Central banks

Five reforms the ECB should embrace

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By: Guest Post

The European Central Bank's target and approach should evolve, argues Lorenzo Bini Smaghi, Société Générale chairman, Project Associate at the Harvard Kennedy School's Belfer Center for Science and International Affairs, and Senior Fellow at LUISS School of European Political Economy in Rome. In this guest post he makes five suggestions for reform.

As the euro approaches its 20th anniversary, it's time to assess the performance of the European Central Bank during its first two decades of operation and assess whether changes may be desirable in its policy framework.

The ECB's primary objective is price stability, defined as "a rate of inflation below but close to 2 per cent". The average inflation rate over the 20 years of the euro has been 1.7 per cent,

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which may suggest success. However, the result has been less satisfactory (a dalliance with deflation) in more recent periods. So some changes to monetary policy strategy, and policymakers' toolkit are worth considering.

Symmetry

First, reconsider the definition of price stability. Most central banks have a simple (in the jargon, symmetric) inflation target. The ECB's however, is asymmetric, based on the concept of "below but close". It is not well understood by the public or, to be honest, market participants.

When inflation hovered around 1 per cent in recent years, several academics and policy makers openly questioned the ECB's view that given the circumstances it wasn't sufficiently close to 2 per cent, and considered the prevailing policy stance as too accommodative. Furthermore, research shows that the ECB's policy decisions over the years anyway reflect a symmetric interpretation of the target around 2 per cent. So why not move to such a target? It would at least be more transparent.

Unequal pillars

Second, the ECB should reconsider its so-called two-pillar strategy when assessing risks to price stability. The two pillars are analysis of economic and monetary data, but the latter — money and credit aggregates — have proved over time to be unreliable predictors of inflationary pressures. On certain occasions they may even have mislead policy makers. In July 2008, for instance, the resilient fast pace of credit growth justified the rate hike which was made, even as the real economy had started to show signs of a slowdown and other central banks were cutting rates. The decision was reversed a few months later, after the collapse of Lehman Brothers.

Progressive haircuts, not floors

Third, is how the central bank treats collateral when attempting to stabilise markets. The ECB has adopted a comprehensive framework for counterparties' use of collateral in the provision of central bank liquidity, but this relies heavily on rating agencies and market prices. The problem is that the rules may produce pro-cyclical effects, exacerbating a situation when the functioning of financial markets is threatened by fears about a borrower's ability to repay debt.

The introduction in 2006 of a rating floor for sovereign bonds, for instance, created a unique situation where the central bank does not accept one of its member states' public bonds as collateral. Greece, in spite of its graduation from an IMF support program, is still off the list, which may exacerbate market instability. Consideration should be given to return to a system based on progressive haircuts.

Share risk, as well as supervision

Fourth, is the clashing structures of bank supervision and emergency support. Banks that are solvent, but do not have adequate collateral, may require the central bank to act as a so-called "lender of last resort". That function for banks is still decentralized, with the national central banks bearing the risks.

Supervisory powers over the continent's banks, however, have been centralized at the ECB since 2014. The governance of the provision of Emergency Liquidity Assistance needs to be aligned to the new single supervisory framework in the Eurozone. In particular, if the decision on whether a bank is solvent and is eligible to emergency lending is centralized, the risk for such lending should be shared.

Exit Troika stage left

Finally, there is the ECB's membership of the so-called Troika, along with the IMF and the European Commission. The Troika designs and negotiates adjustment programs with EU member states in need of financial assistance.

The ECB's participation was initially justified by a need to make sure financial stability considerations were appropriately accounted for in adjustment programs, in particular with respect to banks' capital adequacy. However, since the creation of the banking union the ECB has acquired these powers. Remaining a member of the Troika is now less justified, and the unpopularity of adjustment programmes tends to erode the ECB's reputation and independence.

Continuity is a burden

These are a few issues that require attention of the ECB's policy makers. Indeed, some of the key characteristics of the monetary framework were initially adopted with a view to ensure continuity with the policy design of the late 1990s, and with a view to inherit the credibility of the Bundesbank, the most successful central bank in Europe before the euro. While these features may have served well the ECB at the very start, they have become a burden over time.

Central banks are conservative by nature, and are reluctant to change. Yet the ECB has acquired enough credibility and self-confidence to take the initiative for reassessing its policy framework. It should adapt it to the challenges of the coming decades.

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