The European Central Bank Gone Astray

By Manfred J.M. Neumann

Berlin, March 2012

In this new Stiftung Marktwirtschaft publication "The European Central Bank Gone Astray," Prof. Dr. Manfred J.M. Neumann warns of the dangers of the European Central Bank's (ECB) current lax monetary policy and draws attention to the prohibition of monetary financing of governments. Neumann, a longtime member in the Stiftung Marktwirtschaft's advisory council, the Kronberger Kreis, sees a dangerous potential for medium-term inflation created by the ECB's purchase of government bonds and jumbo loans: "European monetary policy must not be misused to finance national budgets." In his analysis, Neumann explicates his ideas on which adjustments the ECB should embrace at this point in time.

Policy Recommendations

Having maintained an average annual inflation rate of just over two percent, the European Central Bank (ECB) has performed well over the past decade with respect to its objective of price stability. The Bank's interest rate policy has of late been decidedly expansionary. Nevertheless, monetary expansion in the Eurozone has remained relatively moderate. The onset of an inflationary process is therefore not expected for the time being. However, analysis of the overall economic situation supports the conclusion that the ECB's efforts to use unconventional measures to mitigate the effects of public debt and the financial crisis on Eurozone member states creates a dangerous medium-term potential for inflation.

The ECB is willing to twist, if not openly dismiss, the rules governing the common currency. The new program of unimpeded purchases of government bonds and the new direction in refinancing operations, in which multi-year jumbo loans are provided in return for high-risk individual loans and debt securities as alleged collateral, are dangerous missteps. The ECB Governing Council should discontinue complaisant policies. It is only natural that the Governing Council be required to provide national governments with economic policy advice. The Council must, however, maintain distance from the interests of politicians. It must remain at all times clear that the monetary policy of the ECB is not subordinated to the temporary needs of national fiscal policy.

As part of this study, a number of policy recommendations have been developed, of which the most important are the following:

- The ECB should officially modify its policy of purchasing sovereign debt and thereby issue a clear warning that monetary policy will not simply serve the financing of sovereign debt. Likewise, speculative bond transactions of national central banks should also be prohibited.

- Experimentation in long-term refinancing operations and jumbo loans should be declared over. Transactions with a duration of three to six months are preferable, as they facilitate flexibility in the monetary base.
- The policy of relaxed collateral requirements that applies to banks involved in refinancing transactions should gradually be reversed.
- To slow the rise of Target2 debt in the Eurosystem, and in order to prevent debt overload that poses great risks for the banking system, the ECB should tie the permitted level of indebtedness for each bank to its level of core capital.
- The time has come for the ECB to improve public transparency with respect to its monetary policy decisions and intentions. The voting results of interest rate decisions should be published regularly. It is also suggested that the ECB publicizes the governor's suggestions – without disclosing their names – for the interest rate targets of the following year.
- In order to safeguard the ECB's capacity to act, a two-stage model of decision making would be preferable to the intended rotation. The baseline of monetary policy would be set twice a year by the ECB Governing Council in its full constitution. Short-term activities, including interest rate policy, would be managed by the ECB Executive Board.

It remains to be seen whether the ECB will correct its decisions or whether a majority of the Governing Council has decided to permanently follow a policy that disregards price stability in favor of supporting national budgets. In the latter case, change needs to come from the outside. Specifically, German policymakers should take the initiative and strive for a reformation of voting rights in the ECB Governing Council. The distribution of voting rights according to the economic and financial importance of member states that is, to their share of ECB capital, would only be logical in a situation in which the "one member, one vote" principle fails.

Prof. Dr. Manfred J.M. Neumann is a member of the expert advisory council of the Federal Ministry of Economics and Technology. He does research at the Institute for International Economic Policy at the University of Bonn, where he held the chair of public economics between 1981 and 2006. In addition to a number of other positions, he has been a member of the Kronberger Kreis, the scientific advisory council of theStiftung Marktwirtschaft, since 1992.