

BUCHBESPRECHUNG

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Three global and one regional crises in the two decades since its establishment have provided the European Central Bank with an experience of an old hand, although it is the greenhorn in the illustrious circle of advanced countries' central banks. Michael Heine and Hansjörg Herr, both professors emeritus of economics, use this as an opportunity to reflect on the background of the ECB, its monetary policy before and through the crises as well as the expansion of its day-to-day business to financial market supervision.

A glance into the book reveals that the authors offer a blend of historical review, descriptive empirics, and qualitative analysis. Their core messages are: (i) The ECB has done quite well despite its various shortcomings (mandate, strategy, design ...). (ii) The ECB has no central fiscal policy actor in the Eurozone or the European Union, with which it could coordinate its monetary policy. (iii) The way the European Union organises fiscal policy, e. g. by means of the fiscal criteria first of the Maastricht Treaty and later the Stability Growth Pact (SGP), is dysfunctional for the functioning of a monetary union in general and the European Monetary Union (EMU) in particular. (iv) The run-up to EMU and the design of the ECB is reflecting Germany's interest. (v) Neoclassical economics and its recommendations are deficient.

With three exceptions – the rise in its interest rates in 2008 at the beginning of the Global Financial Crisis, its policy during the European sovereign debt crisis until *the* speech of Mario Draghi and the shift towards quantitative easing only in January 2015 – Heine and Herr attest the European Central Bank a prudential approach during crises times. Their major critique of the ECB focuses on the institutional design in form of its independence, its narrow mandate of price stability, requiring HICP inflation 'below, but close to 2 per cent' and the two pillar strategy. While acknowledging that the ECB parted from the latter already in her early stages, though not officially (Gros and Capolongo 2019), Heine and Herr question the necessity of the independence of central banks per se. They emphasize that historically up to the 1970s central banks have been rather departments of the treasuries of their respective countries; in such institutional setting, central banks were able – and due to the lack of independence more often than not rather obligated – to finance directly the central government's budget. With a certain degree of regret, Heine and Herr comment (p. 30) that although the ECB is purchasing sovereign bonds on the secondary market, "(...) it is not possible for the ECB to freely finance those governments that are in dire financial straits."

They argue that history offers various examples of policy makers who would not exploit such a privilege and of central banks who had ensured low inflation rates though lacking independence (p. 29). Heine and Herr trace back the strict requirement in the run-up to EMU to turn member countries' central banks' independent from fiscal policy actors to the German government and particularly to Deutsche Bundesbank. "This [the independence of the ECB, MM] reflects the interests of Germany and was in line with the neoliberal spirit of the times" (p. 17). Who would doubt that Deutsche Bundesbank, a congregation of "high priests of monetary policy" (Financial Times, 23 January 1993) and notorious beyond Europe for its low-inflation-only focus, would have exerted all influence at its disposal to make sure that the upcoming European Central Bank would reflect the German role model?

However, even if we only focus on the period of post-WWII,¹ this kind of truism includes a central omission: Already since the 1970s, there has been a global trend towards independent central banks, triggered by the experiences of stagflation in advanced countries and of hyperinflation and dollarisation in developing countries and emerging markets. Certainly, the dogma of the independence of central banks has found its way into any neoliberal analysis; however, blaming neoliberalism only is too simplistic and ignores the fallacies of Keynesian and structuralist-inspired fiscal, monetary and exchange rate policies in the 1970s and 1980s which found their nemesis in widespread internal and external instability.

Heine and Herr stress that the one-objective only approach and the lack of other goals as for instance supporting growth and full employment as equal objectives to price stability hampers the ECB's policy even in good times. In crises times, they identify the lack of a comprehensive lender of last resort (LoLR) function for public households as a major constraint to the ECB's intervention capacity to stabilise the economy (for instance p. 104, but see also p. 4, p. 19, p. 28, p. 41, ...).

However, there is a misconception of the LoLR function à la Bagehot. A central bank offers to illiquid, but *solvent financial institutes* access to central bank liquidity against perceived good collateral, which was at Bagehot's time a whole collection of securities as bills, advances or even deposits of bills (Bignot et al. 2009, p. 17f.) and covers today government securities and to some extent corporate bonds. While the LoLR function prevents, that an illiquid financial institute has to fire sale its assets, so that it becomes insolvent itself and causes spillover to other financial institutes, the LoLR function does cover by no means the finance of public spending in form of purchases of government securities directly from the government itself. Whether at all and if yes, under which conditions such a monetisation is required is a complete different issue.

Some contemporary emphasize that the ECB is indeed financing government spending with quantitative easing: She is intervening into the secondary bond market, purchasing broadly member states' bonds (plus private companies' bonds). The ECB does this, however, not to fulfil a LoLR function for governments nor in order to finance government spending or directly monetise any government debt – as Heine and Herr proclaim (p. 111). She acts in that manner either to reduce market interest rates in a rather deflationary environment or to mitigate the negative impacts of the sovereign-bond-bank nexus on the balance sheets of the Eurozone banks,² and hence to stabilise the Eurozone banking system. In both cases, she is acting according to her expanded mandate, which meanwhile covers financial market stability and macroprudential supervision.

In the Maastricht Treaty, there is a no-bailout clause, which according to Heine and Herr is the fiscal analogy of the lack of the LoLR-function and whose aim was "(...) to prevent an irresponsible fiscal policy by governments in EMU member states" (p. 17). However, this is wrong; the aim of the no-bailout clause was to prevent that an irresponsible fiscal policy by one or several, perceived sovereign EMU member state governments would become a liability to the other governments and thus prevent free-rider behaviour, too. A bailout is a form of controlled socialisation of liabilities, e.g. from financial institutes, non-financial corporations or in our case of Eurozone member states. The aim of a bailout is to prevent a default of the actor in question and in terms of governments to

1 For a historical review on the changing focus and role of central banks since the birth of modern central banking in the 19th century, see Goodhart (2010).

2 For an update on the home bias in EZ banking systems, see Meyland and Schäfer (2018).

maintain the functioning of the public sector and the provision of public goods. If a bailout is out-ruled, we observe not the socialisation of liabilities, but the socialisation of the costs of debt distress and possible default. In case of systemically important financial and public institutions, to which certainly governments of Eurozone member states belong, the costs of debt distress are not limited to the debtor in distress, but are dispersed across the economies and societies across Eurozone member states.

Hence, the ban of a bailout in the Maastricht Treaty does not prevent that a (perceived irresponsible) fiscal policy by one or several EMU member state governments would become a liability to the other governments. From a macroeconomic point of view, Eurozone member states only have the choice between a controlled, policy-mediated socialisation of costs and an anarchic, market-mediated socialisation of costs, with the latter being sub-optimal in terms of scale and intensity of economic and social impacts as well as undesirable effects.

Heine and Herr strongly criticise that there is no bailout clause available within EMU; this lack, however, cannot be compensated by introducing a LoLR function of the ECB for public households as they propose. In contrast to illiquidity of financial institutes, which central banks address, insolvency issues are conceptionally taken care of by fiscal policy actors. In that sense, the European Monetary Union is unfinished business.

While most of their five core messages mentioned above might be controversial within the economics' discipline, it is the EU's fiscal policy – or better the lack of a joint fiscal policy actor, to which Heine and Herr devote most of their arguments (e.g. complete chapters 3, 7, and 11 as well as partially chapters 5, 9, 13 and 14). Heine and Herr can take credit to stress insistently in their book that EMU will not be functioning properly as long as there is not a fiscal policy counterpart, with which the ECB is able to coordinate its monetary policy in order to facilitate a consistent mix of monetary and fiscal policy. With few differences, Heine and Herr draft fiscal policy in EMU conceptionally similar to fiscal policy within a nation state: in good times, to enable an inclusive development of the various regions in EMU and in bad times, they stress the necessity of well-known counter-cyclical policy. They also mention interregional transfer mechanisms as unemployment insurance and the complicated issue of pension systems (p. 42), but also taxation, which has been the classical instrument of redistribution.

On the background of their sharp critique of the SGP, it seems somehow inconsistent, when Heine and Herr (p. 23) stress, that "(...) a monetary union requires binding agreements and cooperation between member states in order to achieve a functional fiscal policy in terms of economic policy and to prevent a free-riding." What actually is required to complete the monetary union and transform it towards a mature economy is the creation of a central fiscal policy actor, or in other words a European government, which is elected by the European Parliament and provided with the right to tax and the right to raise loans or issue bonds. Authors (p. 7) point out that there is no Eurozone budget separate of or in addition to the EU budget. Again conceptionally, this is not necessary, as all EU member states, but one, have finally to join the Eurozone. Only Denmark – and during the period of EU membership the UK – has an opting-out clause. Hence, at some point in the future, the EU budget will become the budget of the Eurozone.

Besides the LoLR issue and dysfunctional fiscal policy, there is a third thread running through the book; Heine and Herr refer to the Federal Reserve System (Fed) as a benchmark to compare and assess ECB policy as well as identify shortcomings for Eurozone member states. There are two

aspects, which deserve mentioning. First, in comparison with the Fed, the ECB responds gradually and sometimes with a time lag, while the Fed seems to react quicker and more “aggressive” (p. 84) when she identifies adverse developments (see for instance chapter 7 and 13). Heine and Herr explain this different behaviour with the ECB attaching less value to economic growth due to her limited mandate than the Fed. It would have been also interesting to see whether historical experience (here the newcomer, there the condensed one-century experience) would make a difference for response time and precise design of monetary policy in crises times.

Further, Heine and Herr (p. 28) compare Eurozone member states’ risk to become insolvent with that of the US government. “First, the Fed guarantees the financing of the US public budget at all times, so that the US federal government cannot become insolvent in domestic currency. (...) For the governments of the EMU member states the euro is a currency that they cannot produce themselves, so they can in fact, become insolvent in their ‘own’ currency.” Actually, here they use an improper analogy and compare rather apples and oranges.

The peers of individual Eurozone member countries as for instance Germany, France, Italy or Spain are California, Texas, Florida or the New York State – all without direct access to the Fed finance and without any possibility to produce their own currency. In that respect, there is no difference between member states of the Eurozone and states of the United States of America. Legally, the US states cannot become insolvent and file for bankruptcy; however, economically they do.³ Nevada, Illinois, New Jersey, Texas or sunny California, just to name a few, can all tell a story about not being able to pay operating expenses. In 2010, the State of California announced a state of financial emergency, forcing far-reaching cuts in spending at the height of the financial crisis, including mandatory furlough for public sector workers without salary and the issuing of so-called “IOUs”, which a broad range of financial institutes stopped to accept. Meanwhile, 46 out of 50 states and the district of Colombia have balanced budget requirements (Rueben and Randall 2017), showing that without proper insolvency laws, the choices of federal states are limited whether in the US or the Eurozone.

In contrast, the peer of the US government, however, which enjoys the above mentioned guarantees by the Fed, would be the EZ government, which does not exist, yet. What does make a difference for the federal states in the US is that the U.S. government practices redistribution towards them in an extent of between 12% and up to an incredible 42% of the respective states’ GDPs (The Pew Charitable Trusts, 2016). In contrast, the total EU budget has been limited to a negligible 1% of total EU GDP until Covid-19.

After all the critique of the lack of a central fiscal policy actor and the EU’s dysfunctional fiscal policy coordination mechanism SGP, which Stiglitz called “automatic destabilizer” already 2003, it is unclear from the book, why Eurozone member states would resist to move forward towards a fiscal union with a central government ideally elected by the European Parliament.

From a normative point of view, various institutions of a country serve simultaneously and comprehensively all legal, political and economic issues and areas of one country. Historically, however, we notice that the evolution of all three areas is not always simultaneously taking place, neither

3 According to insolvency laws in the USA, only municipalities and counties can default. However, in 2017 Puerto Rico declared default on its liabilities, though backed by a special allowance. Before Puerto Rico, only Arkansas had to default during the Great Depression. Every now and then, there is a discussion about whether federal states should actually be allowed to default; Covid-19 provided fuel for the next round.

when a federation crumbles nor when a new country or federation is emerging out of once independent states. The former could be nicely observed at the beginning of the 1990s when the Soviet Union collapsed; while the new independent transition states quickly introduced major legal and political reforms in order to become independent, the introduction of a new currency often took several years after political independence. On the other side, German legal and political unification took place in October 1990, while the expansion of the West German Mark to East Germany took place already three months earlier.

Heine and Herr argue that some of the shortcomings of EMU could have been envisaged following the discussions of the well-known authors of the optimum currency area Peter Kenen, Ronald McKinnen and Robert Mundell due to both asymmetric and symmetric shocks to come (pp. 47–48). However, the OCA approach raises the question under which conditions countries should adopt a fixed exchange rate regime, but does not require countries to give up their own currency or their own central bank. Within OCA, the countries involved in the peg are still independent, while within EMU member states are *not*. The much too early passed away Tommaso Padoa-Schioppa (2001) earmarked EMU in the following way: “Unlike the Bretton Woods adjustable peg and the EMS, EMU is *not* a binding *international* exchange rate arrangement. Instead, it establishes at the European level the *domestic* monetary order that normally exists within a nation: *one* currency, *one* central bank, *one* monetary policy” (p. 4, emphasis in the original).

With the transmission of fiscal policy from the national level to the monetary union level, the then-remaining scope of national fiscal policy would be reduced in terms of both its area of activity and its effectiveness to a level comparable to that of states of a federal union. In other words, any regional integration process entails losses of sovereignty on the national level and a rise of sovereignty at the supranational or union level. However, while the formation of a common central bank is widely agreed upon as an indisputable requirement for the formation of a monetary union, fiscal policy actors on the national level are reluctant to envisage a similar institutional change for themselves as it would directly downgrade their fiscal powers (Fritz and Metzger, 2006). On the other hand, a regional integration process is a learning-by-doing process, too. Since the creation of EMU, member states are regularly adjusting fiscal rules and procedures; the EU Recovery Plan might turn out as a game changer for the EU, paving the way towards the rights to tax and to raise finance on capital markets.

In sum, Heine and Herr offer a rather eclectic collection of essays, touching upon a broad variety of topics of European integration, including incomes policy and wage negotiations within EMU and a one-pager on the Irish crisis. The book would have served better to call it ‘*Macroeconomic Policy within EMU*’. Owing to the broad and diverse issues, Heine and Herr fall short of a deepened discussion of forward-looking issues related to the ECB, e.g. accountability of the ECB to the European Parliament (Maricut-Akbik, 2020; Fromage, 2019), distributional effects of QE (Metzger and Young 2020) or the potential role of the ECB to assist Green Finance (Bremus et al., 2020; de Grauwe, 2019).

In addition, inaccuracies arise, for instance, “Basel II was developed in the 1990s following the triumph of neoclassical models.” (p. 135). The Basel Committee on Banking Supervision published the first draft of Basel II in June 1999 following the South-East Asian crisis and the final accord was adopted only after several revisions in 2005 (Basel Committee on Banking Supervision, 2005; Metzger, 2006). Similarly, Heine and Herr (p. 32) state that “(l)ike all central banks in the world, the ECB can intervene in the foreign exchange market and thereby influence the exchange rate of the

euro". Technically, this is true, however, she does not have a mandate for intervening into the forex market, though she might have an internal threshold below which she would actually intervene. But Heine and Herr do not offer any explanations on that issue.

However, the claim that "(...) there are no strong independent institutions on a central level – except for the European Central Bank" (p. 5) cannot be perceived to be an inaccuracy. The EU had independent institutions already before the creation of EMU, in particular in jurisdiction and auditing. The supreme court of the EU, the Court of Justice of the European Union, interprets and enforces EU law in member countries, may revoke legal acts and sanction EU institutions; it deals with competition law, trade, agriculture and – gaining importance in times of crises – State aids.⁴ In addition, the European Court of Auditors (established 1977 and a supranational institution since 1993), meanwhile having five chambers and a staff of almost 900, contributes to public accountability and will have to address the growing needs for auditing arising from the EU-financed Covid-19 measures the Recovery Plan for Europe and the Next GenerationEU programme. Moreover, in particular in the core fields of monetary policy and financial market supervision, we have seen the creation of a range of new independent supranational institutions in the last decade. The EU transformed the former standing-setting bodies in banking, insurance and securities with only advisory competences into the supranational European Supervisory Authorities⁵. The EU also complemented the supervisory financial market architecture by introducing the European Systemic Risk Board, which the ECB president chairs and includes inter alia the governors of Member States' central banks and the Chairpersons of the European Supervisory Authorities. Finally, with the banking union, institutions with rather microprudential supervision, the single supervisory mechanism (SSM) and the single resolution mechanism (SRM) were established. Hence, the evolution of the monetary union and the institutional advancement within the last 20 years do not confirm "EMU's institutional crisis" (p. 176) – in contrary.

This regional supervisory landscape with supranational institutions is unique; actually, no other regional integration scheme shows these kind of supranational institutions. The ECB has been one of the major players, if not *the* major player, who took responsibility to advance the financial market architecture and address regulatory gaps in supervision. When we compare the progress within EMU institutions in form of organisations, rules and regulations, with any other global or regional integration scheme, we cannot help but acknowledge that EMU shows an unrivalled reform dynamic. The design of monetary policy, regulation and supervision are all learning-by-doing business. In these last two decades, the ECB has proven to be adaptive and flexible in reasoning and action. While the ECB's baptism of fire occurred directly after the introduction of the euro, when international investors tested the resilience of both the new currency and its central bank, pushing the euro to an all-time minimum below parity to the US dollar, the coming-of-age occurred rather on a fast track. The European sovereign debt crisis invited international investors again to speculate against the euro, from which the ECB, the euro and the European Monetary Union as such emerged stronger than ever. These remarkable achievements are worthwhile to devote a book to her.

4 The Court of Justice of the European Union (https://europa.eu/european-union/about-eu/institutions-bodies/court-justice_en) comprises the Court of Justice and the General Court, interprets and enforces EU law in member countries, may revoke legal acts and sanction EU institutions; it deals with competition law, trade, agriculture and State aids. Its beginnings date back to 1952. For the European Court of Auditors see its website (<https://www.eca.europa.eu/en/Pages/ecadefault.aspx>).

5 European Banking Authority, European Securities and Market Authorities, European Insurance and Occupational Pension Authorities. Interestingly, the European Stability Mechanism is not part of the EU as its target group includes only Eurozone countries.

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