<sup>18</sup>. The instrument of minimum reserves aims at allowing the credit institutions to smooth out daily liquidity fluctuations and at increasing the demand for central bank refinancing, through regular liquidity-providing operations.

- (iv) *Pre-crisis policy record* – The ECB regularly publishes accounts of its policy record. In 2004, it published the following account of its experience from January 1999 to June 2003: "The Eurosystem's operational framework has been functioning well since the start of 1999. The operational framework has generally allowed the ECB to steer liquidity conditions and short-term interest rates in a smooth fashion." (ECB, 2004:89).

---

<sup>16</sup> Under a repurchase agreement, securities are sold for cash with a simultaneous agreement to repurchase them from a counterparty at an agreed price on a set future date. Under a *reverse* repurchase agreement, securities are bought for cash with a simultaneous agreement to sell them back to the counterparties at an agreed price on a set future date.

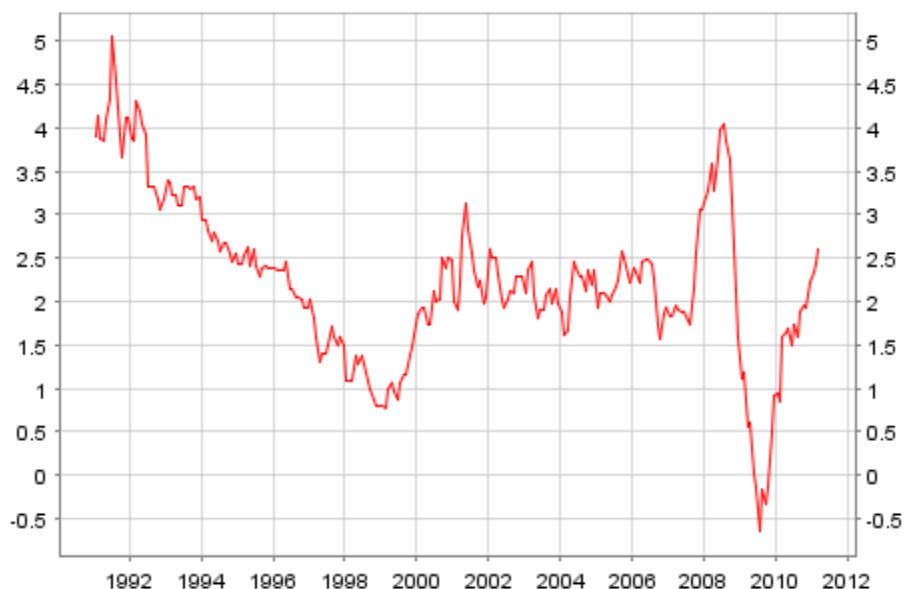
<sup>17</sup> Between January 1999 and June 2000, the Eurosystem conducted its MROs as fixed rate tenders. Between June 2000 and October 2008, the MROs were conducted as variable rate tenders with a minimum bid rate, due to the overbidding in the fixed rate MROs. Since October 2008, the MROs are again conducted on a fixed rate procedure (see Section 4).

<sup>18</sup> Long-term liabilities and repurchase agreements are not subject to a reserve ratio.

In 2008, it published a special issue of the Monthly Bulletin, celebrating “The first ten years”. In its Concluding Remarks, the following statement is made: “After the launch of the euro, the Eurosystem’s achievements have been no less important. The monetary policy strategy of the ECB is now well understood and viewed as credible. During the past ten years it has provided a solid basis for responding to a number of challenges. Average annual HICP inflation has been slightly above 2% since the introduction of the euro, despite a series of exogenous shocks.”(ECB, 2008:145).

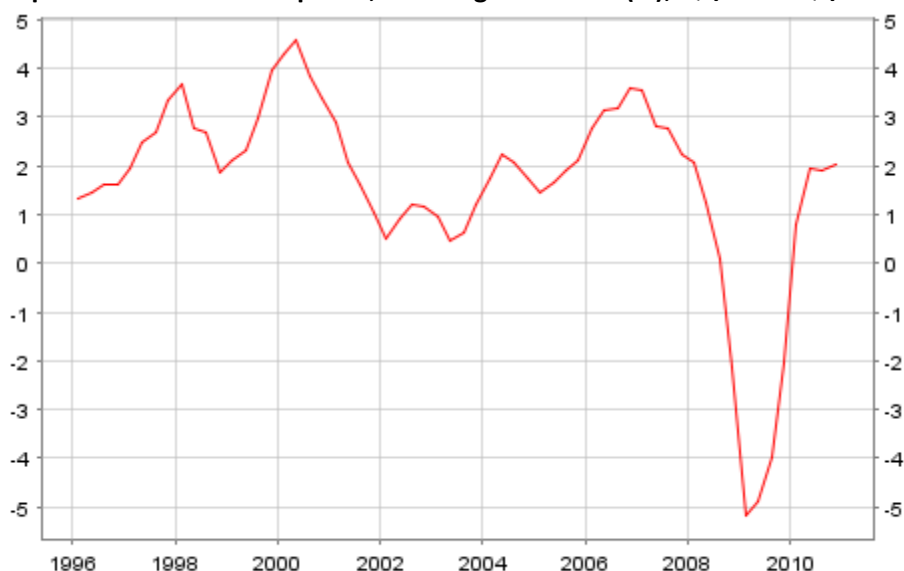
How valid is the claim of achievement put forward by the ECB in relation to its monetary policy? By way of an assessment, we shall examine (a) the rate of inflation and (b) the rate of GDP growth in the euro area since the 1990s.

**Graph 1 - Inflation rate (Harmonised Consumer Price Index) annual rate of change (%); Jan 1991-Mar 2011**



As it can be seen in Graph 1 above, in the 1990s inflation decreased considerably, largely as a result of the convergence criteria of the Maastricht Treaty (1992) and the restrictive economic policy these implied. After 1999, the inflation rate kept close to the 2% ECB benchmark, while it spiked upwards in late 2007 and early 2008, as a result of various factors, including an increase in the price of oil and in that of commodities, as well as the stimulus measures taken by governments faced with a deepening of the crisis. On the basis of this data, the claim of achievement made by the ECB appears to be substantiated. However, if we turn to the ‘real’ economy, this achievement needs to be qualified. Graph 2 shows GDP growth over the period 1996-2010.

**Graph 2 – GDP at market prices; annual growth rate (%); Q1/1996-Q4/2010**



With the exception of the immediate pre-dotcom bubble years (1999-2000), the GDP growth rate of the euro area fluctuated between 0.5% and 3% on a quarterly basis, while it became negative in late 2008 and throughout 2009, i.e. as the financial crisis spread to the rest of the economy, followed by a tentative recovery in 2010<sup>19</sup>. This low activity rate of the euro area is a concomitant of the restrictive monetary policy of the ECB, as well as of the fiscal conservatism implicit in the Stability and Growth Pact. It is in this sense that the ECB's claim of achievement needs to be qualified.

Overall, although prices, in the narrow sense of the HICP, were largely stabilized in the pre-crisis period, in the euro area on average, this came at a cost for the economy, as well as for European society. Furthermore, the ECB massively missed the oncoming financial crisis, which exposed many of the fallacies of monetarism. As the crisis shook the very foundations of the global financial system, the ECB, like other central banks, adopted a more pragmatic position, although the monetarist/neoliberal features inherent in its very design were not significantly altered.

#### **4. ECB monetary policy in the face of the crisis**

*“The ECB's broad-based and medium-term-oriented monetary policy strategy has guided the design and implementation of the monetary policy stance during the crisis. Specifically, maintaining price stability over the medium term has required the rapid lowering of the key ECB interest rates, as well as non-standard measures to ensure their effective transmission to the economy ... These exceptional measures are of a temporary nature and will be phased out gradually, progressively and in a timely manner when financial conditions improve or if*

<sup>19</sup> The above data and observations refer to the euro area on average. There is also the distributional aspect, yet another facet of the 'real' economy, not discussed in this paper.

*these measures begin to pose risks to the ECB's primary objective of maintaining price stability" (ECB, 2010:63)<sup>20</sup>*

The above quote is indicative of the mood of the ECB with regard to the crisis. More than two years into the crisis, its main concern remains that of price stability.

In actual fact, the policy response of the Bank escalated from drastically lowering its key interest rates in the early stages of the crisis, to devising new approaches within its constitutional mandate later on. In this section, we shall review the ECB monetary policy response to the crisis, as it unfolded in parallel with the increasing intensity of the latter.

Starting in August 2007, the ECB undertook a variety of liquidity-providing operations, in order to allow the euro area banks to draw the full amount of liquidity they needed at the prevailing main refinancing rate (4%). In July 2008 however it increased its key interest rate by 25 basis points to 4.25%, fearing inflationary pressures.

A few months later, with the collapse of Lehman Brothers (on 15/9/2008), the financial crisis deepened dramatically. The ECB responded by reducing its key interest rate, which fell to 1% by May 2009, a historic low, at which it remains to this date. In addition, the ECB introduced the so-called 'Enhanced Credit Programme', focusing specifically on euro area banks. This included the following measures:

- Providing unlimited liquidity at a fixed rate in all refinancing operations against collateral. For example, the outstanding amount of MROs increased from €190 bn at end-2007 to €340 in December 2008.
- Lengthening the maximum maturity of refinancing operations from three months prior to the crisis to one year. When the first one-year LTRO was introduced (June 2009), the allotted amount reached €442 bn.
- Extending the list of assets accepted as collateral, to include asset backed securities (ABS), for which the market had collapsed. Thus, prior to the crisis approximately 360 financial institutions participated on average in each MRO. This went up to over 800 during the crisis.
- Outright purchases in the covered bond markets<sup>21</sup>. A total amount of €60 billion was spent on this measure, which was ended in June 2010. In total, 422 different bonds were purchased, 27% on the primary market and 73% on the secondary market. The Eurosystem mainly purchased covered bonds with maturities of three to seven year, which it intends to hold until maturity.
- Providing liquidity in foreign currencies and especially in US dollars.

In effect, the 'enhanced credit programme' offered an unlimited supply of funds to euro area banks. So much so, that "the banks demanded more liquidity than they needed to finance their daily transactions" (ECB,2010a:67)<sup>22</sup>. Further, the banks did not use the

---

<sup>20</sup> ECB, 2010, "The ECB's Monetary policy stance during the financial crisis" in Monthly Bulletin, January (63-71)

<sup>21</sup> Covered bonds are long-term debt securities issued by banks to refinance loans to the public and private sectors, often in connection with real estate transactions.

<sup>22</sup> ECB, 2010a, The ECB's response to the financial crisis, Monthly Bulletin, October (59-74)

additional liquidity for interbank lending, but deposited it back in the ECB's deposit facility. As shown in Graph 3, the amount of bank deposits with the Eurosystem increased considerably over the period in question.

**Graph 3 – Deposits of MFIs with the Eurosystem  
(outstanding amounts; mio €) Sept 1997- Feb 2011**



As a result, it may be argued that the ECB became the banks' *lender of last resort*, albeit with regard to the euro area banking system as a whole, rather than to any bank in particular. The reasons given by the ECB for this are that (a) securitization made banks increasingly reliant on financial market funding, thereby increasing their vulnerability to changes in the financing conditions in interbank markets; and (b) bank financing remains an important source of external financing by non-financial corporations in the euro area - approx. 75% - as opposed to the USA, where it amounts to less than 50%. Whereas its first reasoning be considered as valid, its second one is an example of supply-side economic thinking, ignoring the role of aggregate demand.

From the start, the ECB stressed that the non-standard measures were of a temporary duration. Thus, beginning in December 2009, it began to phase them out. However, by mid-2010, the public debt crisis of Greece and other peripheral countries was recognized as a euro area crisis. Accordingly, the ECB reintroduced its non-standard measures, together with a new programme, the 'Securities Market Programme', allowing Eurosystem interventions to be carried out in the euro area public and private debt securities markets.

Two points were stressed at the announcement of the Securities Market Programme. First, that Eurosystem purchases of government bonds are limited to secondary markets, since article 21 of its Statute strictly prohibits the *direct* purchase of any debt instruments from the national authorities. Secondly, all such purchases are to be fully sterilized through liquidity-absorbing operations. Over the period May – December 2010, the ECB's holdings of

securities purchased under this Programme reached the amount of €13,102,563,262, which was equal to 11% of its total assets<sup>23</sup>.

Thus, in the face of the public debt crisis - which has historically been known to follow a banking crisis - the ECB aided the euro area banking system through the direct and indirect provision of funds - refinancing and buying bonds on the primary and secondary markets – whereas it aided the euro area governments through the indirect provision of funds only – buying bonds on the secondary bond markets. In monetarist terms, this is supply-side economics and in political terms, it is favouring the private sector over the public one.

Further, this asymmetry tends to overlook the fact that money as a concept is directly related to the authority of the state. As it has been argued, “in all modern monetary systems the state plays an active role ... It chooses the unit of account; it imposes tax liabilities in that unit; and it issues the money-thing that is used by private markets for ultimate clearing. Any story of money that leaves out an important role for the state represents little more than fantasy, a story of what might have been, that sheds little light on the operation of real-world monetary systems” (Tymoigne and Wray, 2006:14)<sup>24</sup>.

Overall, the monetary policy followed by the ECB has in the face of the crisis been pragmatic, largely due to the intensity of events and the ensuing uncertainty. In particular, its balance sheet increased considerably both in relation to GDP and the banknotes in circulation, as well as by comparison to other central banks, such as the Federal Reserve and the Bank of Japan, as shown in Table 2.

**Table 2 – Total balance sheet assets relative to GDP and banknotes in circulation**

	<b>Eurosystem</b>	<b>Federal Reserve</b>	<b>Bank of Japan</b>
	<b>Relative to GDP (%)</b>		
June 2007	10	6	16
Peak (ref. date)	19 (2/1/2009)	15 (17/12/2008)	23 (31/3/2009)
August 2009	16	14	22
	<b>Relative to banknotes in circulation (%)</b>		
June 2007	144	109	111
Peak (ref. date)	231 (2/1/2009)	266 (17/12/2008)	144 (31/3/2009)
August 2009	194	232	139

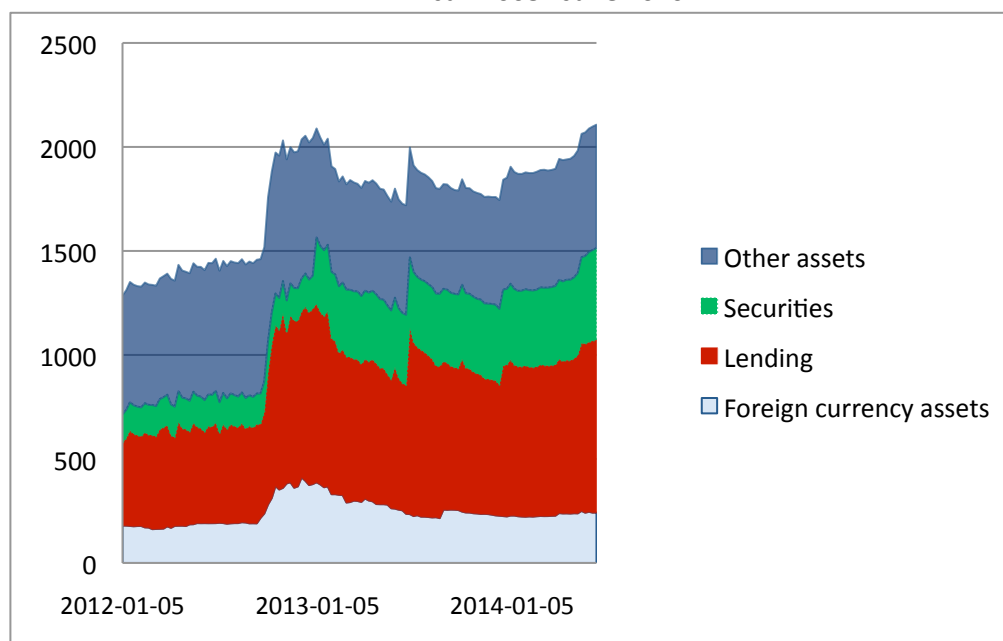
Source: ECB, 2009, *Recent developments in the balance sheets of the Eurosystem, the Federal Reserve System and the Bank of Japan*, in Monthly Bulletin, October (p. 81-94)

On the other hand, the monetarist features of ECB policy can be discerned in its continuing preoccupation with the goal of price stability, as displayed in 2008 (when it raised its key interest rate), as well as in its preferential treatment of the private sector. These features further show up in the structure of its assets. As Graph 4 shows, the share of lending to euro area credit institutions in the ECB balance sheet assets increased considerably by comparison to that of securities of area residents and general government debt.

<sup>23</sup> Annual Accounts of the ECB, p.15

<sup>24</sup> Eric Tymoigne and Randall Wray, L., 2006, ‘*Money: an alternative story*’, in A Handbook of Alternative Monetary Economics, Edward Elgar

**Graph 4 - ECB structure of assets (€ billion)**  
**Jan 2008 - June 2010**



Source: Cecchetti (ibid)

### 5. The missing link: prudential supervision

Prudential supervision arrangements in the EU are based on three principles: decentralization, segmentation and cooperation.<sup>25</sup> That is, supervision is exercised by a multiplicity of bodies both at the EU and the member state level. Furthermore, in many instances, different segments of the financial industry are overseen by different bodies, while coherence across such a decentralized and segmented structure is sought through bilateral and multilateral cooperation. There are arrangements, largely under the auspices of the ECB, for the exchange of information and the possible coordination of policies relating to financial stability, but stability measures remain essentially the responsibility of the member states.

In particular, the European System of Central Banks has only a limited role with regard to the safeguarding of financial stability. According to art. 127.5 of the Treaty, “The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system”. In this sense, prudential supervision is a “non-basic” task of the ESCB, by comparison to its other tasks, which are considered as ‘basic’ (art 127.2).

On the other hand, according to Art. 127.2 of the Treaty, the ESCB is responsible for the “smooth operation of payment systems”. That is, should there be an explicit *payment*

<sup>25</sup> Lastra R.M., 2003, “The Governance Structure for Financial Regulation and Supervision in Europe” in *Columbia Journal of European Law*, 10, 1, Fall and Schinasi, G.J. & P.G. Teixeira, 2006, *The Lender of Last Resort in the European Single Financial Market*, IMF Working Paper WP/06/127

*system failure*, the ECB has competence to act as lender of last resort (LOLR). Thus, although payment system supervision is difficult to dissociate from banking supervision, the Treaty does so.

However, should a crisis occur outside the payment system, then the role of the ECB is ambiguous. In particular, Art. 127.6 of the Treaty, also known as the “enabling clause”, allows for a possible expansion of an ECB supervisory role on the basis of a unanimity rule, rather than the formal amendment of the Treaty: “The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings”.

We argued above (Section 4) that in the face of the crisis, the ECB adopted a pragmatic approach by extending its monetary operations both in terms of the tools employed and in terms of the amount of resources deployed. In this sense, it assumed a lender-of-last-resort (LOLR) function with respect to the euro area banking system as a whole. At the same time, the crisis revealed the missing link in the financial architecture of the euro area. Namely, the inadequacy of the prudential supervision arrangements. This is not surprising in view of the fact that the financial integration policy, which was vigorously pursued in the 1990s, had no counterpart in the area of stability.

In a typical Community fashion, the response of the EU Council and Commission to the crisis was to set up a high-level expert group to look into the problem and suggest necessary policy adjustments. The group was headed by Jacques de Larosière, a former Bank of France president. The DeLarosière report (submitted on 25/2/2009) recommended the setting up of a new financial supervisory structure, which was agreed upon by the European Council and the European Parliament<sup>26</sup> (on 24/11/2010), and it became operational on 1<sup>st</sup> January 2011. Briefly, the new arrangements are as follows:

- *Macro-prudential supervision* – Completely neglected until now, it is going to be the responsibility of a European body, the European Systemic Risk Board (ESRB). This will consist of the EU central bankers, the chairs of the three supervisory committees also established and the ECB President and Vice President, under the auspices of the ECB. Its tasks include: monitoring developments in the economy and in the financial system, in order to identify and prioritise potential threats to stability; issuing risk warnings in the case of such threats, as well as recommendations on the measures to be taken; monitoring the follow-up to warnings and recommendations; liaising with the IMF, the Financial Stability Board and third country counterparties. The ESRB has no binding powers, which does of course limit its overall effectiveness.
- *Micro-prudential supervision* – A new architecture is envisaged, consisting of a network of European financial supervisors, the European System of Financial

---

<sup>26</sup> Reg. 1092/2010 establishing a European Systemic Risk Board; Reg. 1093/2010 establishing a European Banking Authority; Reg. 1094/2010 establishing a European Insurance and Occupational Pensions Authority; Reg. 1095/2010 establishing a European Securities and Markets Authority.



Supervision (ESFS). More specifically, the existing committees by financial services sector (banking, insurance & pensions and securities) - known as 'Level 3' committees, set up in 2005 to provide technical assistance to the Commission on financial regulation matters - were given a legal personality and an extended supervisory mandate. This includes: ensuring a single set of harmonized rules and their consistent implementation across the EU; developing a common supervisory 'culture' and practices; ensuring a co-ordinated response in crisis situations; collecting micro-prudential information. Further, they are responsible for the authorization and supervision of certain entities with pan-European reach, e.g. credit rating agencies and EU central counterparty clearing houses.

In the newly established prudential supervision arrangements, the ECB has been assigned a 'specific' task, in accordance with Article 127.6, quoted above. This task concerns the day-to-day running of the ESRB and in particular, the provision of analytical, statistical, administrative and logistical support<sup>27</sup>.

Overall, although the new prudential supervision arrangements take account of the information-related synergies between supervision and core central banking functions, the separation of authorities raises issues of policy effectiveness and co-ordination. In this sense, the new structure will only be tested at the next financial crisis. However, to the extent that price stability remains the overarching policy objective of monetary and indeed economic policy, more generally, financial stability comes as a poor second in more ways than one.

## **6. Summary and Conclusions**

In this paper, the following points were raised:

- Central banking, like any other economic institution, is best viewed in the context of the historical process, of which it is part. The current monetarist model of central banking pertains to the period from the late 1970s onwards, in which neoliberalism became the prevalent ideology.
- The ECB, established in 1998, on the eve of the introduction of the single European currency, is a product of its (historical) time. Thus, it is 'narrow' in its conception, both constitutionally and operationally. Its focus is on price stability, not only as a goal, but also as a means of policy. It has had no role in the area of financial stability, much less in that of economic stability.
- Prior to the crisis, the ECB's monetary policy concentrated on short-run market operations. Its benchmark was an inflation rate "below but close to 2%", to which it religiously stuck. This was more or less achieved, largely as a result of the restrictive policies prevailing in the EU throughout this period. The 'success' of the restrictive monetary policy was however at the cost of a low rate of growth for the euro area over the same period.
- The financial crisis erupted in August 2007. The ECB responded by injecting liquidity into the system. However, its obsession with price stability led it to increase its key interest rate in mid-2008, just as the crisis was gathering speed.
- The collapse of Lehman Brothers in September 2008 was a wake-up call for the ECB. Starting in October 2008 and continuing until well into 2010, it introduced a series of

---

<sup>27</sup> Reg. 1096/2010 of 17/11/2010

‘non-standard’ measures, aiming at keeping the euro area financial institutions not only liquid, but also solvent. Unlimited resources were made available to them at a historically low interest rate. This policy did not discriminate between solvent and insolvent units, neither was the question of moral hazard raised in any context. Such was the urgency with which the ECB responded to the financial crisis.

- As the financial crisis spread to the public budgets, the ECB responded by extending a helping hand to the euro area governments. Such help however was indirect and limited in size, by comparison to that given to the financial sector.
- Lastly, the role of the ECB in prudential supervision of the financial services sector is so limited, as to have made no difference in its dealing with the crisis.

So, where does one go from here? In view of the above, has the crisis led to a shift in policy from price stability to financial stability? If so, does this signify the start of a new era? What are the implications for economic policy more generally? We shall attempt some answers.

The financial crisis certainly made the ECB and the European elites acutely aware of the risks inherent in modern finance and in the market system more generally. Under the pressure exerted by the crisis and in the fear of worst to come, the ECB departed from its habitual monetary conservatism. It extended help to the euro area credit institutions in an indiscriminate way. When the sovereign debt crisis succeeded the financial crisis, however, the ECB reverted to its conservative stand, invoking its statutory constraints. Thus, the shift in policy that was detected in its unconditional support of the financial sector did not materialize in the case of the public sector.

Further, the recent decision by the European Council to set up separate bodies to deal with the public debt of the euro area member states – through the European Stability Mechanism – and to oversee the financial services sector – through the European Systemic Risk Board – is indicative of the fact that the dividing line between price stability and financial/economic stability remains unchallenged, at least notionally.

Therefore, it may be argued that any shift in ECB policy that may be detected in its response to the crisis has been temporary and thus of no importance. Does this mean then that the ECB will simply return to its pre-crisis policies and mode of operation? We think not. Apart from the fact that some institutional changes, albeit limited, have happened and that they will have to be accommodated in the ECB’s mode of operation, the pre-crisis system was found to be singularly lacking in many respects. In the words of Jean Claude Trichet, the President of the ECB:

*“Concerning the ex post returns with the considerable costs of the current turmoil, we have to realize that our financial system as a whole, including its non-regulated and non-listed entities, was neither strong nor efficient. It did not allocate capital properly and it did not manage risks well. ... We have to put reserves and buffers back into the system; they are the protection against serious damage in a downturn and they are an integral part of sound finance”<sup>28</sup>.*

A remarkable admission!

On the level of central banking more generally, Goodhart (ibid) and Lamfalussy (ibid), both well-respected, mainstream economists and former central bankers, have come to the conclusion (i) that central banks need to be given macro-prudential supervisory authority; (ii) that this will not impair their price setting role and (iii) that they need to work closely with

---

<sup>28</sup> Keynote address at the Committee of European Securities Regulators, 23/2/2009

the government, whereby their 'independence' should be regarded as an operational concept.

In our view, a more permanent shift in policy away from the prevailing monetarist paradigm and towards that aptly described by Goodhart and Lamfalussy may only happen if enough pressure is applied to counter the resistance put up by the financial industry. The crisis did exert a sudden and extremely strong push. As the pressure deriving from this push eases, a reversal in ECB monetary policy is likely. For example, at the time of writing, there are strong indications that the ECB key interest rate will be raised in the name of price stability and in spite of the public debt problems faced by a number of euro area member states and the fitful recovery of others<sup>29</sup>.

Thus, it is necessary to keep up the pressure for change through the social and political process, as well as on the intellectual level. What may appear as technical and thus distant to the average man and woman in the street needs to be made comprehensible and hence, of relevance. In this way, it becomes a tool for change.

---

<sup>29</sup> Even the Economist deplors such a move, which it considers incidental of a 'neurotic monetarist'!  
"Trigger happy: The European Central Bank is planning to raise rates too soon", 31-3-2011