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Policy Issues

ECB 2.0: Bye-bye Bundesbank*

By Martin Lück, Frankfurt

I. The SMP was the ECB's Original Sin

In May 2010, the ECB for the first time activated its Securities Markets Programme (SMP), whereby the bank purchased government bonds from distressed European countries in the secondary market. Although we believe that, at the time, the ECB undertook this step rather reluctantly and under significant pressure from politicians, this arguably marked the start of the central bank's gradual departure from its previous position, which had been entirely focused on the preservation of price stability. True, then ECB President Jean-Claude Trichet argued that the SMP was aiming at repairing the dysfunctional transmission mechanism of monetary policies (a position often repeated by his successor, Mario Draghi, ever since). Yet it can hardly be doubted that the SMP also meant that monetary policy was becoming increasingly intertwined with fiscal policies, if only by reducing the yields governments needed to pay. This argument is especially hard to dismiss if the total amount of EUR211bn, to which the ECB's SMP purchases have accumulated so far, is taken into account.

1. The ECB is Moving away from its Bundesbank Origins

In this note, we argue that, with the transition reluctantly started by Mr Trichet and continued more proactively by Mr Draghi, the ECB has moved away from its original role, which was coined after the Bundesbank model. We highlight some of the characteristics of this change, explain why a central bank's proactively getting into fiscal policies does not need to compromise its independence forever, and we argue that even a more Banca d'Italia-style ECB does not mean Europe will end up in an Italian-style monetary union altogether. We conclude with some remarks on what all this may mean for the inflation outlook.

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II. How the ECB is Shaking off its Bundesbank Past

1. A Very Banca d'Italia-like Position

Upon its creation by the Maastricht Treaty in 1992, the euro area was built around one powerful and well-equipped institution, the ECB. In this, there are important parallels to the Italian case, because the Banca d'Italia has arguably been far more of a solid backbone to Italy's post-WW II economy than the country's more than 60 ever-changing government coalitions. It is doubtful that, without Italy's central bank in a pro-active role (which automatically meant participation in growth-oriented policies, voluntary wage accommodation and even debt monetisation, although the latter was probably not always entirely voluntary; see below), the country would have been able to achieve the rank of the world's fifth-largest economy by the 1990s.

2. The Bundesbank: As far from Politics as Possible

The contrast to the Bundesbank could not have been more striking. Built on Germany's inflation experience (both open hyperinflation during the Weimar Republic and hidden inflation at the end of WW II), the Bundesbank was designed as a central bank strictly independent from the government. This independence included protection from direct government interference with monetary policy, but also prohibition of debt financing and an exclusive focus on the aim of maintaining price stability. In combination of these legal provisions, the Bundesbank's actual role and self-perception morphed into that of a secluded, almost ascetic institution, which wanted nothing to do with the profane depths of everyday political struggle.

III. A Bundesbank-like ECB Could Work only as Long as Things Went Well

1. The Early ECB was Very Successful as a Bundesbank Clone

The sharp contrast between the Bundesbank and the Banca d'Italia illustrates why the euro area will need an ECB acting more alongside the Italian model of central banking. As long as things went well, i.e., fiscal numbers in the euro zone were kept reasonably close to the Maastricht criteria and structural imbalances had not led to levels considered unsustainable by the financial markets, the ECB was able to emulate the Bundesbank. This means it could completely stay out of anything but monetary policy. This focus led, as we know, to remarkable results, producing inflation rates closer to target than the Bundesbank had ever reached.

2. In Times of Imbalances, the Eurozone Needs a More Proactive Central Bank

However, the ECB's Bundesbank-like abstinence from any other field of economic policy became unsustainable when the subsequent banking crash, the 2008–09 recession and the sovereign debt crisis led to an explosion of the debt-deflation cocktail in Greece, as well as severe disruptions in other countries in the eurozone periphery. Within as little as six months into what is today known as the euro crisis, in May 2010, the ECB found itself pressured to massively purchase peripheral sovereign bonds in the secondary market. With this, the ECB performed a clear turnaround in its stance. It has often been argued that without this change, it would have been very hard for the euro area to remain intact until today.

IV. Mr Draghi is Transforming the ECB More Actively

1. Mr Trichet was More Hesitant to Transform the ECB

We think that while Mr Trichet, who had become a strong supporter of Bundesbank-style central bank independence during his years in Frankfurt, was reluctant to open the ECB for a more constructive role, this turnaround was pursued more proactively by his successor, Mario Draghi. It can be argued, in our view, that several steps in the ECB's policies as well as changes regarding the institution itself would not have taken place under Mr Trichet's lead. These include:

- *The second repo rate cut in December 2011.* We think that, in the light of the bank's economic and monetary analysis, the logic of Mr Trichet's presidency would have suggested no rate cut, given that growth appeared satisfactory and inflation was hovering around the ECB's target. So the fact that the ECB, now led by Mr Draghi, opted for a cut suggests to us that the bank's focus had shifted.

- *The board reshuffle*. When ECB chief economist Jürgen Stark resigned from the board, it was clear to many observers (certainly most Germans) that the next chief economist would also be German. Mr Draghi, however, decided to promote Peter Praet from Belgium to the economist job and asked Jörg Asmussen, Germany's candidate for the board, to instead head up the international department. While this move likely involved a lot of diplomacy, too (it defused Germany's and France's rivalry about the top economist's job), it also illustrated Mr Draghi's remarkable readiness to take pragmatic decisions, even at the risk that these would not go down well in Germany.
- *The December and February LTROs*. As the Bundesbank (and presumably other central banks in northern Europe) disapproved of the SMP, and at the same time there were severe strains in peripheral banking systems, Mr Draghi's ECB decided to offer three-year liquidity to the banks in December 2011, at full allotment and rather generous collateral rules. With this move, which implicitly extended the range of monetary policies to the three-year term, Mr Draghi reached two goals: (1) he channelled liquidity into peripheral sovereign markets, reducing their yields; and (2) he defused the immediate risk of a credit crunch in southern Europe. The measure was then repeated in February 2012, with the result that the ECB's three-year lending to the banking system increased by cEUR1,000bn in only three months' time. Again, we see this as a clear sign for the new pragmatism at the helm of the ECB.

2. *The OMT is the Latest Evidence of Mr Draghi's Determination*

The design of the new Outright Monetary Transactions (OMT) fits well into this pragmatic approach. It addresses the two most important angles of the euro crisis escalation over the past summer. On the one hand, it reduces worries about a lack of EFSF/ESM resources in the case Spain will soon need a programme lowering its funding cost. On the other hand, it explicitly takes the Bundesbank's worries about moral hazard and potential non-compliance of bond-buying with the ECB mandate into account. Market reactions over the past few months have impressively demonstrated just how appreciative investors are of this new ECB pragmatism.

V. A More Proactive ECB Can – and Will – Stay Independent

1. *Bond-buying per se Does Not Compromise Independence*

By contrast to what is often assumed (and certainly the mainstream view in Germany), a central bank's decision to take a more active role in government bond markets does not necessarily compromise its independence. What is more important than the bond-buying *per se* is the institutional set-up in which the bank conducts its purchases, such as the question whether it buys at its own discretion or can be forced to, as well as the general institutional amalgamation of the central bank's decision-makers (i.e., its board members) with the realms of overall politics.

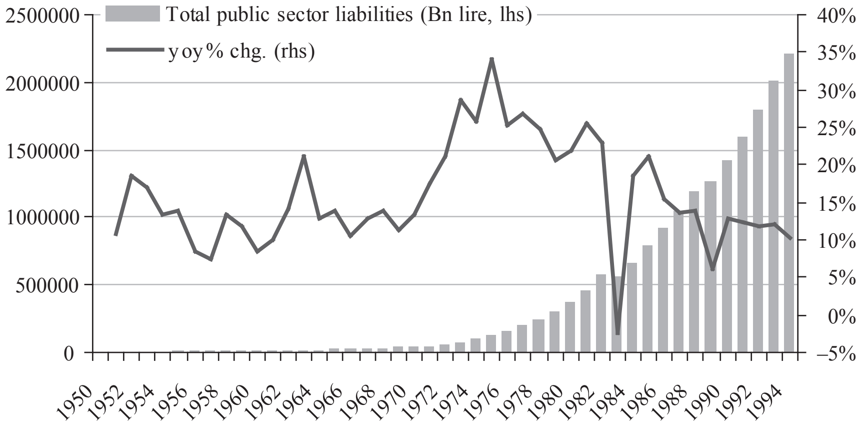
2. *How the Banca d'Italia Got Into Bond-buying*

Again, the Banca d'Italia is a good example. The Italian central bank became closely intertwined with the political system in the mid-1970s. As a consequence, it found itself forced to accommodate generous wage increases agreed by trade unions and employers' associations, as well as the fast-rising funding needs of the public sector. In 1975, a decree by a government committee (CICR) stipulated that the central bank needed to purchase all short-term government paper that remained unsold in the regular auctions. By that, the public sector administration received easy access to central bank financing, which led to a huge increase in public sector liabilities in the years that followed (Figure 1). At the same time, it also meant that creation of the monetary base was *de facto* endogenised, and the preservation of monetary stability was taken out of the central bank's hands, with the well-known results.

It can therefore clearly be argued that the Italian example justifies the Bundesbank's worries about too close links between monetary and fiscal policies. It reflects that if the central bank allows itself to get utilised by profligate governments, this probably leads to excessive increases in public sector liabilities and loss of control over the monetary base.

3. *The Banca d'Italia Regained its Autonomy*

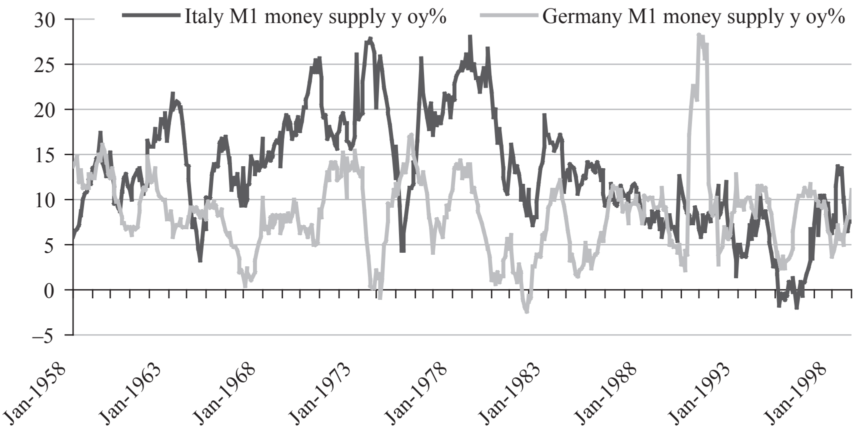
Interestingly, however, in the Italian case, the central bank's close intertwinement with fiscal policies did not lead to a *permanent* loss of operational independence. Only six years later, in mid-1981, what became



Source: Banca d'Italia.

Figure 1: Italian Public Sector Liabilities, 1950–1994

famous as *divorzio* (divorce) led to a separation between the central bank and the treasury, restoring the Banca d'Italia's control of the monetary base. Growth of public sector liabilities plummeted in 1983 and, after rebounding in the year thereafter, continued to slow for the decade that followed (Figure 1). Money creation decelerated significantly (Figure 2). The fact that this separation was possible at all can, to some extent, be explained by the improvement of the institutional set-up. It was mainly the deepening of money markets that allowed the Italian central bank to resort to less dirigiste and more market-oriented monetary policymaking in the early 1980s. It can also be explained by the orientation of the people at the helm of the central bank. The orientation and skills of the Banca d'Italia governors responsible for the *divorzio* (Paolo Baffi and Carlo Azeglio Ciampi) clearly demonstrated that, even in an adverse set-up and outright dependence on the government, a central bank is well able to regain its leeway. As the Italian case shows, co-operating with the government, even to the degree of outright debt monetisation, does not necessarily lead to a permanent loss of independence, as long as the central bank's leadership is firmly convinced that monetary stability is in the best interest of the economy.



Source: Haver, UBS.

Figure 2: Narrow Money Supply in Italy and Germany, 1958–1998

4. The ECB will Remain Focused on Monetary Stability

From this perspective, the orientation and skills of the ECB president leave little doubt that, by turning more co-operative, he – and the wide majority of the ECB council as well – have not light-heartedly surrendered their independence to Europe's fiscally profligate governments. It rather suggests the majority of the ECB council believe that this move was unavoidable under the given circumstances. It should by no means make us believe that the ECB has given up its aim of preserving monetary stability in the euro area.

VI. Something Needs to Give: For a Better European Balance

As we indicated above, one of the major flaws of the euro area from the very beginning has been its concentration on monetary policy. What happened is that a group of very heterogeneous member countries forced themselves into a straitjacket of one-size-fits-all monetary policies (which meant giving up the levers of interest and – probably even more importantly – exchange rates), without establishing institutions or at least mechanisms capable of reigning in the economic consequences that would almost necessarily arise from this. French calls for *governement économique* fell on deaf ears, just as German plans for political union did, and the Maastricht criteria introduced as an emergency remedy in the Stability and Growth Pact 1997 proved too weak a framework to prevent divergence.

1. The ECB is Providing a Bridge Solution

From this angle, the ECB, which is the only thoroughly designed euro area institution anyway, comes into focus as the only policymaker that can make a difference, in the sense that it allows for enough time for European politicians to repair the institutional flaws of the currency union. In this, the central bank makes sure that the risk of exploding funding cost in the periphery is defused, allowing peripheral countries to build a track record in their reform efforts, and providing more space for politicians to deepen institutional integration. The new OMT policy is the most pronounced step in this direction so far. By allowing itself to get more involved in general economic policymaking than the Bundesbank would ever have found appropriate, the ECB is providing a bridge solution to the euro crisis. Nothing more and nothing less.

2. Europe's Central Bank Policies Start Looking More Italian …

Solving the fundamental problems of the euro area, which mainly consist of competitiveness gaps, excessive debt and unsuitable institutions, will take time. In allowing for the time necessary to address these problems, the ECB has stepped away from its austere, Bundesbank-like position, and moved in the direction of a more co-operative central bank, responsible for more than monetary stability. This role is, again, more similar to that of the Banca d'Italia, although this is not to say that it is acting less independently.

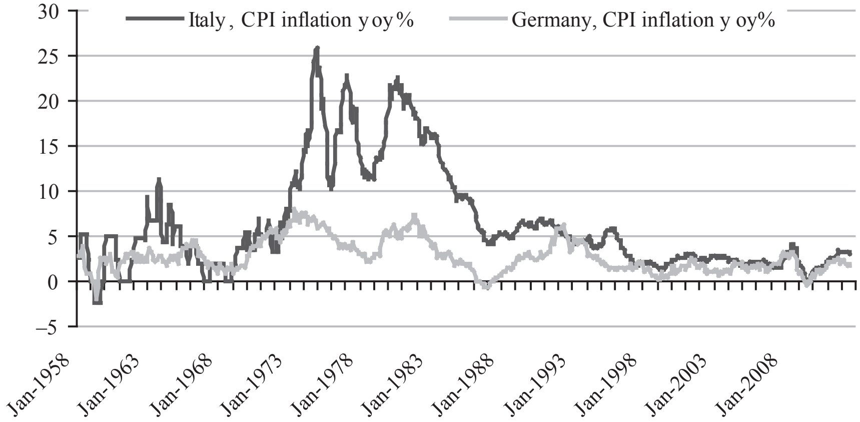
3. … While its Fiscal Policies Look Increasingly German

Does this mean the euro area is on its way to an Italian currency union, as some have suggested? We do not think so. The reason is that, while the understanding of central banking has clearly turned more Italian, in our view, fiscal policies are gradually turning more German. Few countries question the need of fiscal consolidation today, and some are making huge progress, despite the hardship connected to spending cuts and higher taxes. Most eurozone countries have accepted the idea of tying their hands in fiscal policies, introducing German-style debt brakes into their legal framework. It is thus evident that the euro area is moving towards some more 'German' fiscal discipline, while the price for this is some more 'Italian' central bank policy, at least for the foreseeable future, i.e., the time span necessary to repair the above-mentioned flaws in the euro set-up.

VII. Inflation is Not the Biggest Risk

1. Inflation is a Long-term Worry – if at all

Many, especially in the northern parts of Europe, fear that any solution to the euro crisis will involve inflation, at least to some degree. While we tend to agree (because inflation is a viable alternative in the absence of real growth and eases the social cost of fiscal consolidation), we think it is a worry more relevant for the medium- to long-term perspective. In the short term, the risk is too low rather than too high inflation, we believe.



Source: Haver, UBS.

Figure 3: Consumer Price Inflation in Italy and Germany, 1958–2012

If the euro zone inflation target remains at 'below but close to two percent' (the ECB's mantra) and, at the same time, the periphery needs to turn more competitive, i.e., needs inflation rather close to or even below zero, this by definition means that inflation must exceed two percent in the core countries, mainly Germany. In a much-noticed speech in a Bundestag financial committee hearing earlier this year, the head of the Bundesbank economics department made it clear that his institution is very much aware of this. So if inflation above two percent is necessary and accepted as an unavoidable part of the overall solution even by Germany's austere central bank, it is particularly striking that Italian inflation is still hovering above Germany's (Figure 3). Note that Germany's GDP growth come in at c1 % on annual 2012 average, whereas output contracted by c2.4 % in Italy.

2. *Inflation is One of the Rare Options to Allow for More Growth*

In the absence of the room for deficit spending and the time it takes for structural reforms to generate growth, inflation provides some of the rare options to ease the pressure of fiscal tightening. This becomes even more important if we consider that the other realistic option, i.e., allowing for more time for fiscal adjustment in the periphery, is very unpopular among core-European politicians. This makes the absence of inflation look more like a threat than a relief.

3. *Even Germany has Occasionally Experienced Higher Inflation*

The fact that inflation could well work as a blessing rather than a curse in the near future of the euro area makes it even less reasonable to fuel worries of an 'Italianisation of central bank policies'. It is true that German savers have more reason to worry about inflation than private individuals in other countries, due to Germans' high savings but low exposure to real assets (housing, equities, commodities, etc). Yet it is also true that, on several occasions in the past, Germany has lived quite well with higher inflation for some time (Figure 3). In the aftermath of Germany's reunification, inflation ran north of 5 %, without leaving long-term damage to people's trust in the general solidity of monetary policy. So higher inflation for some time is not necessarily damaging. True, German reunification was a period of very special historical significance. But maybe some day we will realise, with hindsight, that the days of saving the euro area were a very special moment of European history, too.

Summary

ECB 2.0: Bye-bye Bundesbank

Over the past three years, the ECB has taken on a more proactive role in helping to solve the euro crisis. In this, the bank has gradually moved from its Bundesbank-like origins to an understanding of central banking more akin to the Italian model. In this note, we explain why we believe this is good news, although it may sound alarming for some northern Europeans. At the same time, a more Banca d'Italia-like position of the ECB does not mean the euro area has turned into an Italian monetary union altogether, as some have argued. The reason is that European fiscal policies are rather turning more 'German'. ECB 2.0 does not necessarily mean more inflation either. And even if it does, some inflation would probably be less costly than the threat of a deflationary decade that is hanging over Europe today.

Zusammenfassung

EZB 2.0: Bye-bye Bundesbank

In den vergangenen drei Jahren hat die EZB eine aktivere Rolle zur Lösung der Euro-Krise eingenommen. Dabei hat die Bank sich graduell von ihren Bundesbank-ähnlichen Ursprüngen hin zu einem Verständnis von Zentralbankpolitik entwickelt, das eher dem italienischen Modell ähnelt. In diesem Beitrag erläutern wir, warum wir dies für begrüßenswert halten, obwohl es gerade für einige nordeuropäische Länder eher alarmierend klingen mag. Auch bedeutet eine eher Banca d'Italia-ähnliche Position der EZB keineswegs, daß sich die Eurozone als Ganzes in eine ‚italienartige' Währungsunion verwandelt, wie manche behaupten haben. Der Grund ist, daß die europäische Fiskalpolitik im Gegenzug eher ‚deutscher' wird. Die EZB 2.0 bedeutet auch nicht zwingend höhere Inflation. Und selbst wenn dem so wäre, dürfte ein bißchen mehr Inflation gesamtwirtschaftlich weniger schädlich sein als die Gefahr eines deflationären Jahrzehnts, die gegenwärtig über Europa hängt.