The politicisation of the European Central Bank

The European Central Bank (ECB) has become a more political actor during the course of the economic and financial crisis that started in 2007 and has yet to end. Originally conceived on the impartial model of the German Bundesbank whose overriding aim was to ensure price stability, the ECB has found itself taking on an ever more active role in steering the eurozone economy through the difficulties of the financial and eurozone crises. This increased politicization comes not only in the monetary sphere, where ECB President Mario Draghi's activism is widely credited with stopping the acute phase of the euro crisis in 2012, but especially in the increased powers the ECB will be given to supervise euro-area banks as part of the developing European Banking Union.

As well as its own increasingly political role, the ECB is also used by other European institutions (the European Parliament and member states) for their own political ends as a proxy battlefield for their European preoccupations more generally. Lying behind both these active and passive forms of politicization is the fact that the ECB, due to its very independence which is guaranteed by treaty, is one of the very few European actors which can act unilaterally and hence it has much greater agency and independent power in economic affairs than nominally more influential bodies, such as the European Commission.

This brief investigates the ways this politicization of the ECB has come about, explores possible reasons for this shift, and looks at the significance for the European Union (EU) of the ECB's changing role in European affairs.

Basis for independent ECB action

Article 127(1) of the Treaty on the Functioning of the European Union (TFEU) explicitly sets out in its first line that the "primary objective" of the ECB shall be to maintain price stability.[1] So far as it does not prejudice this objective, the ECB is then tasked with supporting the European economy more generally. This additional role is specified more clearly in paragraph 6, allowing the Council of the European Union unanimously to confer specific tasks on the ECB relating to the prudential supervision of credit and other financial institutions. In line with standard global practice for the governance of central banks, and in order better to guarantee price stability, the ECB is constrained by treaty (article 130 of TFEU) to be independent, and not to "seek or take instructions" from other EU or external bodies; equally, other bodies are forbidden from attempting to influence the ECB. This independence is meant to allow the Executive Board and Governing

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Council of the ECB to be impartial in determining interest rates and in assessing any changes in the general price level. The insulation does not stop at decision-making. As well as these high-level instructions for independence and impartiality, there are various provisions on the human resources level to ensure that individuals working at the bank (especially in senior positions) maintain their independence of action, such as fixed non-renewable terms and restrictions on who can appoint them and how they can be removed from office.

These independence requirements are at the core of the ECB's mandate and were strictly demanded by various national central banks when the ECB was being set up, most especially the Bundesbank. German historical experience of political interference in central banks and resulting hyperinflation has heavily influenced Germany's absolute requirement that any European central bank be fully independent from national governments and European institutions, so that it could maintain a stable price level without political influence.[2]

It is this mandate-driven, rules-based action which we characterize as conservative or apolitical. In this, the ECB has been highly successful and has played a very conservative hand in its monetary policy, without overstepping the bounds of its mandate or its rules. However neither the treaty setting up the ECB nor European politicians seem to have envisaged a central bank which would itself develop a more political role and become involved in Europe-wide political decisions on the economy, stretching (at best) the limits of its mandate and the strictness of its rules. Due to the euro crisis this is precisely the situation the EU finds itself in: a politically-engaged central bank, rather than the feared politically-used central bank.

ECB crisis response

To an extent, the increasingly political role played by the ECB is on par with developments in other western economies since the start of the financial and economic crisis in 2008. Both the Bank of England (BoE) and US Federal Reserve have been forced to invent ever more creative ways of injecting liquidity into their economies without stoking massive inflation in a bid to stimulate economic activity that has been forestalled by inadequate financial flows. Where these two bodies differ from the ECB, of course, is the European context in which the ECB finds itself. In a Union structure which is designed to be consensual, and so to avoid drastic or sudden action, the EU found itself ill-equipped to deal rapidly with the onslaught of the financial crisis, which quickly undermined not just the European banking sector, but also the public finances of a number of euro-area member states. Due to the then-lack of financial and economic coordination possible within the euro states, undue strain was put on the euro itself - despite the currency's relatively strong position if it had been allied to one sole economy as are the dollar and pound, for example. During the summers of 2011 and 2012, the spread between German and Greek bonds hit nearly 1600 basis points (or sixteen percentage points), while Italy and Spain both broke through the 500 basis points (or five

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percentage points) barrier that was widely seen as the mark of unsustainable public finances for a eurozone economy.

ECB reticence during the early days of the crisis has in fact been seen as one of the causes that exacerbated the global financial crisis in the European context: while the ECB focused on monetary action to control the price level, the European financial system threatened to fall apart.[3] According to this critique, the ECB was, in some ways, too rules-based, too mandate-driven. This almost negatively apolitical stance from the ECB was seen as unsatisfactory by most European politicians who lamented the ECB's unwillingness to become a lender of last resort to member states and the European banking system.

The situation came to a head during "summer crises" of 2011 and 2012. As sovereign debt markets threated to spiral out of control, outside investors became convinced that there was no political leadership within the Eurozone. They also began to worry that due to the ECB's lack of involvement in shoring up European financial markets, there was no actor in Europe able to prevent a disorderly break-up of the Eurozone. Such concerns crystallized around the possible 'expulsion' of Greece from the monetary union. European politicians' rhetorical insistence that the collapse of the eurozone was "unthinkable" did not seem to reassure the markets. There was an appetite from many European leaders for a more political ECB to emerge, one which would press against the bonds that were designed to constrain it. Eventually this happened, through lack of other acceptable alternative. The acute phase of the crisis only came to an end in July 2012 when the ECB's president, Mario Draghi, pledged that the ECB would do "whatever it takes" to save the euro.[4]

To a large extent the ECB stepped into the void left by other actors. Its legal basis in the treaties, although strictly protecting its independence, also allowed the central bank to act unilaterally, unconstrained by external factors when it came to issues that fell "within its remit". As we have seen, this remit is not, in fact, only limited to guaranteeing price stability, but also includes bolstering the eurozone financial system. Draghi argued that "to the extent that the size of the sovereign premia [borrowing costs] hamper the functioning of the monetary policy transmission channels, they come within our mandate." In focusing his new, more political actions in terms of the ECB's mandate, Draghi managed to square the circle of an independent, rules-based central bank, taking on a more active and creative role in the European economy. In policy terms this marked the start of the ECB's Outright Monetary Transactions (OMTs) which pledged the ECB to buy government bonds from member states that were finding it hard to fund their borrowing from the markets. This pledge sharply reduced governments' borrowing costs, allowing them to roll over their debt and avoid forfeiting, and in so doing removed much of the systemic risk facing private bondholders that the eurozone would break up, further reducing the spread between peripheral economies' sovereign bonds and German ones. As a measure of the success of Draghi's one statement, Spanish bond yields fell within the day to 6.8 per cent and Italian to 6 per cent from 7.6 per cent and 6.6 per cent respectively.

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The ECB, therefore, despite its own initial hesitation and reservations by a number of especially German ECB board members, took a step which irrevocably bound it to shore up the public finances of member states in a bid to maintain the integrity of the euro itself. Though this move was successful - even, perhaps, vital – in preventing the collapse of the single currency, it marks a critical change in the role of the ECB from impartial 'German-style', rules-based and mandate-driven central bank only concerned with keeping inflation positive and below 2 per cent per annum, to a more politically-involved institution which explicitly, even if in a round-about manner, has begun to fund member state finances.

This change in the ECB was not entirely new and it was highly controversial. Tensions over this issue had already flared in 2010 when a German ECB governing board member, Juergen Stark, quit over deliberations within the bank as to whether to purchase peripheral eurozone debt without strict 'conditionality': that is, the imposition of further austerity measures by the receiving governments and structural economic reforms to rebalance their economies to lead out of recession. The legacy of his resignation, and similar German governmental demands during European Council negotiations, has led to conditionality being enshrined in the European Stability Mechanism (ESM), the permanent vehicle designed by member states and the ECB to provide future financial stability to member state governments of up to 500 billion euros. By creating a permanent mechanism within a separate organization, the hope is that the politicization of the ECB that was made necessary during the crisis can be drawn back, so that it can return to being a mandate-driven, rules-based central bank on the model of the former Bundesbank.

This, however, is unlikely to happen due to additional roles that are being given to the ECB as part of the reworking of the infrastructure for European financial stability.

ECB and longer-term infrastructure for European financial stability

The major addition to the ECB's remit that has formally come about as a response to the eurozone crisis is its upcoming role as the host for the Single Supervisory Mechanism (SSM) as part of the developing banking union. The SSM is the first stage of the banking union project, and will create a centralized supervisor for banks that fall within its remit: the eurozone and any other member states which decide to participate. The remaining steps (still to be agreed by the European institutions) are a Single Resolution mechanism, a eurozone resolution fund, and a combined deposit guarantee scheme for participating member states. The aim of the banking union itself is to break the vicious cycle between banking system collapse and sovereign debt unsustainability, by pooling responsibility for the supervision, resolution, and deposit guarantees of member state banking systems, so that sudden shocks to their banking and financial systems do not only have to be borne by single, and potentially weak, member state finances. [See accompanying brief].

After much debate about the eventual form of the banking union, the European Commission in September 2012 unveiled its proposals for the single supervisory mechanism, deciding to create it through a step-by-step approach. There were two

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Regulations, one a Council Regulation conferring powers on the ECB to become the Single Supervisor itself, which had to be passed by unanimity but only by member states within the European Council.[5] The other was a regulation which aligned various voting modalities within the European Banking Authority (EBA) to accommodate the new single supervisor.[6] This was to be passed through the usual post-Lisbon Treaty co-decision procedure between the European Parliament and the European Council. Both Council and Parliament early on decided to treat the two regulatory proposals as a package, thus giving Parliament an effective veto over the Council-only Regulation establishing the ECB as the SSM.

It is the need for this EBA Regulation which is most striking, because it highlights how powerful, and political, the ECB is to become as the single supervisor for banks within the Eurozone. Under the guise of harmonizing banking supervision across the eurozone, the ECB has been given authority to supervise directly all euro-area banks with assets over 30 billion euros or which represent at least 20 percent of their host nation's gross domestic product (GDP) or which have received direct assistance from the European Financial Stability Facility (EFSF) or the ESM. It will also be overall responsible for the supervision of all the around 6000 banks in the euro-area, through coordination with national supervisors.

In monitoring these banks, the SSM will be ensuring the implementation of the Single Rulebook, which the European Institutions are developing to harmonize banking rules across the EU. In practical terms, this means that the ECB will be able to require banks to raise their capital requirements to a certain extent, if necessary, and will be able to issue warnings if a bank or banking system looks likely to enter a crisis. Hence, the ECB through the SSM will have considerable sway over a number of large, influential, and financially important institutions within the EU.

The point to underscore is that banking supervision is inherently political in nature. As much as safeguarding banks may at times seem technical, the decision to require banks to raise capital or to shed assets requires political, as well as technical, assessments because it will have a material economic impact on European citizens. Some citizens will lose and others will gain as a result of the ECB's decision to change how specific financial institutions balance their books. This leads some to question whether this role is viable with central bank independence, and whether it may not lead to political confrontation with member state governments.

The member states have long resisted handing over banking supervision to the ECB. The idea was first proposed in December 1998 and then immediately dismissed. This is another demonstration of the political nature of supervisory power. There will be, in effect, a transfer of sovereignty from the member states to the ECB, which sits uneasily with the idea of an apolitical, independent ECB. Germany, in particular, after starting as one of the main initial proponents of the Banking Union so as to lessen the burden on its economy of having to support weaker EU economies, has backed away mightily during the course of the various negotiations on the BU, including over the SSM, to try to limit the amount of sovereignty transferred to the ECB. The idea is that - however technical

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some of the issues the SSM will have to deal with may be - having a supranational body controlling the fate of financial institutions which are so directly important to the healthy functioning of an economy represents an unacceptable loss of power for the member state. It is for this reason that Germany managed successfully to lead a coalition of states that did not want the SSM to supervise directly all banks in the eurozone.

An additional political headache comes from the fact that not all EU member states will be supervised by the SSM, as non-euro states can keep their national supervisors unless they choose to pool this responsibility with those countries in the Eurozone. By contrast, all EU supervisors are collected together inside the European Banking Authority responsible for creating a common financial regulatory framework. This creates the prospect that the European Central Bank will suddenly gain preponderant influence in the EBA – shaping the rules for everyone in ways that will suit best those who are within the single supervisory framework. EU member state governments outside the Eurozone are not thrilled with this prospect.

Through strenuous effort of a coalition led by the UK, the voting modalities were changed to allow an effective veto by non-SSM-participating member states on decisions made by the EBA. That rectified the imbalance but only by underscoring the political nature of the ECB's new responsibilities. Worse, the political sword cuts both ways and so efforts by non-Eurozone governments to block regulations that the ECB believes it requires to fulfill its supervisory mandate would be the equivalent to giving political instruction to the ECB. Indeed, there were some, especially within the Directorate General for the Internal Market and Services (DG MARKT), who felt that this blocking minority in the European Banking Authority would *itself* would jeopardize the independence of the ECB. The politics of sovereignty is ever complex.

In an effort to mitigate the politicization of the ECB's core task – the control of the monetary supply – from these additional responsibilities as the single supervisory mechanism for Eurozone banks, a delicate reordering of the internal structure of the ECB has been necessary. This reordering is intended to provide a 'great wall' inside the central bank between those working on its monetary issues and those working on the supervisory side. This separation would go all the way up the Governing Council, which is obliged by the Treaty to take all final decisions from the bank, thus making a split Governing Council an impossibility. To mitigate this, there is being established a Supervisory Council below the Governing Council which will theoretically in effect take all supervisory decisions, which will then only have to be ratified by the Governing Council.

It seems highly unlikely that in the future there will not remain question marks over the ability of the people at the top of the bank to keep the two areas of activity separate, and that this doubt over the potential political role of the ECB may seep down to lower levels of the bank's hierarchy on both the monetary and supervisory sides. By stretching their interpretation of the ECB's mandate to its limit by giving it this role as the SSM, and because of the relatively minor scope for additional activity from the ECB, the European Institutions have added this relatively political role to the ECB, threatening perceptions of its independence from wider economic policy-making.

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Political uses of the ECB

As well as the ECB's active politicization resulting from the crisis – both in the short term of buying up member state debt, and longer term as an institution increasingly involved in the running of European economies – the ECB is being politicized by other actors who are imposing their own preoccupations onto the institution. Most notably the European Parliament has started trying to impose its will on the selection of the members of the Executive Board, despite the fact that this is traditionally one of the main tests of a central bank's independence. Parliament argues that this is justified because the increasingly political nature of the ECB, with perhaps direct effects on European citizens' lives, requires that there should be "democratic oversight" of the bank through the ability of the Parliament to nominate and veto choices for the Board. So far Parliament has insisted on having a female member of the Board to ensure some gender 'balance' or at least female representation (there is not currently a single woman sitting on the board), though in a show-down with member states Parliament's demand was ultimately refused.

Member states also use the ECB to reflect their concerns with the direction of travel of the EU itself. For example, the UK has used the politicization of the ECB through the single supervisory mechanism to try to secure safeguards for itself over financial regulation, and Germany has used this increase in powers also to argue for Treaty change more widely so as to clarify certain legal points, or alternatively not to allow too much sovereignty over banking oversight to move to the European level. German regional politicians in particular are often seen to have cozy relationships with their local, large regional banks (Landesbanken), which would be threatened by remoter oversight of the banks from the European level. Thus by threatening Treaty change over the ECB, some politicians hope to be able to limit the increase in the ECB's powers.

The ECB, then, has not only become politicized through its own efforts and increasing importance to the European economy, but also through other actors attempting to use the institution to highlight, or perhaps counteract, their own preoccupations with the current status of European integration more widely. Of course this only reflects the ECB's increased status since the start of the financial crisis as an effective institution, on the principle that politicians (and especially MEPs) will only act if they think the action will resonate with the public. The increasing sparring over the ECB demonstrates how much more important it has become.

Reasons and implications for the politicization of the ECB

The ECB has become more political since the start of the financial crisis. Largely, this is because the ECB, due to its very independence, is the only EU institution which can make decisions unilaterally on a scale large enough materially to affect the European economy as a whole. The ECB, in a way, is the only actor that can act – at least rapidly and determinedly. The ECB has had to fill the gap left by consensual, but ineffective, European political processes. This is even more the case given the fact that all peripheral member states and most EU member states have had at least one change of government since the start of the crisis, leading the ECB to be not only the most effective single actor, but also one of the most stable.

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The increased politicization of the ECB has come at the expense of its reputation, at least, for independence, and has created considerable strain with some member states (most obviously Germany) which want to keep a Bundesbank-style, strongly independent and limited, mandate-driven, rules-based central bank. However the reasoning for this would imply that the current EU model of consensual and slow governance is not fit for purpose: at least not in a crisis situation. This has led the ECB to be forced by circumstances and the potential break-up of the euro to take advantage of its capacity for action to step into the breach and fill the gap left by other institutions. As the ECB becomes or remains more powerful, however, we should expect to see further efforts to clarify its role and perhaps even to constrain its powers, as we have already seen from the European Parliament and some member states.

There are some reasons for thinking that the ECB may have reached the limits of its political power for the time being: the decision not to give the role of Single Resolution Mechanism to the ECB (much more politically sensitive than SSM), and the fact that the ECB has been keen to stress that its OMTs are to be 100% sterilized so as not to affect its efforts at maintaining price stability, show that EU politicians and officials at the ECB themselves are keen not to allow anything to interfere with its core aim and independence, reflecting what have always been strong German preoccupations with the central bank's objectives, make-up, and role.

The ECB may be increasingly political but for a central bank we should expect it to remain one of the least politically engaged among all those in developed economies.

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[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:en:PDF
[2] http://www.bundesbank.de/Redaktion/EN/Standardartikel/Bundesbank/Views_Insights/background_eurosystem_independence.html
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