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ECB: Independence at Risk?

The extraordinary measures taken by the ECB to combat the financial crisis have led many observers to question whether the bank has put its independence at risk. The bank's vow to do "whatever it takes" to save the euro has added a second (and potentially contradictory) goal alongside its primary mission of achieving price stability. This expansion of the ECB mandate could expose the bank to national and European political demands, thereby endangering its prized independence.

The European Central Bank (ECB) has undertaken extraordinary measures during the current financial crisis. First, it dramatically increased the monetary base. The ECB changed the distribution system from a variable rate tender system to a fixed rate tender system with full allotment. Second, it began buying government bonds in order to reduce credit spreads between member countries of the Economic and Monetary Union (EMU). Third, the ECB explicitly pledged to do "whatever it takes" to preserve the euro as the common currency.[1] Given this background, politicians and academics question whether the ECB still has the same degree of independence it had before. As this article will show, independence is not only a question of the legal framework but also of the actual implementation of monetary policy.

There are several theoretical assumptions that can explain why central bank independence is in fact useful. First, an independent central bank might have greater credibility in achieving price stability. Governments have an incentive to make use of the short-run trade-off between inflation and output growth. Through surprise inflation, a government could reduce unemployment rates, a tactic which could be used ahead of an election.[2] Since individuals know that governments could exploit this trade-off, they will increase their inflation expectations, assuming that they have rational expectations.[3] This would lead to higher inflation rates while unemployment remains constant, resulting in a higher misery index.

Second, a government's preferences with respect to inflation and output stabilisation might differ between left-wing and right-wing governments. A change of government would thus lead a non-independent central bank to change its monetary policy. The result would be higher inflation and output variability.[4]

Third, a central bank that is subject to directives from the government might help to finance the government deficit by either directly buying government bonds or by increasing inflation taxes through increasing the money supply. Both measures tend to increase inflation in the long run.

1 http://www.ecb.int/press/key/date/2012/html/sp120726.en.html.

2 This refers to the political business cycle model by W.D. Nordhaus: The Political Business Cycle, in: Review of Economic Studies, Vol. 42, No. 2, 1975, pp. 169-190. According to this model, governments try to make use of the Phillips curve trade-off. This leads to higher output and inflation variability. The model was criticised because it assumes that individuals have adaptive expectations. Thus, the model is not in line with the theory of rational expectations; see A. Alesina: Macroeconomic Policy in a Two-Party System as a Repeated Game, in: The Quarterly Journal of Economics, Vol. 102, No. 3, 1987, pp. 651-678.

3 This is known as the time-inconsistency problem; it was first mentioned by F.E. Kydland, E.C. Prescott: Rules Rather than Discretion: The Inconsistency of Optimal Plans, in: Journal of Political Economy, Vol. 85, No. 3, 1977, pp. 473-491.

4 This is the result according to the partisan theory by D.A. Hibbs: Political Parties and Macroeconomic Policy, in: American Political Science Review, Vol. 71, No. 4, 1977, pp. 1467-1487. Thus, governments act in a way that satisfies their partisans. Left-wing governments try to reduce unemployment rates by increasing inflation rates. Right-wing partisans favour stable prices, and therefore, right-wing governments try to bring down inflation rates.

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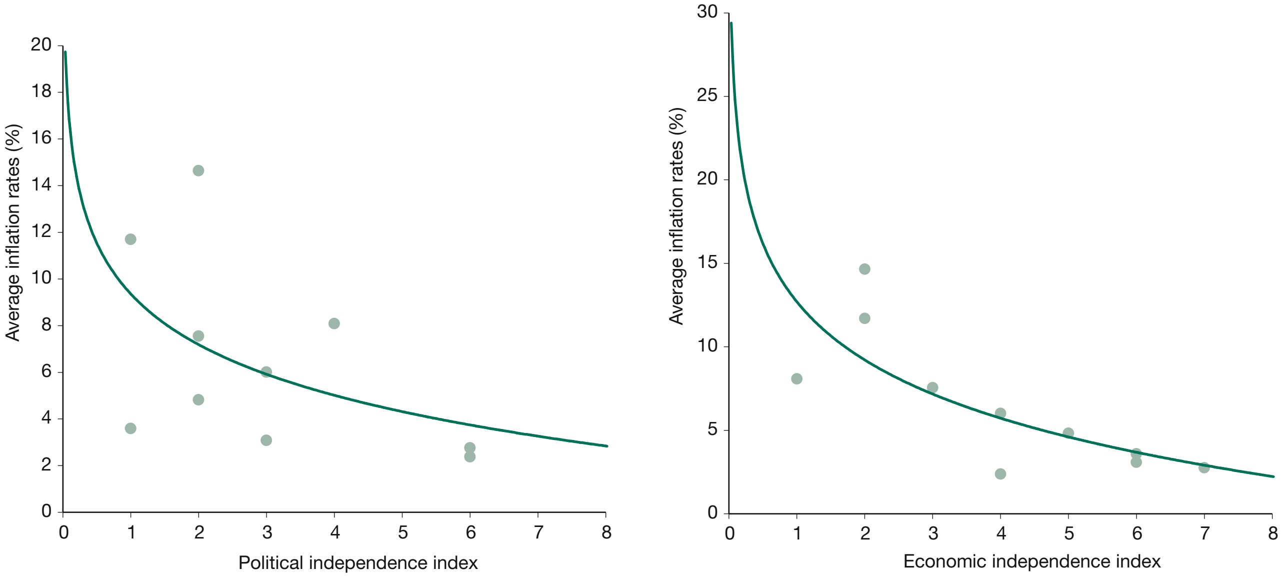
Figure 1

Central bank independence and inflation rates in 11 euro countries, 1980 until euro adoption



Sources: OECD; V. Grilli, D. Masciandaro, G. Tabellini: Political and Monetary Institutions and Public Financial Policies in the Industrial Countries, in: Economic Policy, Vol. 6, No. 13, 1991, pp. 341-392.

Fourth, an independent central bank might be more interested in long-term developments than politicians seeking re-election.[5] Apart from that, central bankers might be more able to conduct effective monetary policy, as they have better knowledge about transmission mechanisms and financial markets in general.

Lastly, central bank independence makes monetary policy more predictable, which might lead to higher growth rates; this, in turn, fosters investments.[6]

On the other hand, central bank independence could also have negative effects. Due to the Mundell-Tobin effect, GDP growth might be lower. Thus, under an independent central bank, the nominal interest rates are high, which leads to higher real interest rates.[7] Furthermore, a central bank that cannot be influenced by the government might be reluctant to coordinate its monetary policy with fiscal policy.[8] Accommodative monetary policy might, however, be useful in order to prevent crowding out if the government conducts expansionary fiscal policy to stimulate the economy. Moreover, some argue that the sacrifice ratio under an independent central bank is higher, as inflation rates are lower and wage contracts are negotiated less often.[9]

Independence and macroeconomic performance

As theory leads us to opposing results, empirical evidence is a better gauge of the effect of central bank independence. There are several indices with which to measure central bank independence. The most common indices are those by Alesina;[10] by Eijffinger and Schaling;[11] by Cukierman;[12] and by Grilli, Masciandaro

5 Another argument is that central bankers might be more likely to implement unpopular measures, as they do not seek re-election if they are appointed for several years and if they cannot be re-appointed by politicians; see F.S. Mishkin: The Economics of Money, Banking, and Financial Markets, Harlow 2013.

6 The predictability of monetary policy leads to lower risk premia in real interest rates, which stimulates economic activity; see A. Alesina, L. Summers: Central Bank Independence: Some Comparative Evidence, in: Journal of Money, Credit, and Banking, Vol. 25, No. 2, 1993, pp. 151-162.

7 S.C.W. Eijffinger, J. de Haan: The Political Economy of Central Bank Independence, Princeton 1996.

8 F.S. Mishkin, op. cit.

9 R.L. Miller, D.D. VanHoose: Money, Banking, and Financial Markets, Mason 2004.

10 A. Alesina, R. Gatti: Independent Central Banks: Low Inflation at No Cost?, in: The American Economic Review, Vol. 85, No. 2, Papers and Proceedings, 1995, pp. 196-200.

11 S.C.W. Eijffinger: Central Bank Independence: Criteria and Indices, in: Kredit und Kapital, Vol. 13, Special issue, 1995, pp. 185-217.

12 A. Cukierman, S.B. Web, B. Neyapti: Measuring the Independence of Central Banks and Its Effect on Policy Outcomes, in: The World Bank Economic Review, Vol. 6, No. 3, 1992, pp. 353-398.

Table 1
Independence rankings of selected central banks

Central bank	Alesina index	GMT index (political)	GMT index (economic)	LVAU	Eijffinger-Schaling index
Canada	2	4	7	0.46	1
ECB	4	6	7	0.81	5
Japan	3	1	5	0.36	3
New Zealand	1	2	3	0.69	3
Sweden	2	-	-	0.47	2
Switzerland	4	5	7	0.68	5
UK	2	1	5	0.53	2
US	3	5	7	0.51	3
Maximum value	4	8	8	1	5

Sources: P.L. Siklos: Changing Face of Central Banking: Evolutionary Trends Since World War II, West Nyack 2002; S.C.W. Eijffinger, E. Schaling: Central Bank Independence in Twelve Industrial Countries, in: Banco Nazionale del Lavoro Quarterly Review, No. 184, 1993, pp. 49-89; S.C.W. Eijffinger, M. van Keulen: Central Bank Independence in Another Eleven Countries, in: Banco Nazionale del Lavoro Quarterly Review, No. 192, 1995, pp. 39-83; A. Alesina: Macroeconomics and Politics, in: S. Fischer (ed.): NBER Macroeconomics Annual 1988, Vol. 3, Cambridge 1988, MIT Press, pp. 13-62; V. Grilli, D. Masciandaro, G. Tabellini: Political and Monetary Institutions and Public Financial Policies in the Industrial Countries, in: Economic Policy, Vol. 6, No. 13, 1991, pp. 368 f.

and Tabellini (which we abbreviate to GMT).[13] In this article, we mainly refer to the latter index. This index consists of two main components: political independence and economic independence. Political independence is characterised by the "capacity to choose the final goal of monetary policy".[14] Economic independence, on the other hand, is the "capacity to choose the instruments with which to pursue these goals".[15] Both of these elements are explained by eight criteria. This article focuses on the ten euro countries mentioned in the GMT article: Austria, Belgium, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain. We take the values of the indices and compare them with the average annual consumer price inflation rates and the average yearly growth rates from 1980 until the last year before each country introduced the euro. The results of the inflation comparison are presented in Figure 1.

The left part of Figure 1 shows the GMT index values for the political independence of central banks on the horizontal axis and average inflation rates on the vertical axis. The right part shows the relation between the economic independence of central banks and mean inflation rates. According to the figure, there seems to be a negative correlation between independence and inflation rates.[16] More independent central banks had, on average, lower inflation rates. This result is confirmed by several other studies.[17] However, we find different results using the Cukierman index instead of the GMT one. This reveals a general difficulty in precisely measuring central bank independence.[18] Comparing the GMT index with average growth rates shows that there is almost no relationship between these variables. Independence and GDP growth are only marginally negatively correlated. This is confirmed by other studies that show that central bank independence does not have an impact on economic activity or output variability.[19]

The overall result then is that central bank independence tends to foster price stability but does not influence economic growth. This leads to the questions of how independent the ECB is and whether its inde-

13 V. Grilli, D. Masciandaro, G. Tabellini: Political and Monetary Institutions and Public Financial Policies in the Industrial Countries, in: Economic Policy, Vol. 6, No. 13, 1991, pp. 341-392.

14 Ibid., p. 366.

15 Ibid., p. 366.

16 Hayo and Hefeker criticise that these correlations cannot be interpreted as causal relationships, as independence is an endogenous variable in this context; see B. Hayo, C. Hefeker: Reconsidering Central Bank Independence, in: European Journal of Political Economy, Vol. 18, No. 4, 2002, pp. 653-674.

17 See e.g. C. Crowe, E.E. Meade: Central Bank Independence and Transparency: Evolution and Effectiveness, in: European Journal of Political Economy, Vol. 24, No. 4, 2008, pp. 763-777; and A. Alesina, L.H. Summers, op. cit.

18 Mangano shows, for instance, that the GMT and Cukierman indices are only slightly correlated; see G. Mangano: Measuring central bank independence: a tale of subjectivity and of its consequences, in: Oxford Economic Papers, Vol. 50, No. 3, 1998, pp. 468-492.

19 S.C.W. Eijffinger, E. Schaling, M. Hoeberichts: Central Bank Independence: A Sensitivity Analysis, in: European Journal of Political Economy, Vol. 14, No. 1, 1998, pp. 73-88.

pendence might be at risk due to the measures taken during the financial crisis.

Table 1 shows the ranking of the ECB compared to other selected central banks with respect to the previously mentioned indices. The bottom row of the table shows the maximum value that these indicators can have. According to each one of these indices, the ECB is the central bank with the highest legal independence worldwide.

The independence of the ECB: legal perspectives

The legal "independence"[20] of the ECB represents a multi-layered concept, based on – broadly speaking – four pillars:

- The ECB is independent as an institution; that is to say, being an institution *sui generis* it holds legal personality distinct from that of the EU.
- It is independent with respect to its internal personnel policy.
- It is independent from any financiers.
- Most importantly, it is independent with regard to its primary goal of preserving price stability.[21]

Institutional autonomy

As an autonomous institution, the ECB cannot be instructed by third parties, i.e. governments or international political councils; it is not responsible to any subordinate organisation nor to any legitimising body. Though the EU and the member states are allowed to address non-binding consultations to the ECB, no form of authoritative participation exists. The ECB has its own internal decision-making bodies which have been granted powers to adopt legally binding measures.[22] This characteristic distinguishes the ECB from any other institution within the EU, as those institutions are restricted to acting *on behalf* of the EU and in its name.[23] However, the ECB's acts are subject to the judgement of the European Court of Justice (ECJ),[24] and as the ECJ ruled in its 2003 OLAF decision, its form of institutional independence does not entirely separate the ECB from the European Union, as the ECB still has to work in line with the objectives and goals of the EU.[25]

Personnel independence

The ECB's personnel independence is less marked than its institutional autonomy, as the appointment of its highest management level – the Executive Board – is based on a consensual decision of the heads of the member states.[26] However, this direct political influence is weakened by the structure of the Governing Council, which serves as the main decision-making body of the Eurosystem. Whereas the Executive Board is responsible for the day-to-day *implementation* of the monetary policy, the Governing Council makes the decisions *defining* the political direction to be followed by the Executive Board. The Governing Council consists of the members of the Executive Board as well as the governors of the national central banks of the euro area countries.[27] The latter traditionally put an emphasis on their autonomous status as "bureaucratic" experts acting beyond the emotional uncertainties of the daily political discourse and decision-making processes. Moreover, the personnel independence is strengthened by the prohibition on re-electing the members of the Executive Board, who serve for a relatively long term of office (eight years). The rules for dismissal of the members of the Bank's governing bodies are highly restricted; the ECJ alone can retire a member of the

20 In this paper, "independence" and "autonomy" are used interchangeably; for a different approach, see B. Dutzler: Der Status des ESZB aus demokratietheoretischer Sicht, Der Staat (2002), pp. 495, 497 ff. For a socio-cultural study on central bank independence, see also, most recently, C. Tognato: Central Bank Independence. Cultural Codes and Symbolic Performance, New York 2012.

21 For the most comprehensive study of the legal independence of the ECB, see S. Gaitanides: Das Recht der Europäischen Zentralbank, Tübingen 2005, pp. 41-135; see also D. Meyer: Unabhängigkeit und Legitimität der EZB im Rahmen der Staatsschuldenkrise, Kreditwesen 3, 2011, p. 127; and from a national viewpoint O. Issing: Unabhängigkeit der Notenbank und Geldwertstabilität, Stuttgart 1993.

22 For the legal background, see the discussion in R. Smits: The European Central Bank in the European Constitutional Order, Utrecht 2003, p. 20.

23 T. Tohidipur: The Emperor's New Clothes, in: P. Dann, M. Rynkowski (eds.): The Unity of the European Constitution, Berlin 2006, p. 181.

24 See also D. Curtin: Executive Power in the European Union: Law, Practices and the Living Constitution, Oxford 2009, p. 140.

25 ECJ C-11/00 Commission vs. ECB [2003] I-7147. In some way, this decision caused a breach in the idea of indefeasibility still proclaimed by the ECB itself; see T. Tohidipur, op. cit., p. 181. One has to bear in mind that the President of the ECB has to appear in front of the European Parliament to explain and justify specific aspects of the ECB policy; see also D. Fischer-Appelt: Does the EU need a single European Securities Regulator?, in: H. Hofmann, A. Türk: EU Administrative Governance, Cheltenham 2006, pp. 244, 276. On the OLAF dispute, see also C. Zilioni, M. Selmayr: Recent Developments in the Law of the European Central Bank, in: P. Eeckhout, T. Tridimas (eds.): Yearbook of European Law, Oxford 2006, pp. 1, 11-13.

26 For this aspect, see S. Liebler: Der Einfluss der Unabhängigkeit von Notenbanken auf die Stabilität des Geldwertes, Frankfurt a.M. 1996, p. 28.

27 On the relation between the ECB and the national central banks in the Eurosystem, see L. Quaglia: Central Banking Governance in the European Union: A Comparative Analysis, London 2008, pp. 118-120.

Executive Board, only on application by the Governing Council or the Executive Board itself, and only in accordance with the criteria laid down in Article 11.4 of the Statute.[28]

Budget independence

The ECB budget is not granted by the parliaments of the member states or by the EU. Since it receives no funds from the Community, the ECB budget does not form part of the overall budget of the EU. Instead, the budget is made up of shareholder contributions from the national central banks; that is to say, it draws on "own resources distinct from those of the Community budget".[29] As a consequence, the responsibility for the budget rests solely with the managing bodies of the ECB; every budget has to be approved by the Governing Council.[30]

Goal dependence

The main objective of the ECB is to guarantee price stability. Given this background, the structural independence of the ECB is to be distinguished from its *goal dependence*. Whereas the ECB is generally at liberty to organise itself and craft its economic strategies as it deems appropriate, the indisputable commitment to price stability is – as leading ECB officials once put it – "written in stone".[31] This article will not discuss the merits of the ECB's understanding of price stability,[32] which it defines as an annual increase in the harmonised index of consumer prices that is "below", but "closer to" two per cent than to the one per cent midpoint of the zero to two per cent target range.[33] From a *legal* perspective, the restricted goal enforces the accountability of the ECB, as it prevents the ECB from shifting its focus to less debated or more attractive political fields on a day-to-day basis. This, again, strengthens the ECB's independence.[34] Its primary goal, as prescribed in the Treaty, cannot be overruled in order to follow government revenue motives or concurring policies of the EU.[35] While the ECB has to support the economic strategies of the euro area, it can only do so to the extent that the goal of price stability is not jeopardised.

Threats to independence

Recent economic and political actions by European institutions raise the question whether ECB independence is increasingly at risk. First, its personnel independence was partly attacked by the heavy-handed political demands issued by French President Nicolas Sarkozy in the case of Bini Smaghi. When Mario Draghi assumed the ECB presidency, there were two Italians but no French in the ECB Executive Board. Sarkozy demanded that Bini Smaghi be replaced by a French central banker. Even though a member of the Executive Board cannot be forced to resign by the head of a member state or by the European Council, Sarkozy's public attempt to influence Smaghi's decision reveals a crucial difference between *de jure* and *de facto* independence. The ECB's independence is dependent on the precondition of respect from leading European and national authorities; as the factual power employed in day-to-day politics demonstrates, this respect cannot easily be guaranteed by law.

Second, the ECB risks its own instrument independence by taking over the task of supervising national banks.[36] If monetary policy decisions are made in order to support or to rescue national banks with liquidity problems, it is not difficult to predict that conflicts will arise with respect to the (restricted) primary goal of the ECB. From an external perspective, the ECB acts as a single institution, and thus those conflicts cannot be solved by merely separating internal areas of responsibilities; they can only be avoided by removing the task of national bank supervision and assigning it to a separate institution. To put it frankly, building a "Chinese wall" *within* the ECB between monetary policy and banking supervision will not suffice; from a legal

28 See C. Zilioni, M. Selmayr, op. cit., p. 16.

29 ECJ C-11/00 Commission vs. ECB [2003] I-7147.

30 See also J. de Haan, S.C.W. Eijffinger, S. Waller: The European Central Bank. Credibility, Transparency and Centralization, Cambridge, MA, 2005, p. 126.

31 O. Issing, V. Gaspar, I. Angeloni, O. Tristani (eds.): Monetary Policy in the Euro Area, Cambridge 2001, p. 65. However, the ECB is *goal independent* to the extent that it can define the price stability criteria by itself.

32 On this debate, see O. Issing et. al., op. cit., p. 65; K. Kaltenthaler: Policymaking in the European Central Bank, Plymouth 2006, p. 73; from a critical standpoint, K. Dyson: The Politics of the Euro Zone: Stability or Breakdown?, Oxford 2000, pp. 16-17.

33 J. Galí, S. Gerlach, J. Rotemberg, H. Uhlig, M. Woodford: The Monetary Policy Strategy of the ECB Reconsidered. Monitoring the European Central Bank, London 2004, pp. 11-12.

34 L. Thomas: Money, Banking and Financial Markets, Mason 2006, p. 320.

35 S. Collignon: Monetary Stability in Europe, London 2002, p. 135.

36 This is not to question the necessity of a banking union. Furthermore, one has to keep in mind that one of the main problems is that European banks are heavily invested in domestic government bonds; see D. Gros: Banking Union with a Sovereign Virus, in: Intereconomics, Vol. 48, No. 2, 2013, pp. 93-97.

point of view, this ignores the status of the ECB as an indivisible institution.

Third, the guarantee to rescue the euro "whatever it takes" adds a second "main target" to the ECB's Treaty-based primary goal, which could potentially lead to conflicts if the targets require opposing actions. Given the high political relevance of this issue, it cannot be foreseen whether the ECB would give priority to its price stability target. In a rather paradoxical way, the ECB reduced its own political independence by the – seemingly – independent decision to introduce a new target. If financial investors attempt to test whether the ECB is really willing to uphold its guarantee to rescue the euro, the ECB would eventually be forced to buy an unrestricted amount of government bonds. If consumer prices were rising at the same time, the ECB would be stuck in a homemade dilemma.

Fourth, the bond purchasing programmes lead to an uncontrollable threat to the ECB budget. A euro country default could cause massive financial losses. This would reduce the ECB budget surplus and thus its budget autonomy. Relatively low losses would merely reduce the retransfer to national governments; greater losses, on the other hand, would lead to capital losses which could only be offset by repayments from the respective national central banks or by the issuing of money by the ECB – with the corresponding risk of inflationary adventures. Furthermore, purchasing large amounts of government bonds might boost the incentives for governments to increase spending, thereby endangering price stability in the long run. This would all result in an open breach of those statutory provisions once "written in stone".

Conclusions

This all shows that the goal of price stability has moved from a single unitary target towards a *primus inter partes*, with the *primus* increasingly marginalised by the *partes*. Although the primary goal of price stability is clearly specified in the Treaty, the ECB has enlarged its political responsibilities by adding the overarching mission to rescue the euro in its current form. This is surely the consequence of a narrow reading of the ECJ's OLAF decision, which established that the ECB has to act in line with the general aims of the European Union.

This is not to say that each of the ECB's actions exceeded the scope of action permitted by the Treaty. One of the inevitable problems of the legal framework is surely its vagueness, which allows the ECB to react to different unforeseeable economic problems in a flexible way. However, the aspects mentioned above reveal that – in sum – the Treaty-based goal of price stability is endangered in a way that can be regarded as violation of the Treaty. The ECB cannot simply expand its own mandate; this requires a stipulation by law through an amendment of the Treaty. This is the consequence of the primacy of politics.[37] Otherwise, democratic legitimacy as a main trait of the "European idea" is lost.[38] This is not to question the independence of the ECB as an institution. It is rather to strengthen its independent position by focusing on its goal dependence and shielding it from national and European political demands.

To be sure, independence is not an end in itself. If institutional and structural independence were to lead to economically negative results, one should question it at the political level. From an economic standpoint, central bank independence is only valuable as long as it helps to improve macroeconomic achievements.[39] However, as we have shown, the economic stability of the eurozone is not endangered by the ECB's independence but by its self-imposed dependence on additional political targets. As the legal framework is vague, price stability requires a rather conservative handling of monetary instruments.[40] This depends on legal stipulations, but it also depends – probably to a greater extent[41] – on the central bankers' political preferences towards price stability.

37 This especially includes the question whether or not a state should remain a member of the eurozone. By purchasing large amounts of government bonds of those countries that could potentially leave the eurozone, the ECB appears not only to be rescuing the euro as a currency but also the eurozone in its current form.

38 The merely indirect democratic legitimacy of the ECB's managing level is also an issue worthy of closer scrutiny. The lack of direct democratic legitimacy can partly be addressed through greater transparency of the central bank's decisions; see also C.S. Weber: EZB: Mehr Transparenz wagen, in: Wirtschaftsdienst, Vol. 92, No. 12, 2012, pp. 827-832.

39 There are other approaches to achieve price stability, e.g. imposing a fixed exchange rate system.

40 This refers to Rogoff's proposal that monetary policy should be placed in the hands of conservative bankers; see K. Rogoff: The Optimal Degree of Commitment to an Intermediate Monetary Target, in: The Quarterly Journal of Economics, Vol. 100, No. 4, 1985, pp. 1169-1189.

41 The power of statutory law is naturally restricted by its vagueness. However, one might try to compose incentives, for instance on a contractual private law basis. This idea was put forward by Walsh, who proposed that the labour contracts of central bankers should make the payment dependent on achieving, for instance, a specific degree of price stability; see C.E. Walsh: Optimal Contracts for Central Bankers, in: American Economic Review, Vol. 85, No. 1, 1995, pp. 150-167. This, however, would only transfer the problem of time-inconsistency from central bankers to politicians; see B.T. McCallum: Two Fallacies Concerning Central Bank Independence, in: American Economic Review, Vol. 85, No. 2, 1995, pp. 207- 211.