European Parliament

DG INTERNAL POLICIES OF THE UNION
- Directorate A -
ECONOMIC AND SCIENTIFIC POLICY
POLICY DEPARTMENT

Monetary Dialogue – 28 September 2020

Executive summaries of the papers prepared by the Monetary Expert Panel[1]

1. ACCOUNTABILITY MECHANISMS OF MAJOR CENTRAL BANKS AND POSSIBLE AVENUES TO IMPROVE THE ECB'S ACCOUNTABILITY

Background

Independence of monetary authorities is a key tenet of modern central banking. Independence, however, must go hand in hand with strong accountability mechanisms towards the public and its elected representatives.

Four papers were prepared for the ECON Committee by the Monetary Expert Panel, comparing the accountability practices of major central banks in other jurisdictions (the Bank of England, the Swiss National Bank, the Bank of Japan and the Federal Reserve) with those of the European Central Bank (ECB) and offering recommendations on how to improve the ECB's accountability framework.

Papers

Accountability Mechanisms of the Bank of England and of the European Central Bank by Rosa M. LASTRA (Queen Mary University London)

- In a democratic system governed by the rule of law, **central bank independence must always be accompanied by adequate mechanisms of accountability**.
- **While too broad independence may lead to an unacceptable 'state within the state', too much accountability threatens the effectiveness of independence**. The design of 'accountable' independence varies across jurisdictions.
- **Institutional accountability ought to be 'diversified' *(trias politica)***, encompassing parliamentary oversight, judicial review, audit control, and a degree of 'executive' responsibility. The emphasis of this paper is on accountability to Parliament.
- **Performance control is conditional upon the objectives and targets imposed upon the central bank, while the principle of transparency is a market-based form of accountability**.
- **Public support (*de facto* accountability) contributes to societal legitimacy**.

[1] Available at http://www.europarl.europa.eu/committees/en/econ/monetary-dialogue.html

- **The UK experience – presented in this paper – is significant** in that it has expanded and reformed the accountability arrangements (parliamentary oversight and others) of the Bank of England in response to the expansion of the Bank's powers in recent years.
- **The role of the ECB has also grown significantly in response to the global financial crisis and to COVID-19**. The pandemic also evidences the need for better coordination in economic policy making.
- **This paper focuses on accountability for the monetary policy functions**, though both the ECB and the Bank of England have a wide range of other functions (including prudential supervision post GFC).
- **The adequate locus of institutional accountability for the ECB in the conduct of monetary policy resides at the European level** (judicial review by the European Court of Justice and accountability to the European Parliament/Committee on Economic and Monetary Affairs - ECON).
- **This paper recommends that European Parliament/parliamentary accountability be strengthened** and that the 'Monetary dialogue' be renamed as 'Monetary hearings' reflecting the need for enhanced oversight.
- **In terms of the content of such 'hearings', compliance with the ECB mandate (primary and secondary objectives) will remain of paramount importance** and must be continuously explained and justified. Hearings are particularly importance when the central bank navigates through a crisis.
- The paper seconds the **establishment of a euro area subcommittee within ECON** to scrutinise monetary policy.
- **Effective audit control provides a basis and input for subsequent parliamentary oversight and improves transparency**.
- **ECB monetary policy measures must be subject to a proportionality test when subject to judicial review** by the Court of Justice of the European Union (Weiss).
- **The distributional and other effects of monetary policy are important issues from the perspective of democratic legitimacy** and must be considered by the EP/ECON.

Independence with Weak Accountability: The Swiss Case by Charles WYPLOSZ (The Graduate Institute, Geneva)

- **The SNB is formally independent and subject to weak accountability requirements**. In addition, on the basis of a strong track record, the consensus is that the SNB is delivering on its mandate. These two elements explain that there is hardly any debate about monetary policy in Switzerland. Experts may quibble with some decisions, but criticism is generally absent from debates within political and media circles and the broader public.
- **The accountability requirements from the ECB are rather weak too**. The ECB is accountable to the European Parliament whose powers are limited and the process, the Monetary Dialogue, is not particularly demanding. Yet, the need for effective accountability is much stronger in the euro area.

- **One reason is that public opinion is divided**. The decisions by the ECB can be simultaneously lauded and criticised, including by policymakers, financial market participants and even academics because of pre-existing prejudices.
- **Another reason is that the hearings of the President and of other members of the Executive Board before the Economic and Monetary Affairs Committee do not allow for precise and in-depth questioning**. In addition, MEPs frequently reflect in their interventions the views of their public opinions. Opposite views make it nearly impossible to focus on important but highly technical issues.
- **A more dynamic Monetary Dialogue would attract more attention from the media, which would translate into heightened public visibility**. It could well emphasise disagreements, which some may see as potentially dangerous.
- **Prejudices will not vanish soon but the European Parliament has a particular responsibility**. The Monetary Dialogue can be much improved by allowing an in-depth discussion of ECB actions.

How Can the European Parliament Better Oversee the European Central Bank? by Grégory CLAEYS, Marta DOMÍNGUEZ-JIMÉNEZ (Bruegel)

- **In the wake of the successive crises that have affected the euro area over the last twelve years, the role of the European Central Bank (ECB) in managing the euro-area economy has expanded considerably**. Its use of less-conventional monetary tools and various asset purchase programmes has increased its footprint in financial markets and in the real economy. Although we consider that this development has been warranted by the situation, it increases the need to ensure effective accountability to the European Parliament (EP), the only directly-elected EU institution.
- **This paper assesses the current ECB accountability framework, and compares it to that of the Bank of Japan (BoJ)**. Even if the functioning and degrees of independence of the BoJ and ECB differ significantly, some useful lessons can nonetheless be drawn from the Japanese experience.
- **To be more accountable, the ECB's primary and secondary objectives should be clarified and transparency about decision-making should be increased.** Moreover, in contrast to parliaments of other jurisdictions, the European Parliament's competences are very limited: it can neither appoint nor sanction the ECB's Executive Board members, while fundamental changes in the functioning of the ECB would require a change to the EU Treaties, which must be approved unanimously by EU Member States.
- **The BoJ Act of 1997 intended to increase BoJ independence, but the BoJ remains much less independent than other major central banks, and in particular the ECB**. There is a high degree of government involvement in monetary policy decisions in Japan, as "close contact" and coordination are written into law and established in practice. For instance, while the main objectives of the BoJ are enshrined in Japanese law, the quantitative definition of price stability (which evolved over time) is determined by the BoJ, but the most recent change has been heavily influenced by the government. The Japanese Parliament is also much more powerful than the EP as it can modify the law governing the functioning of the BoJ and veto appointments to the BoJ Policy Board. BoJ decision-making processes are also more transparent than those of

the ECB, as the BoJ publishes detailed minutes of monetary policy meetings with details of individual votes and reasons for dissent.

- **We make three main recommendations to improve the ECB accountability framework**. First, the EP can, and should, **improve the Monetary Dialogue**, to transform it into a real hearing aimed at evaluating the ECB's effectiveness in fulfilling its price stability mandate and in contributing to the achievement of EU objectives. The EP should also look into the proportionality of the tools used by the ECB to fulfil its mandate in order to ensure that the ECB does not overstep its treaty-based competences. The Monetary Dialogue would also benefit from a reduction in the number of MEPs participating, to give participants the chance to engage genuinely with the ECB President and to ask follow-up questions (as is the case in Japan). The ECON Chair should also ask at each meeting a fixed set of questions related to the ECB's performance.
- Second, **the EP should push the ECB (using in particular the ongoing strategy review) to publish more detailed minutes of Governing Council meetings**, which would include the votes of the members (as is the case for the BoJ), as this is legally at the discretion of the ECB. This would enable more effective scrutiny, create the right incentives at the individual level for Governing Council members, and, by allowing easier identification of the pros and cons of its policies, it would also alleviate concerns raised in some euro area countries about the proportionality of the ECB's actions.
- Finally, **amid calls for the ECB to 'green' its monetary policy, additional clarity on the role and ranking of secondary objectives is required**. However, ranking of goals is a political task, so it should preferably be decided by elected bodies and not by unelected technocrats. The EU's legislators should thus reveal their preferences. This clarification about the ECB's objectives would in turn facilitate parliamentary scrutiny.

Accountability at the Fed and the ECB by Karl WHELAN (University College Dublin)

- **This paper reviews the independence and accountability of the ECB and the Federal Reserve**.
- **While the ECB makes significant efforts to be accountable for its actions, there are several improvements that could be made** to European institutions to improve its independence and accountability.
- These include **reforming the process of appointing ECB Executive Board members**, **improving the transparency of ECB decision-making** and **reforming aspects of the Monetary Dialogue** to make the questioning more effective.
- **Accountability starts with the process of appointing central bankers**. The European Parliament has correctly called for a dialogue with the European Council about how members of the Executive Board are appointed.
- The paper recommends that the European Council should only appoint Executive Board members that have been **recommended by the European Parliament and should avoid appointing people who are currently serving in political roles**.
- **The ECB can improve its communication procedures and accountability surrounding emergency lending to banks** as past failures in this area have been damaging to its reputation.

- **The ECB should consider providing more information about Governing Council meetings**, including explicit vote tallies and meeting accounts that provide names of which Council members made which points.
- **In many ways, the Federal Reserve's institutions are inferior to those of the Eurosystem.** The Eurosystem is far more independent from political control than the Federal Reserve and the process of appointing the executive board of the ECB is less politically charged than the process of appointing members of the Board of Governors of the Fed.
- **However, the US Congressional hearings with the Federal Reserve chairman are more effective at holding the Fed accountable** for its actions than the Monetary Dialogue is with the ECB.
- **This partly reflects the current procedures of the Dialogue meeting**, which does not feature regular back-and-forth exchanges of views with the President.
- **The ECON committee should consider adapting the Dialogue to have fewer Members asking questions**, but with each member given more time.
- **The committee should also consider having specific themed sub-sessions** where all of the questions for a period of time cover the same topic.
- **The Committee should consider moving the Dialogue meetings to a smaller committee room**, allowing the MEPs to sit closer to the President, in a similar way that Senators and Congressmen sit relative to the Fed Chair at their hearings.

2. THE ECB'S ASSET PURCHASE PROGARMME: EXPERIENCE AND FUTURE PERSPECTIVES

Background

In response to the unprecedented shock brought by the COVID-19 pandemic, the European Central Bank (ECB) has deployed a massive package of monetary policy stimulus to safeguard the monetary policy transmission mechanism and keep the euro area economy afloat. As part of this package, the ECB has stepped up its asset purchases, including with the introduction of the new pandemic emergency purchase programme (PEPP) with an envelope of EUR 1.35 trillion by June 2021.

Over the years, the impact and the side effects of the non-standard asset purchase programmes have been widely debated. Should they remain as part of the ECB's toolkit in the future, considering that inflation is expected to stay low and that interest rates are in negative territory?

Six papers were prepared for the ECON Committee by the Monetary Expert Panel, presenting empirical evidence and discussing future perspectives of the ECB's asset purchase programmes.

Papers

Go Big or Go Home? The ECB's Asset Purchase Programmes in Macroeconomic Perspective by Pierre L SIKLOS (CASE – Center for Social and Economic Research, Warsaw, Poland; Wilfrid Laurier University and Balsillie School of International Affairs, Waterloo, Canada)

- **GDP growth in the euro area has been disappointingly low and the ECB has under-performed in reaching its own inflation target for several years**. Since the single currency area was created real GDP growth and inflation rates have converged although important divergences remain, especially when it comes to expectations of future growth and inflation.
- **There was a gathering economic storm even before COVID-19**. The pandemic merely exacerbated forces already at play though it would offer the ECB an opportunity to lead by example.
- **Concerns over asset purchase programs by central banks are global and are not new**. Indeed, they can be traced back to the 1990s in Japan. Concerns are two-fold: the size of these interventions and their scope. The latter give rise to worries that monetary and fiscal policies become blurred, and with good reason.
- **The paper examines the record of the ECB since 1999 but focusing on three episodes**. They are: the global financial crisis, the euro area sovereign debt crisis, and the period since non-standard policies, also referred to as unconventional monetary policies, were implemented. The last period can also be said to include the ongoing pandemic crisis.
- **Over the series of crises, some lessons have been learned**. Overall, the ECB's response has improved. The impact of its increasingly frequent and large interventions has arguably become more muted over time. The most important lesson, not completely digested, is the critical need for fiscal and monetary policies to operate in harmony. This need not require a single fiscal policy; it does, however, require a fiscal response from Member States. It also requires better coordination among the sovereign Member States.

- **Legal, policy, and practical threats to good practice in the conduct of monetary policy in the euro area remain**. Missing is a more aggressive attempt by the ECB to engage with the public to counter some of the external pressures faced by the institution.
- **The sharp divide between Northern and Southern Europe over the net benefits of collective action in the euro area could stand a closer look at some of the evidence**. Some of the loudest critics of ECB policy appear to see only costs when there have also been beneficiaries among members who believe a single monetary policy has penalised their economies.
- **Bank centred financing continues to be a threat to economic resilience and recovery and it also has implications for the conduct of monetary policy**. In particular, we do not yet know the full fallout from the ongoing pandemic on the banking system.
- **The record of asset purchase programs in the euro area is mixed**. There is clear evidence that long-term yields have declined but the record at the shorter end of the term structure is less successful. At the macroeconomic level, the best that can be said is that ECB interventions have softened the economic blows from successive crises. However, this is not a recipe for the long-term success of monetary policy.
- **Talk of exit from non-standard monetary policy is premature**. Instead, a clear roadmap of conditions under which the ECB's monetary policy stance would return to some 'new normal' is essential. Together with better fiscal-monetary coordination and greater public engagement, these are the pre-conditions for achieving a more optimistic future for the euro area.

APP vs PEPP: Similar, But With Different Rationales by Christophe BLOT, Jérôme CREEL, Paul HUBERT (Sciences Po – OFCE)

- **The ECB's asset purchase programmes have been implemented at different times in different economic environments and may pursue different objectives**. We review these considerations to analyse the consequences of such programmes.
- **The APP arrived at a moment when the euro area was facing strong deflationary risks whereas the PEPP was implemented when the inflation outlook was uncertain** (because the Covid-19 crisis is a mix of a supply, demand and uncertainty shocks) but fragmentation risks were on the upside and sovereign risks and increasing spreads could impair the transmission of monetary policy across euro area countries.
- **The declared will to tackle the fragmentation of the euro area** and the removal of the self-imposed limits suggest that the ECB sets a sort of "spread targeting" objective to the PEPP.
- From the point of view of this "spread targeting" objective, the **PEPP is successful with both the level and volatility of sovereign spreads at low levels**.
- **This outcome was obtained without a full utilisation of the potential resources of the PEPP**. The weekly flow of purchases is indeed decreasing since July. This suggests that the signalling effect of the PEPP was strong and credible in taming sovereign stress.
- **Ultra-loose and "disproportionate" monetary policy raised the risk of overshooting the inflation target and exceeding the price stability mandate**.

- The effectiveness of monetary policy decisions, asset purchases in this context, has to be **assessed with respect to the objective of the programme and the economic context in which it was implemented**.
- **The transmission of monetary policy relies on various interactions between macroeconomic and financial variables** such that the price stability objective cannot be insulated from the real economy.
- **In the situation where the pandemic crisis prevents fiscal consolidation and makes a rise in inflation or in real GDP uncertain**, an accommodative monetary policy that reduces nominal yields and so financing conditions, is undeniably relevant to ensure public debt sustainability.

COVID-19 and the Future of Quantitative Easing in the Euro Area: Three Scenarios with a Trilemma by Luigi BONATTI, Andrea FRACASSO, Roberto TAMBORINI (University of Trento)

- **The COVID-19 pandemic modified profoundly the economic structures, the economic processes, and the transmission mechanisms of policy actions in the euro area.** Because of its depressing effects on both the supply side and demand side, large parts of the conventional wisdom in economic policymaking appear as unfit.
- **The pandemic has dragged the ECB into a trilemma**, among **preserving the integrity of the euro area** against massive flight-to-safety phenomena and self-fulfilling prophecies, on the one side, and "**monetary orthodoxy**" (the central bank with a single mandate of price stability and no debt financing over the long term) and "**fiscal orthodoxy**" (fully national fiscal sovereignty under budget and debt constraints plus "market discipline") on the others.
- **Both the PEPP**, that is the extraordinary QE programme established to address the crisis and preserve the integrity of the euro area and the smooth functioning of monetary policy, **and the agreement on a "Next Generation EU" package** connected to the EU budget **open a timely and necessary relaxation of these orthodoxies**. Yet, these solutions have been presented and justified as **exceptional and temporary**, aiming to prevent economic collapse and buying time until the recovery.
- In this paper we argue that what will happen to this consensus and what unconventional tools will become part of the ECB's new toolbox in the future rests much on the **economic and political scenarios that will materialise once the pandemic will end**, especially if it will be evident that in some countries the political conditions for fiscal consolidation and effective growth-enhancing reforms are missing.
- If the economy will **recover immediately**, or after a little while, the rationale for expansive asset purchases will be weaker. In the case of a **prolonged stagnation**, the ECB would be economically justified to continue its unconventional interventions, but prolonged and large QE purchases will be accepted only if a consensus will be reached on a revised review of the ECB' strategy and, possibly, on the reform of the euro area economic governance. The ECB would eventually face a difficult choice between supporting the debt of the countries in trouble or exposing the euro area to a crisis that might lead to its implosion. This is, ultimately, a threat to the very existence of the ECB.
- **The ECB cannot be left to deal with this dilemma alone.** This is the right time for euro area countries to check whether guidelines and strategies shaping the ECB's policies are still

appropriate for the post-COVID-19 world and eventually try to modify it. The PEPP and other extraordinary measures are buying time, also to accomplish this profound rethinking.

The ECB's Asset Purchase Programmes: Effectiveness, Risks, Alternatives by Joscha BECKMANN, Salomon FIEDLER, Klaus-Jürgen GERN, Stefan KOOTHS, Josefine QUAST, Maik WOLTERS (Kiel Institute for the World Economy)

- **The ECB's asset purchases have been particularly effective in stabilising financial market conditions during times of high financial distress, i.e. at the peak of a crisis. There are, however, tendencies of decreasing efficacy over time.** Asset purchases have a stronger effect on risk perception compared to inflation expectations. Effects of quantitative easing (QE) on output and inflation are highly uncertain. Effects on "periphery" relative to "core" countries seem to be larger. While there is strong evidence for a stabilising role of asset purchases in the short term, it is less clear to what extent the effectiveness of QE is lasting over time. The available APP evidence points in the same direction as the international evidence, with the effects on euro area long-term yields, output, and inflation being somewhat smaller compared to the US and the UK, but larger than for Japan.
- **Large scale asset purchases by the central bank may lead to unintended side-effects which need to be taken into account.** Important potential drawbacks of QE policies include decreasing the incentive to engage in fiscal consolidation and structural reforms, putting undue constraints on future monetary policy, encouraging excessive risk-taking in the financial sector, reducing the growth potential of the economy via a misallocation of resources, a "zombification" effect, and increasing wealth inequality.
- **First assessments of the effect of the emergency programme in response to COVID-19 suggest a substantial stabilising impact on financial market variables as well as on the outlook for economic activity and inflation but could be skewed to the upside.** While asset purchases have been instrumental to stabilise sentiment in the acute crisis, it remains unclear what the contribution of additional liquidity is once uncertainty has returned to normal levels.
- **While QE seems to have become a standard policy measure over recent years, a sustained policy of large-scale asset purchases entails substantial side effects and risks.** Asset purchases of the ECB have been successful in stabilising expectations and supporting growth in the euro area over recent years, but at the same time allowed other policy areas not to deliver on important policy challenges. A cost-benefit analysis of asset purchases and QE is complicated by the difficulty to quantify its exact effect on the economy as well as the side risks. Using asset purchases not regularly but only under extraordinary circumstances is a possible strategy to consider because of both, the emerging evidence that QE is particularly effective in times of crisis and the risk that unintended side-effects build up over time.
- **To help create an environment that would enable the ECB to exit from QE, we suggest the introduction of a rule based fiscal back-stop mechanism for sovereign debt risk premia.** Bond yield risk premia of Member States would be allowed to fluctuate freely in the capital markets, but only up to a politically chosen ceiling, of say 500 basis points, at which a common institution funded by solvent euro area Member States would intervene to cap the yield spread. This would preserve the role of yield spreads as a market signal, incentivising Member States in progressing with structural adjustments, while fully containing the risk of shifting to bad equilibria due to non-fundamental market movements.

This Time is Different: The PEPP Might Not Work in a Sectoral Recession by Angela CAPOLONGO, Daniel GROS (CEPS)

- **Central bank bond-buying, like the PSPP or the PEPP, is not an 'all-purpose' policy instrument**.
- **It can be very effective in reducing risk spreads when financial markets are in turmoil, like 2008/2009 or March/April 2020**. When uncertainty is very high and market participants only want the security of cash, it is essential that the central bank becomes the 'buyer of last resort'.
- **However, central bank bond buying becomes much less effective when markets are calm**. In these circumstances the main aim becomes increasing inflation. But when a central bank buys government bonds it only substitutes one form of public sector liability (government bond) with another (deposit at the central bank). This might influence (long term) interest rates but the ultimate impact on inflation is limited as can be seen from the meagre results of QE2 and 3 in the US, the failure of the monetary arrows in Japan and the fact that after years of PSPP the inflation rate in the euro area barely budget.
- **A number of studies, almost all of them by authors associated with the Eurosystem, claim that the PSPP has been effective in lowering (long-term) interest rate and lifting inflation**. However, the estimated magnitudes are in the order of at most 1 percentage point higher inflation, spread over several years.
- **QE is likely to be even less effective in today's circumstances of a 'sectoral recession'**. Rates on safe assets are already negative and risk spreads very compressed. The further minute reductions in long-term interest rates that could be achieved by any expansion of the PEPP are unlikely to have a meaningful impact on demand which is held back in some sectors by social distancing measures and lingering fears about the virus.
- **Policy-makers can react in very different ways when a policy instrument becomes less effective**: one reaction is to 'double the dose' in order to achieve the desired result. The other reaction is to use it less because collateral damage becomes more important relative to the limited results one can expect.

Theory, Evidence, and Risks of the ECB's Asset Purchase Programme by Pierpaolo BENIGNO (Universitat Bern), Paolo CANOFARI (Università Politecnica delle Marche, Ancona), Giovanni DI BARTOLOMEO (Sapienza Università di Roma), Marcello MESSORI (Luiss Guido Carli, Roma)

- **A central bank's long-term asset purchase is an unconventional monetary tool**. It represents a departure from the traditional composition of the central bank's balance sheet and utilises the monetary transmission channels in new ways.
- **We discuss the theoretical aspects and the effectiveness of three channels that can be impacted by the ECB's asset purchase programme (APP)**: the interest-rate channel (either by a portfolio-rebalancing or a signalling mechanism); the credit-easing channel; the implicit-guarantee channel.
- **Almost all empirical studies agree that the ECB's APP substantially improved the euro area (EA)'s financing conditions**. The flattening of the yield curve, the increase of bank loans, and the compression of sovereign debt yields played a significant role in strengthening the economic recovery after the European crisis (2011-2013).

- **After relaunching its APP at the end of 2019, the ECB announced an unprecedented amount of net purchases to deal with the COVID-19 crisis.** This was the correct response to the economic depression, but it was only a part of a complex policy strategy. However, the novelty brings new concerns.
- **We offer a provisional analysis of the drawbacks often associated with a prolonged ECB APP** (from March 2015 to the end of 2018), the moderate APP re-starts since November 2019, and its relaunch after the COVID-19 shock.
- **Early literature stresses four potential drawbacks which relate to bank profitability, financial bubbles, social inequality, and the overlapping between monetary and fiscal policies**. These concerns are not so crucial for the case of the ECB's APP before the pandemic shock.
- **Significant risks of the ECB APPs are about their future unwinding**. In a post-COVID scenario, these risks are also related to the fiscal stance and the architecture of the EA. The **implicit-guarantee channel produces the most negative impact**, since it can lead to a sovereign debt crisis.
- **The latter channel usually covers solvency problems for the issuer of the securities involved in the purchases, most notably for the national treasuries issuing public bonds**. When the ECB APP's unwinding takes place this implicit guarantee vanishes.
- **A long-term asset purchase by the ECB can be an important complement to other unconventional monetary tools** in order to help credit easing when the banking sector is under financial stress.
- **The ECB APPs can also be used for stabilisation purposes**; and other unconventional tools can also be used to shape the yield curve (forward guidance, yield-curve targeting and long-term central bank deposit securities). These latter tools are not subject to the above shortcomings.
- **Our main conclusions are that the APP and other unconventional monetary policy (UMP) measures can become standard policy tools**. However, in normal economic times, their quantitative amount should be limited. Hence, in the post-pandemic there will be a crucial problem concerning the APP's unwinding.