The ECB: A Democratic Problem for Europe?

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During the eurozone crisis, the European Central Bank (ECB) did not just respond to the risks of financial instability; it also expanded its influence over the economic governance of the European countries and increased its authority in the area of banking supervision. This situation is problematic with regard to the democratic balance of power in Europe.

"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." These words, spoken by Mario Draghi in London on 26 July 2012, were the subject of most of the commentary and analysis regarding the action of the Central European Bank during the crisis. With his comments, the president of the ECB was seeking to stabilise sovereign debt interest rates and thus reduce the risk of defaulting on the debts of peripheral eurozone countries, which threatened the very existence of the common currency. A few days after this speech, the ECB clarified its position on monetary policy by announcing a new instrument, Outright Monetary Transactions (OMT), a potentially unlimited programme for the purchasing of sovereign debt on secondary markets (securities exchange markets). Although this programme has not yet been activated, the threat it carries has enabled member states of the euro area to finance themselves more cheaply by discouraging market operators from speculating on a rise in interest rates on sovereign debts.

This announcement caused two types of reaction that provide a good illustration of the fine line that the ECB has had to tread during the crisis. On the one hand, some analysts believe that Mario Draghi's intervention saved the euro zone, with the Financial Times even naming him Person of the Year. On the other hand, some German economists and leaders such as Otmar Issing and Jens Weidmann[1] have harshly criticised the OMT programme, believing that the ECB has gone beyond the scope of its mandate, focused solely on price stability, and has increased the risk of moral hazard. In this case, the moral hazard is the incentive for member states to spend more than they should because the ECB's potential interventions would invalidate the "market discipline" that restricts public debt.

The public debate has thus centred on the effectiveness of the ECB's monetary instruments at the expense of substantive discussion on the political consequences of the compensation demanded of member states for its interventions. Thus, like all the previous measures taken by the ECB in response to the crisis (to which we shall return later), a possible implementation of the OMT would be attached to specific conditions in the form of austerity measures aimed at bringing about greater flexibility in the labour market and reducing the budget deficit through lower government spending. The ECB has therefore been a key player in

[1] Issing is an economist with markedly orthodox views, and a former member of the boards of the Deutsche Bundesbank (1990-1998) and the ECB (1998-2006). Weidmann has been director of the Bundesbank since 2011, and as such a member of the ECB's Governing Council.

imposing austerity measures in the euro area countries experiencing financial difficulties (Greece, Portugal, Ireland, Italy, Spain, Cyprus). Mario Draghi's quote can be reformulated by clarifying the implicit consequences of ECB intervention: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro [if you do what we ask you to do]".

The ECB's unprecedented influence on the economic governance of the euro area is a major democratic problem: its independence from political power is only justified through a limiting of its powers in the monetary sphere. The ECB's incursion into the economic sphere thus further limits the impact of the people's vote on the distribution of wealth in Europe. The key political question that then arises for the ECB observer is this: to what extent is the ECB justified in enforcing budgetary and regulatory policies – for which it has no mandate – in the name of the proper functioning of monetary policy and the objectives of financial stability?

To answer this question, we must first understand that the ECB is one political player among many, seeking to defend and promote its own interests[2]. Next, we must analyse the impact of the eurozone crisis on the balance of power between the various actors of the Economic and Monetary Union (EMU) and therefore on the way in which the ECB has managed the risks triggered by the crisis while taking advantage of the opportunities that have presented themselves.

The ECB, a political actor strengthened by the crisis

While plans to create a single European currency date back to the Werner report of 1971, it was not until the early 1990s that the ECB was established with the signing of the Maastricht Treaty, becoming operational on 1 January 1998. One of the factors that explain the creation of the first supranational central bank in the world is the decisive role played by economic ideas.

First, the creation of the ECB was part of a global movement, underway since the 1980s, to delegate monetary powers to independent central banks. Second, the ECB was conceived according to a specific model of a central bank, the Deutsche Bundesbank, which at the time was the most powerful in Europe. In order to obtain the agreement of the central bankers and German negotiators on the creation of the single currency, the ECB therefore benefited from a high level of independence linked with a focusing of its limited responsibilities on the objective of price stability. The combination of these two elements can be understood thus: in exchange for a very low level of control by political authorities, the ECB is entrusted with limited responsibilities focused on controlling inflation, at the expense of other traditional roles of central banks such as supporting growth, financing governments and supervising banks.

The important thing to remember here is that the creation and characteristics of the ECB are primarily the result of a particular paradigmatic situation at a specific moment in the history of European integration. ECB staff therefore have a particular interest in protecting and disseminating these ideas among other actors of the EMU. The reason is simple: the conceptual elements that helped to "make" the ECB can just as easily help to unmake it. Ever since the creation of the single currency, the various presidents of the ECB have called for structural reforms aimed at making the various product and labour markets more flexible, and for strict adherence to the rules laid down in the Growth and Stability Pact. There are also "material" reasons to defend these principles: if member states lose the trust of market operators and can no

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[2] In doing so, our approach is consistent with traditional political science works, particularly those of the neo-institutionalist and strategic constructivism movements. The works of N. Jabko on the European Commission can be highlighted: Nicolas Jabko, *L'Europe par le marché, histoire d'une stratégie improbable,* Paris, Presses de Sciences-Po, 2009.

longer have their debts refinanced by them, then they might force the central bank to buy their treasury bonds directly (monetisation of debts). However, before the financial crisis began, the ECB did not have the leverage it needed to exert pressure on EMU policy makers in order to implement these reforms; this particular period of reconfiguration of the political systems will change that.

The risks and opportunities triggered by the eurozone crisis

During the crisis, the ECB had to come to terms with a major paradox: it had to respond to the risk of the eurozone collapsing while taking into account the tensions caused by its new monetary instruments within the Governing Council[3].

From May 2010, the ECB dealt with the problem of the banking crisis turning into a sovereign debt crisis by buying sovereign debt on secondary markets in order to stabilise them through the Securities Market Program (SMP). This instrument drew criticism from supporters of the conservative model of monetary policy, embodied by the Bundesbank. Indeed, in buying sovereign debt, the ECB had crossed a red line that the central German bank had not crossed once since the 1970s and revived the taboo subject of the monetarisation of debt. In response to the SMP, two major figures in the Governing Council resigned: Axel Weber, then director of the Bundesbank, and Jürgen Stark, who represented monetary orthodoxy on the board. The day on which the latter announced his resignation, the euro reached its lowest value for six months and the FTSE All-World Index, covering 90% of global market capitalisation, fell by 3.07%.

The ECB took action to address these tensions: it set parameters for the SMP so as to protect its original reputation, based on the Bundesbank model. This setting of parameters revealed the political nature of the ECB's action during the crisis; it did not merely maintain the transmission channels of its monetary policy as it claimed, but also sought to protect its institutional heritage and therefore its autonomy.

For its use of the SMP remained limited, particularly in comparison with similar programmes established by the American and British central banks, which may have reduced its effectiveness[4]. In addition, the ECB only published the weekly amount of its operations without specifying in any detail the composition of the treasury bonds bought on secondary markets. It justified the SMP as a technical operation whose purpose was to restore the proper functioning of the transmission channels of monetary policy; it could not publicly disclose the fact that its purchases solely concerned treasury bonds of countries in financial difficulties[5] (Greece, Portugal, Ireland, Spain, Italy). Had this been revealed, it would have undermined the principle of unity of its monetary policy (no differentiation between countries) and caused even greater internal tensions.

Protecting its orthodox reputation thus enabled the BCE to use the financial crisis as an opportunity to expand its field of influence over the governance of economic policy in the

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[3] The monetary policy of the euro area is managed under a federal structure: the European system of central banks, which encompasses all of the national banks and the ECB. Decisions are made by the Governing Council, which is made up of the directors of the national central banks and the six members of the board, the executive branch of the ECB.

[4] The purpose of the securities purchase programmes is to convince financial market operators of the central bank's determination to make purchases in order to deter speculative activity, see Paul De Grauwe, "The European Central Bank as Lender of Last Resort in the Government Bond Markets", *CESifo Economic Studies,* No. 59 (3), pp. 520-535, 2014.

[5] Nevertheless, the correlation between variations in sovereign debt interest rates and the weekly amounts of securities purchased allows researchers and financial journalists to determine the purpose of the ECB's purchases.

eurozone countries. Two features of crisis periods can explain how central bankers were able to make this shift outside their original sphere of authority.

Firstly, a financial crisis causes a disruption to the routine situations within a political system and increases the value of certain strategic resources held by the actors. In the case of the ECB, its position as an interface between the financial markets and the political authorities combined with the pressure placed on member states by market operators has enabled it to influence decisions over which it would not normally have any control.

Secondly, crisis periods are unique events that cause a wave of uncertainty among leaders with regard to their own grid of economic interpretation and the solutions to be implemented. ECB staff therefore helped to establish a framework for the financial crisis as a budgetary and fiscal crisis in order to be able to expand its sphere of influence beyond the monetary field in a more decisive way[6].

The ECB's impact on European economic governance

The most obvious means by which ECB staff have expanded their influence over the economic governance of the euro area is their monopoly on liquidity[7]. Normally, central bankers' capacity to intervene in the markets is merely a technical tool, but it takes on a particular political dimension during times of crisis. Indeed, when governments and commercial banks are no longer able to refinance themselves on the markets, the ECB can exert coercive pressure on government leaders who rely on its intervention in order to avoid the collapse of their banking system or inability to reimburse their borrowers.

This coercive pressure by central bankers can be exerted both officially and unofficially. First of all, the ECB used its instruments for buying sovereign debt for countries that submitted a request for financial assistance to their eurozone partners (Greece, Ireland, Portugal, Cyprus), under the condition that the reforms they demanded in return were properly implemented. In this case, the monitoring of the required reforms has been carried out *in situ*, as part of the "troika" missions in conjunction with the International Monetary Fund (IMF) and the European Commission.

Next, the ECB used the SMP in a more unofficial, bilateral way, particularly in dealing with tensions over the Italian and Spanish debts from August 2011. In both cases, ECB directors sent a letter to the government leaders specifying the reforms that were to be implemented in exchange for buying securities. The unplanned disclosure by the *Corriere Della Serra* of the letter addressed to Silvio Berlusconi provided an exceptional archive document: unofficial coercive pressure from the central banks, requiring an immediate response, is very rarely disclosed to the public[8]. The letter reveals that the ECB was not only calling for reforms in very remote areas of its monetary powers (liberalisation of public services, regulation of the labour market and

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[6] This framework was by no means evident given that the origin of the crisis lay more in incompetent risk management by the financial and banking sectors than in uncontrolled government spending. On this subject, see the highly convincing explanation given by Mark Blyth, *Austerity: The History of a Dangerous Idea.* Oxford, Oxford University Press, 2013.

[7] The ECB thus carries out the traditional function of central banks as a "lender of last resort", that is, a higher authority helping to refinance banks exposed to a lack of liquidity on the money markets. By extension, this notion can also be applied to the sovereign bond market.

[8] This letter can be found here:
http://www.corriere.it/economia/11_settembre_29/trichet_draghi_inglese_304a5f1e-ea59-11e0-ae06-4da866778017.shtml?fr=correlati

healthcare system), but it had also specified that these measures should be adopted by government decree at the expense of the parliamentary process.

The monitoring of these political and budgetary conditions by the ECB is not confined to the realms of discourse. When Silvio Berlusconi challenged certain measures during the final phase of their implementation in October 2011, he contributed to his own downfall in November 2011. On 7 November, interest rates linked to the Italian debt reached record levels but did not trigger an intervention by the ECB in the secondary markets. Its restraint, intended as a means of forcing compliance with its purchases, was one of the factors that led the Italian prime minister to resign that same day. After his resignation had been announced, the ECB reactivated the SMP and bought the Italian treasury bonds.

Furthermore, in order to obtain liquidity from the ECB in their refinancing operations, commercial banks deposited securities in exchange. During the crisis, the ECB used its power to define which securities were accepted during these operations to put pressure on European economic governance. The most significant example was the debate on the possibility of a partial default on the debts of countries that had been bailed out. This possibility, raised by Angela Merkel and Nicolas Sarkozy in October 2010, aimed to reduce the costs of repaying the Greek debt and the financial support mechanisms borne by the citizens and taxpayers of the euro area by reducing the value of securities held by private market operators. Given that the ECB itself held securities that could be downgraded and that this option challenged the key role of the markets in the functioning of societies, it quickly opposed a partial default on the Greek debt. Although the ECB was the only actor to refuse this option, it was able to influence negotiations by threatening to no longer accept Greek treasury bonds in its refinancing operations, which would have meant the immediate collapse of the entire Greek banking sector and a considerable risk of a spread to other countries. Even though the Greek government had substantially reduced the value of its sovereign debt securities, the ECB's threat enabled it to obtain two important concessions: this option was limited solely to Greece, whereas leaders had envisaged it for other countries, and the securities held by the ECB were not affected by the downgrade. In other words, in playing its role as lender of last resort, the central bankers exerted unilateral pressure on all the leaders of the euro area in order to force them to comply with "market discipline", to the detriment of the social costs for citizens caused by refinancing the debt.

Beyond their monopoly on bank liquidity, the ECB also expanded its sphere of influence within the EMU in a less coercive manner, through its expertise on financial matters and its moral authority over government representatives. During my research, I conducted interviews with staff from the Economic and Financial Committee (EFC), a vital arena in the governance of the EMU, which is made up of advisers to the finance ministers as well as ECB and Commission staff, whose job is to prepare Ecofin and EU meetings on managing the crisis. These interviews revealed that ECB representatives, in this case members of the board who sat on the EFC, played a pivotal role both in timing the decisions taken by the European authorities in response to the crisis, and in determining the content of those decisions.

Government representatives feel that ECB staff have a practitioner's perspective on the markets and that their expertise is more reliable than national regulators or experts from the finance ministries. For example, Jean-Claude Trichet convinced the heads of state to create the European Financial Stability Facility[9] (EFSF) in May 2010 by warning them of the risks of the

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[9] The EFSF is an *ad hoc* financial aid mechanism making available up to 500 billion euros; it was established by the eurozone authorities in May 2010. It has since been replaced by the European Stability Mechanism. In both cases, loans are issued in exchange for the implementation of austerity reform measures.

Greek crisis spreading across the euro area. For ECB representatives, with their recognised expertise and independence from the political authorities, are *perceived* by government representatives to be neutral actors who are not seeking political gain, unlike European Commission staff. Furthermore, as soon as the crisis was labelled a budgetary and fiscal crisis, the previous positions taken by ECB representatives in favour of budgetary orthodoxy took on an almost prophetic dimension and enabled them to increase their moral authority within the EFC. The orthodox reputation of ECB staff allowed them to win the trust of German negotiators in particular and to convince them to help create the EFSF, which Commission staff had not managed to do. They thereby took on the role of creator of alliances between government leaders with opposing interests, a role that the Delors Commission had played when creating the euro.

The central position taken by ECB representatives in the crisis resolution process explains why they were *perceived* as being part of the solution to the crisis without having been one of the causes. However, these perceptions are questionable: an OECD report shows in particular that past monetary policies were the *primary* cause behind the formation of real estate bubbles and therefore the weakening of countries affected by the crisis[10]. What is more, the bank's neutral image combined with its expert status is misleading: the mobilisation of expert arguments is a classic strategy used by actors who have no electoral legitimacy in order to influence decisions.

However, the ECB's moral authority and the recognition of its financial expertise have played a central role in its acquisition of authority in the area of financial supervision. The reorganisation of the European financial supervision system began after the collapse of Lehman Brothers and gave a key role to the ECB, which had been deprived of such responsibilities when it was created[11]. This phenomenon was first seen when the de Larosière group was established, which brought together eight "expert" figures – mostly former central bankers – responsible for proposing reforms to the European financial supervision system upstream of the legislative process; in the creation of the European Systemic Risk Board, whose president is the ECB president; and finally in the establishing of the future Single Supervisory Mechanism, which will hand over ultimate responsibility for supervising each banking institution to the ECB in November 2014.

National decision-makers and supranational bodies had entirely different reasons for placing the ECB at the centre of this reform. For the former, the recognition of financial expertise built up beforehand by the ECB enabled it to "import" this characteristic more cheaply into the new supervisory bodies. For the European Commission and European Parliament, the ECB's moral authority over member states was the primary reason behind their support for the transfer; they could thus be certain that the new supranational bodies would have an impact at national level, which an ad hoc structure would have had far greater difficulty achieving.

The ECB has thus been able to play on the different motivations of EU decision-makers and legislators in order to gradually expand its supervisory authority and become the most important actor in Europe in this area.

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[10] Rüdiger Ahrend, Boris Cournède, Robert W. Price, *Monetary Policy, Market Excesses and Financial Turmoil. OECD Economics Department Working Papers*, n° 597, 2008.

[11] The separation between monetary policy and financial supervision was carried out in the name of monetary orthodoxy (any purpose other than price stability can harm it). The ECB has tried to protect its orthodox reputation by making a largely symbolic division between these two activities, especially during speeches made by the President of the ECB to the European Parliament.

Doctor Frankenstein and his monster

What should we retain of this political analysis of the ECB's action during the euro area crisis? First of all, that the perceptions and ideas of the political actors played a key role in the decision-making process in a crisis period. Far from the idealised vision of theories of European integration claiming that the delegation of monetary policy is a process that governments seek and control, an analysis of the management of the crisis reveals an uncertain process in which the procedure by which the ECB transferred authority and gained influence went beyond political decision-makers. Certainly, when the euro was created no leaders could have imagined that the ECB would one day have the capacity to enforce the implementation of socio-economic reforms within their countries.

We can thus interpret the institutional and political transformation of the ECB during the crisis by referring to the Gothic work by Mary Shelley, *Frankenstein; Or, the Modern Prometheus*. Driven by his desire to improve the world through science, Doctor Frankenstein creates a monster made from thin pieces of human tissue, which gradually escapes his control and turns its creator's life upside down. Similarly, in order to deal with the exchange rate crises of the 1980s and avoid a return to the inflation crises of the 1970s, European decision-makers created the ECB according to the Bundesbank model, granting it a very high level of independence. During the crisis, the central bank gradually freed itself from its initial area of authority and is now disrupting the socio-economic organisation of the EU countries by imposing strict austerity measures. And yet, the quality of European democracy depends on the citizens' capacity to influence government decisions. The intervention of an independent central bank imposing policies that have often been rejected by the citizens concerned interferes with the proper functioning of European democracy and thus risks harming the European integration project in general. Within the framework of the monetary dialogue held between the bank and the European Parliament, the latter invited the ECB to "subject every aspect of its activity to critical self-assessment", including its impact on economic governance[12], even though it has no negotiating power over the bank.

Finally, the European Parliament has also specified that this increased authority in the area of financial supervision should be matched by a strengthening of democratic control over the ECB and greater transparency in its activities. Certainly, these new missions run the risk of deepening the porosity of career paths that already exists between the central banking environment and private financial institutions, which then increases the negative consequences of a possible "capturing" of the ECB by private financial interests. If we are not careful, the Maastricht monster could, despite its original purpose, become a new vehicle for private financial interests in the organisation of European societies.

Further reading

Mark Blyth, *Austerity: The History of a Dangerous Idea.* Oxford, Oxford University Press, 2013.

Clément Fontan, "L'art du grand écart : le modèle ordo-libéral de la BCE face à la crise", *Gouvernement et Action Publique,* under publication, 2014.

[12] The motion for a European Parliament resolution on the European Central Bank annual report for 2012 is available here:
http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A7-2013-0382+0+DOC+XML+V0//EN

Clément Fontan, “Frankenstein en Europe : l’impact de la BCE sur la gestion de la crise de la zone euro”, *Politique Européenne,* N° 42, pp.11-33, 2014.

Frédéric Lebaron, “Quand le gardien du Temple devient le sauveur des marchés financiers”, (http://terrainsdeluttes.ouvaton.org/?p=2777).

Wolfgang Streeck and Amin Schäfer (eds), *Politics in the Age of Austerity*, Hoboken, John Wiley & Sons, 2013.

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