DEALING WITH THE ECB'S TRIPLE MANDATE?

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The prevailing consensus on the role of central banks has eroded. The pursuit of the goal of price stability only is now insufficient to ensure macroeconomic and financial stability. A new paradigm emerges in which central banks should ensure price stability, growth and financial stability. Recent institutional developments of the ECB go in this direction since it will be in charge of the micro-prudential supervision. In addition, the conduct of monetary policy in the euro area shows that the ECB also remained attentive to the evolution of economic growth. But if the ECB implements its triple mandate, the question of the proper relationship between these missions still arises. Coordination between the different actors in charge of monetary policy, financial regulation and fiscal policy is paramount and is lacking in the current architecture. Besides, certain practices should be clarified. The ECB has played a role as lender of last resort (towards banks and, to a lesser extent, towards governements) although this mission was not allocated to the ECB. Finally, in this new framework, the ECB suffers from a democratic illegitimacy, reinforced by the increasing role it plays in determining the macroeconomic and financial balance of the euro area. It seems important that the ECB is more explicit with regard to its different objectives and that it fulfils the conditions for close cooperation with the budgetary authorities and financial regulators. Finally, we call for the ex nihilo creation of a supervisory body of the ECB, which responsibility would be to discuss and analyze the relevance of the ECB monetary policy.

The financial crisis which began in 2007 initiated a debate on the role of central banks and monetary policy before, during and after the economic crisis. In particular, the consensus that had prevailed since the 1980s has cracked. It was based on four main features:

— Price stability is the primary objective (if not only) of central banks;
— Short-term monetary policy has real effects on growth;
— The financial stability can be borne by the central bank or delegated to another authority, but it remains that, according to the Tinbergen principle, these two objectives have to be achieved through the use of two independent instruments. The objective of price stability is achieved through changes in the central bank interest rate while financial stability is based on the control of credit institutions via a micro-prudential policy;
— Price stability leads to financial stability and to macroeconomic stability (around the potential of the economy).

This consensus is now being challenged. The crisis has shown that price stability was not sufficient to ensure financial stability[1] and could even be a vector of financial imbalances.[2] Hence one has questioned the role of central banks.[3] Should they be concerned about financial stability and if so, what is the best instrument to achieve it? Several options can be considered. Central banks can integrate the objective of financial stability in the conduct of monetary policy (the so-called "leaning against the wind" policy). In addition to the micro-prudential regulation, central banks may implement macro-prudential policy. This differs from a micro-prudential approach in that it identifies and limits the sources of systemic risk.

Moreover, this question must take account of the macro-financial environment marked by high unemployment in the euro area and the increase in public debt. Monetary policy decisions have an impact on inflation but also on growth, employment, the dynamics of public and private debt and the level of risk in the financial system. This article aims at shedding light on these issues from a European perspective. If price stability remains the primary objective of the ECB, the Maastricht Treaty does not preclude other objectives, including growth and employment. Moreover, the

1. Already claimed by Borio & Lowe (2002) and White (2006).
2. Macroeconomic stability makes it possible for central banks to keep interest rate at a moderate and stable level, which leads the financial system to increase its level of leverage and vulnerability.
3. See Betbèze *et al.* (2011).

implementation of a banking union explicitly devotes a new prerogative for the ECB: namely, financial stability. The ECB is thus now responsible for banking supervision (micro-prudential instrument). The link between the ECB, pursuing different objectives, and other institutions (national governments implementing fiscal policy and the European Systemic Risk Board managing systematic risk) must be clarified and we show that this link is still raising questions.

1. The ECB's de facto triple mandate

The ECB is *de facto* dealing with three mandates: price stability, growth (employment) and financial stability:

- — Price stability has been enshrined in the Treaty (Article 127) as the main objective for monetary policy;
- — The growth objective is relegated to second rank. The Treaty actually states that "without prejudice to the primary objective of price stability, the ESCB [European System of Central Banks] shall support the general policies in the Union";
- — The implementation of a banking union grants the ECB a role in financial regulation (Council Decision of the European Union of 15 October 2013). ECB will be in charge of banking supervision, micro-prudential policy, as part of a SSM (Single supervisory mechanism). Under the new system of supervision, the ECB will directly supervise "significant" credit institutions. It will assume these new responsabilities in Autumn 2014 and will work in close cooperation with national competent authorities.

Even if the treaty establishes a clear hierarchy among objectives, in practice, the ECB has been concerned with both changes in inflation and growth.[4] An explicit dual mandate would probably be more appropriate. In the US case, Rosengren (2013) considers indeed that the dual mandate helps the Federal Reserve to better account for expansionary monetary policy in times of crisis, where unemployment is very high. In EMU putting equal weights on inflation and growth objectives would imply a revision of the

4. Castro (2011) has recently estimated Taylor rules over 1999:1 et 2007:12 and has found that the ECB has significantly reacted to inflation and output gap.

Treaty, which is a long procedure requiring unanimity of EMU members. Pragmatic views may then be privileged. Since the definition of price stability or optimal level of inflation is not clearly established,[5] the ECB has already sufficient leeway to articulate its action appropriately according to the objectives of employment and inflation.

Moreover, the decisions of the ECB during the crisis have illustrated pragmatism from the ECB. It has notably met the liquidity needs of European banks, changing the operational framework when it was deemed necessary. The ECB has played a role as lender of last resort for banks, although this task is not included in its mandate. Larger defaults resulting from the liquidity crisis could then be avoided. The ECB created a very long term refinancing operation (VLTRO) by which it provided funds to credit institutions for a 3 years period. It was not only important to cover liquidity needs but also allowed banks to support sovereign debt market. Under the SMP (Securities Market Program), the ECB proceeded to purchases of public securities in the secondary market. This program and the OMT[6] announcement (Outright Monetary Transactions), that has followed in September 2012, have illustrated the will of the ECB to tackle the sovereign debt crisis. It has shown that the ECB was able to avoid a narrow interpretation of its mandate and missions.[7] This was notably justified by the need to restore the transmission channels of monetary policy, that had been impaired by the financial turmoils on sovereign debt markets (Cour-Thiman and Winkler, 2013). More recently, Mr. Draghi has adopted a forward guidance strategy, in which the central bank announces that it maintains its main interest rate at a level close to zero for an extended period. The aim is to drive expectations of interest rates, and thus enhance the transmission of monetary policy. This new communication breaks with past speeches ECB in which the ECB did not commit on future interest rate decisions.

5. See Billi & Kahn (2008), for example.
6. The ECB may buy unlimited amounts of sovereign bonds issued by countries which are under EFSF – ESM programs.
7. It should nevertheless be remind that these decisions have generated considerable debate, including the Board of Governors. J. Weidman, president of the Bundesbank, had notably made clear his opposition to the outright purchases of government securities.

In summary, although the mandate of the ECB is restrictive, its action reflects broader concerns. The ECB has focused on both inflation and growth. It has contributed to financial stability, as should do a lender of last resort. In addition, recent regulatory decisions will increase its powers giving the ECB the micro-prudential supervision of the banking system. The ECB therefore pursues three objectives.

2. A Work in progress

If the triple mandate proves to be right, the question of the proper relationship between these missions still arises. The tradeoff between inflation and growth is already duly integrated into the action of the ECB. Press releases routinely evoke the balance of risks between inflation and growth. In the current context of a deflation risk, the ECB could build on its forward-guidance strategy to make explicit a target for unemployment. This choice, made by the Bank of England (BoE) would clarify the communication strategy of the ECB since the stance of monetary policy would become contingent to a threshold on a direct observable variable (Bank of England, 2013). The action taken by the BoE indicates that such a decision is not inconsistent with an inflation target or a mandate focused on price stability.

Another tradeoff arises regarding the relationship between monetary policy and micro-prudential policy. It is common for central banks to be jointly responsible for the conduct of monetary policy and for banking supervision (Netherlands, Spain, United States in particular). Central banks have some expertise of banking monitoring since they collect information for their monetary policy operations. Given the link between the two objectives, a single institution in charge of these two objectives appears more effective to internalize interdependencies. Finally, to the extent that the ECB is the lender of last resort for banks, it is desirable that it has the necessary information and powers to meet liquidity needs.

Moreover, if the SSM provides the ECB with prerogatives in terms of micro-prudential policy, the implementation of macro-prudential policy amounts to a new institution: the ESRB (European Systemic Risk Board). This new tool is essential insofar as the supervision of financial institutions at the individual level is insufficient to manage the risks taken by the financial system as a whole. However, the ESRB is only a proposal body. The macro-prudential policy implementation, through restrictions on the loan-to-value ratio, is ultimately up to the Member States which shall notify and coordinate their decisions with the ECB. Because there is a strong complementarity between monetary policy and macro-prudential policy, it would have been more appropriate for this task to be handled by the ECB, especially as some regulatory tools, such as capital requirements, can be seen as part of both macro- and micro-prudential policies. Moreover, it is likely that with the macro-prudential tool, the ECB would have been able to reduce the asymmetries resulting from the implementation of a common monetary policy in a structurally heterogeneous area. Between 2001 and 2007, the ECB interest rate was probably too high for Germany and too low for Spain. The housing bubble in Spain (or Ireland) could have been avoided if appropriate restrictions on credit growth and loan-to-value ratios had been implemented. Similarly, the monetary authorities could have sounded the alarm about the hypertrophy of Irish or Cypriot banking systems.

Furthermore, the ECB will have to be transparent on the link it intends to do between its monetary policy and financial stability actions. The principle of strict separation of instruments is questioned in favour of a so-called integrated policy-mix in which the central bank may decide to use its conventional instrument (the interest rate) for financial risk considerations. To this end, the ECB might amend its second pillar about monitoring a monetary aggregate to assess risks to medium-term price stability. Its monetarist bias is no longer relevant given the downward trend in money velocity, and could be transformed to reflect a set of signals (credit growth, level of financial system leverage, debt of non-financial agents, real estate prices, etc.) about financial and monetary risks.

The question of the lender and buyer of last resort should be clarified. The ECB has played this role for banks while it was not specifically in charge of this mission. The question is even more acute for the sovereign debt market to the extent that governments are subject to liquidity risks (Buiter and Rahbari, 2012 or De Grauwe, 2011). Since illiquidity causes problems of macroeconomic, financial and social instability, it becomes justified to guard against this risk through central bank intervention. The panic on sovereign debt markets has been a major threat for the euro area. De Grauwe (2012) points out that the fragility of the members of a monetary union is increased because its entities are in fact indebted in a currency they have no control over. The SMP implementation and the OMT announcement in the euro area or the BoE and Fed interventions have shown that this type of measures is essential for the effectiveness of monetary policy and to mitigate risks of financial instability. While the ECB has acted pragmatically, it remains that the doctrine on this issue must be stated. In the absence of further fiscal integration, the formalization of the role of lender and buyer of last resort attributed to the ECB, for both banks and governments, should be considered. Finally, it is crucial that future ECB monetary policies are not conditioned by the attitude or psychology of the central banker in charge, sometimes pragmatic, sometimes dogmatic, as uncertainty harms central bank credibility and the anchoring of expectations.[8]

De facto, central banks own and manage a large amount of public debt (Blommestein and Turner, 2012), a task that they already fulfilled in the past (Goodhart, 2010). The implementation of unconventional monetary policy reinforces the interactions between monetary and fiscal policies and raises the problematic of their coordination. But, nowadays, none of European institutions are in capacity to built such coordination. Decentralised fiscal policies increase the challenge to create it. Nevertheless this is crucial. Moreover, we have to raise the question of ECB's independence and its democratic accountability. The current architecture gives the ECB a very strong independence both in terms of means and objectives. An enlargement of ECB's missions to the financial sphere gives to the central bank an essential role in the determination of Eurozone's macroeconomic and financial equilibrium. The question of its democratic legitimacy (a debate already evoked by J. Stiglitz in 1998) becomes even more accurate. On this subject,

8. This personalization of monetary policy passes on to Bernanke *et al.* (2001) that despite a sort of de facto inflation targeting by the Federal Reserve, in particular under the mandate of A. Greenspan, it was important to establish a de jure inflation targeting: whatever the personality and charisma of the U.S. central banker, the implementation of her/his action in a clearly defined institutional framework would promote the credibility of the commitment to achieve the Fed's dual mandate.

three postures are supported. The first claims that with more responsibilities, central banks are even more subject to political pressures and they need additional protections to guarantee their action. This is the idea defended by the CIEPR (2011). In this case, ECB's independence has to be maintained and may be reinforced. At the opposite of this position, one can imagine that ECB's mandates along with the current macroeconomic and financial context plead for a re-examination of central banks' independence in order to insure a better democratic control. We can recall that independence is nor a historical constant (e.g. Forder, 1998), neither necessary to insure stability (e.g. Hayo, 1998). Finally, in the European perspective, a third way could be to protect ECB's independence in terms of means but to modify its independence in terms of objectives. Objectives of price stability, employment and financial stability could be decided regularly, coordinated and democratically controlled. In the US, this control is exerted by the congress. At the European level, the situation is more complex because the European Parliament gathered not only eurodeputies from Eurozone's countries. This institution has thus to be invented.

3. A subsidiary question: the exchange rate policy

ECB's actions in order to facilitate the recovery and to correct the imbalances could use exchange rate policy. The Maastricht Treaty gives to the European Council the power to formulate general orientations for exchange rate policy. But before that, a consensus has to be reached in the Eurogroup that requires homogenous preferences. And after, the ECB will accept these recommendations only if it doesn't undermine its primary objective. These institutional arrangements lead in fine to a capture (Cartapanis, 2006) or a "quiet hold-up" of the exchange rate policy by the ECB (Creel *et al.*, 2007). This issue is essential since there is currently an international currency war at the expense of the euro. A euro depreciation could be an efficient remedy to help stimulate growth, via more exports, and to alleviate deflation risks. Moreover, a decrease of the euro could have asymmetric rebalancing effects. Blot & Cochard (2008) estimate export price elasticity and suggest that a decrease of the European single currency could be first in favour of the Spanish exports and then help the French ones and lastly the German.[9] An active exchange rate policy could then be effective in reducing the heterogeneities into the Eurozone without envisaging a termination of the monetary union or competitive devaluations in each member states that only exacerbate deflation. In the short run, a consensus between governments is a chimera. Nevertheless, it is now recognized that the ECB's monetary policy is too restrictive given the macroeconomic context (Bénassy-Quéré *et al.*, 2014). A more expansionist monetary policy could allow a depreciation of the euro.

4. Conclusion and policy recommendations

We have emphasized that the ECB has actually followed three objectives. However, the articulation between these objectives needs clarification. To this end, we provide the following recommendations:

1. Without modification of existing treaties, it is important for the ECB to be more explicit on the different objectives. The priority given to the objective of price stability does not seem now to match the practice of monetary policy. The growth objective is essential, as well as financial stability. More transparency would make monetary policy more credible and more effective. It would help to prevent from future financial and banking crisis. Exchange rate policy should not be overlooked because it can redound to the reduction of macroeconomic imbalances in the euro area.
2. In the absence of such clarification, extensive independence of the ECB should be challenged to better match the international standards in this area. Central banks have rarely independence objective: for example, the Federal Reserve pursues an explicit dual mandate, while inflation targeting is institutionalized for the BoE. An explicit triple mandate could be imposed on the ECB, in charge of the governing Council to deal with the tradeoff between these objectives.
3. Yet, the difficulty to handle this tradeoff increases with the number of objectives. This difficulty is amplified in the current context of high public debt and where central banks

9. More recently, Héricourt *et al.* (2014) find however that the differences between the French and the German price elasticity are very small.

are actually dealing with management of public debt. The mandate of the ECB should explicitly mention the role of lender of last resort, the usual task of central banks, which would clarify the need for a closer coordination between governments and the ECB.

4. Rather than questioning the total independence of the ECB, which never get unanimity among the Member States, we call for the set up ex nihilo of a supervisory body of the ECB, responsible for discussing and analyzing the relevance of the conduct of monetary policy under the broader objectives of the ECB: price stability, growth, financial stability and sustainability of public finances.

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