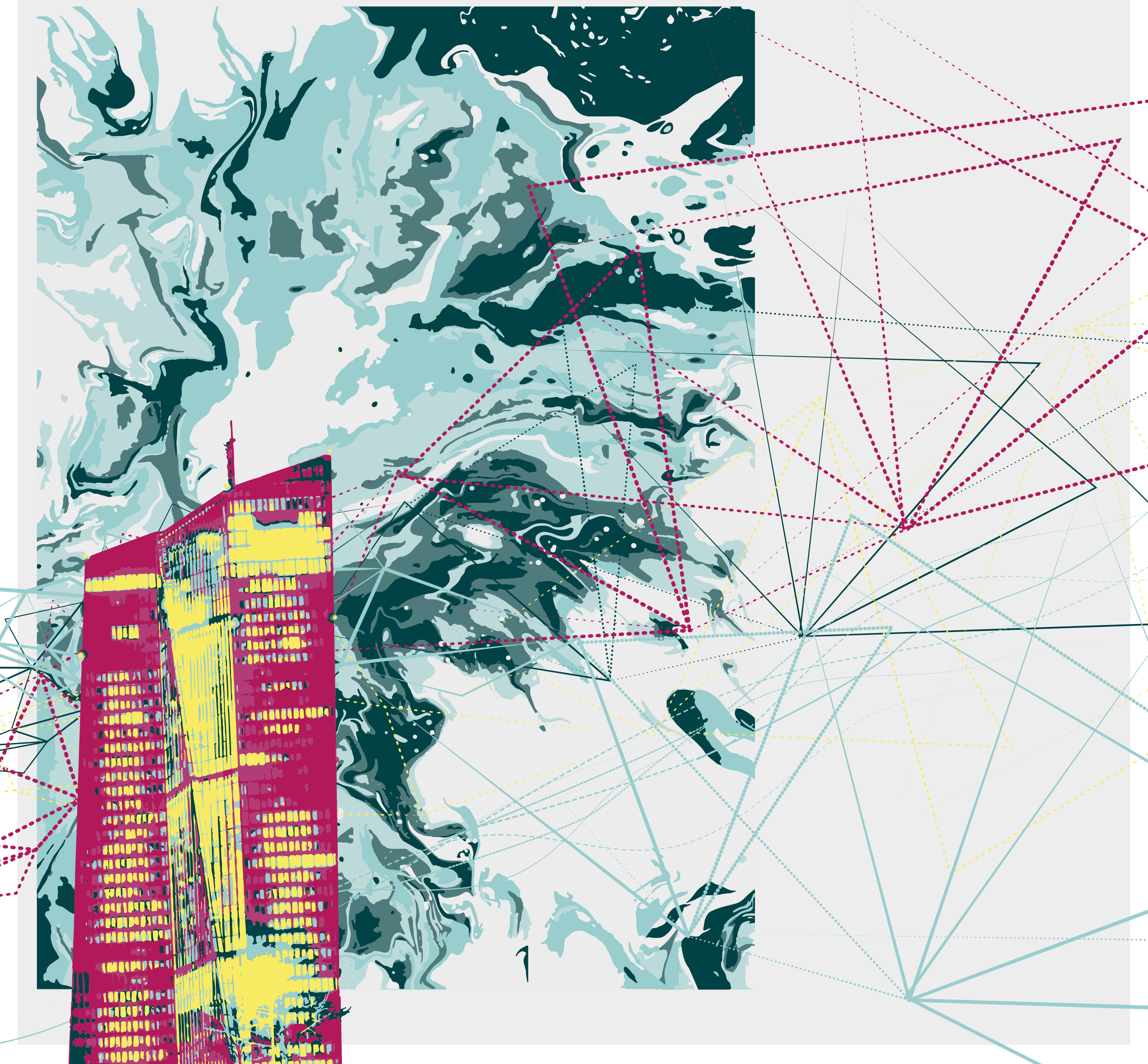
TRANSFORMATIVE RESPONSES TO THE CRISIS

NEXT GENERATION CENTRAL BANKING

The ECB's role in the social-ecological transformation

Conference Results 2021



This paper summarizes the results of
the **Transformative Responses conference**
Next Generation Central Banking:
Climate Change, Inequality, Financial Instability
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EXECUTIVE SUMMARY

In March 2020, the European Central Bank had to intervene massively to prevent a financial meltdown on top of the economic crisis caused by Covid-19. This is not a one-time phenomenon: over the past crisis-ridden decade, the scope and nature of the ECB's interventions has expanded substantially. Such an interventionist stance has become a permanent feature of twenty-first-century central banks as they try to address new challenges and stabilize an ill-regulated financial system.

This motivated the recent online conference *"Next Generation Central Banking: climate change, inequality, financial instability"*, which brought together academics, central bankers, think tanks, civil society activists and politicians in front of an audience of over 800 participants from all around the globe.

Drawing from the conference we conclude that central banks' extensive interventions, however necessary to safeguard price and financial stability, also have significant side effects: they increase inequality and exacerbate the ecological crisis. It has been shown, for instance, that the ECB's asset purchases have a bias to carbon-intensive companies. All of this shows that monetary policy is not neutral - and has never been. The ECB's policy entails a wide range of choices. This considerable discretion calls for improving its democratic legitimacy and clarifying its mandate in light of the new requirements that the current massive social-ecological challenges entail.

One of the reasons for central bank interventions is the inherent instability of the financial system. In order to take the ECB off the front lines and stabilize the financial system, shadow banks should be tightly regulated, thereby lessening the need for central bank intervention.

We welcome that central banks are starting to take climate risks into account, as part of their primary mandate of price and financial stability. The ECB must follow them swiftly and start reflecting on climate risks in its own monetary policy operations. But the ECB needs to go further: it needs to stop supporting high-carbon industries and align its entire monetary policy framework on the transition to a low-carbon economy, be it its conventional policy such as repo lending against collateral or its unconventional policies such as corporate large-scale asset purchases (CSPP) or Targeted Longer-Term Refinancing Operations (TLTROs).

Current monetary policy relies almost exclusively on financial markets for its implementation and its transmission to the real economy. This has not proven very effective in achieving ECB's inflation target in the past decade. Moreover, it has fuelled increases in asset prices, which significantly worsened inequality. The ECB should acknowledge this and develop alternative options to reach the real economy more directly, and to better support the labour market and lower wages. This is key for a sustainable recovery in Europe after the COVID-19 crisis.

The macro financial regime we live in requires central banks to play an active role in markets, especially sovereign bond markets to meet their price stability mandate. However, this also defines governments' fiscal space. As ECB board member Isabel Schnabel recently stressed, the current macroeconomic situation has rendered fiscal policy more important and effective than monetary policy and should therefore not be constrained by central bank decisions. This requires not just a redesign of the EU's current fiscal framework, as a recent public letter argued extensively[1], but also a new mechanism of coordination between monetary and fiscal policy whose mandate is to secure the flourishing of an inclusive, stable and sustainable economy.

The ECB is a key actor in the EU's economic policy, but it lacks clear renewed guidance in support of the EU's core policies, in line with the EUs commitments under international law in the Paris Agreement. This is why, to add legitimacy for the ECB acting on its "secondary objectives", a formal procedure should be developed by the European Parliament, specifying and prioritising the policy objectives that the ECB should pursue beyond its primary mandate.

The ECB is currently conducting its first strategy review in 17 years. Now is the time to establish a comprehensive agenda for the ECB in light of the social-ecological transformation towards a resilient, equitable and climate friendly economy.

THE ECB HAS NEVER JUST BEEN IMPLEMENTING PRICE STABILITY:

IT SHAPES MARKETS AND DEFINES A GOVERNMENT'S FISCAL SPACE.

1 Finance Watch 2021: Reshaping the European Fiscal Framework. Open Letter. *https://www.finance-watch.org/publication/reshaping-the-european-fiscal-framework/*

INTRODUCTION

In March 2020, central banks have once again proven to be the first and last line of defence in crisis-ridden times. With far reaching interventions they **prevented the world from experiencing a collapse of financial markets on top of the severe health and economic crisis** caused by Covid-19. The pandemic came against the backdrop of the mounting climate emergency, while the effects of the great financial crash of 2008 and the Eurozone crisis still loomed large. With central bank interventions becoming more frequent due to inherent instability of our financial system, and massive societal challenges such as climate change and inequality on the rise, we need to rethink what role central banks should play in our economy and society.

Over the past decade, **the scope and nature of the ECB's interventions has expanded substantially**, in line with some of its peers worldwide. The measures taken in the wake of the pandemic far exceeded the interventions of the great financial crisis.[2] In the past, growth rates in Europe have remained low with interest rates already at the zero-lower bound, which led the ECB to implement unconventional monetary policy to achieve its price stability mandate. In March 2020, when sovereign spreads within the Eurozone started to threaten national governments' ability to refinance themselves, the ECB again stepped in with massive purchases of sovereign bonds.

Against the backdrop of the COVID-19 pandemic these actions were unavoidable to safeguard European economies from a financial meltdown. They helped closing the spreads for sovereign government borrowing costs in the short-term. However, **the effectiveness of "unconventional policies" such as quantitative easing is highly contested.** The European Central Bank has frequently failed to achieve their price stability goal of 2% inflation. A key reason for this is the indirect transmission of monetary policy through financial markets.

While the ECB has not been achieving its price stability goal, its current policies are arguably worsening the social-ecological crisis in the medium-term.[3] Over recent years the ECB is increasingly called upon to consider its ecological impact and support the fight against climate change.

To be clear: central banks should not be in the driving seat of the transformation. On the contrary, that should be governments' role. The Next Generation EU program is a first step towards a more stable Eurozone.

2 From 2007 - 2010 the ECB's balance sheet grew by 813 billion euros, compared to 2261 billion during February - December 2020 only. European Central Bank (2021): Central Bank Assets for Euro Area (11-19 Countries), retrieved from FRED, Federal Reserve Bank of St. Louis; *https://fred.stlouisfed.org/series/ECBASSETSW*, March 9, 2021.

3 Schick, Gerhard and Peters, Michael (2020): Central banks in the socio-ecological transformation, Social Europe. *https://www.socialeurope.eu/central-banks-in-the-socio-ecological-transformation*

Fiscal stimulus, an efficient carbon price and emission trading would go a long way in achieving a carbon-neutral economy. However, the belief that central banks only fight inflation is blatantly wrong. **The ECB has never just been implementing price stability: it shapes markets and defines a government's fiscal space.** Future fiscal expansion will likely require close coordination between monetary and fiscal policy.

BEYOND PRICE STABILITY: MONETARY POLICY IS NOT NEUTRAL

The ECB's mandate was drafted thirty years ago and focuses narrowly on preventing inflation. To avoid criticism and uphold the narrow mandate, the ECB claims its monetary policy is market neutral. However, **central bank interventions are by definition not neutral**[4]. They shape market outcomes by selecting some markets to intervene and allowing certain assets as collateral. For example, the ECB's decision to rely on repo markets for implementing their monetary policy has promoted the growth of the unstable shadow banking system.[5]

Contrary to common belief, central banks are not as independent as one might think. Government's fiscal policy directly affects the available monetary policy options. If a government is running austere fiscal policy this automatically puts central banks into a more active role having to prevent deflation. Because of the lack of a joint fiscal EU institution, it was the ECB that had to intervene at the beginning of the pandemic.

SO THE ECB IS ALREADY MAKING SIGNIFICANT CHOICES, HOWEVER WITHOUT A CLEAR MANDATE OR DEMOCRATIC LEGITIMATION.
THEREFORE, IT IS TIME TO RETHINK ITS ROLE.

REGULATE SHADOW BANKING AND STABILIZE THE FINANCIAL SYSTEM

One of the major reasons that central banks have become a crisis fire-fighter are inherently unstable financial markets. **Due to insufficient financial regulation, central banks have had to intervene multiple times to prevent a collapse of the financial system.** During the great financial crisis and the pandemic, central banks provided liquidity to commercial

4 Colesanti Senni, Chiara and Monnin, Pierre (2020): Central Bank Market Neutrality is a Myth, Council on Economic Policies. https://www.cepweb.org/central-bank-market-neutrality-is-a-myth/

5 Braun, Benjamin (2020): Central banking beyond inflation, Transformative Responses Policy Brief. https://transformative-responses.org/wp-content/uploads/2021/01/TR_Report_Braun_FINAL.pdf banks and unregulated shadow banks, acting as market maker of last resort. On both occasions, they stepped in to safeguard the real economy. While this is likely a necessary crisis response, it has created moral hazard and rewarded risk-taking. Much of the turmoil in bond markets in March was due to highly leveraged trades by hedge funds.[6] Once central banks intervened, they did not only stabilise the government bond market, but also bailed out a number of hedge funds. Such effects can and must be prevented.

THE ECB COULD MAKE GREEN LENDING MUCH MORE AFFORDABLE FOR SMALL BUSINESSES AND HOUSEHOLDS AND ASSURE THAT POLLUTINGCOMPANIES DO NOT BENEFIT FROM LOW INTEREST RATES.

Excessive risk-taking and liquidity crises are still a major problem for shadow banks such as money market funds or hedge funds. **Providing minimal liquidity provisions and stress tests for shadow banks would restrict the need for central banks to stabilize the financial system.** Stricter leverage ratios for both commercial and shadow banks would reduce risk. Furthermore, the mismatch between funds' asset liquidity and their redemption policies needs to be addressed, as ECB board member Isabel Schnabel argues.[7] Establishing a European Financial Supervision separate from the ECB that also supervises shadow banks would provide agency.[8] Additionally, lessening the reliance on the US dollar and increasing the Euros relevance by improving the Eurozone's institutional architecture is crucial to improve financial stability. Larger joint denominated Eurozone debt could provide significant benefits by serving as a safe asset and could overall weaken the dependence on the Federal Reserve and their swap lines. Furthermore, central banks need to understand that their monetary policy affects the amount of available collateral.[9]

6 Tooze, Adam (2020): Revisiting The Role of Hedge Funds In The March 2020 Treasury Market Turmoil, Chartbook Newsletter #7. *https://adamtooze.substack.com/p/chartbook-newsletter-7*

7 Schnabel, Isabel (2020): COVID-19 and the liquidity crisis of non-banks: lessons for the future, Speech at the Financial Stability Conference on "Stress, Contagion, and Transmission" organised by the Federal Reserve Bank of Cleveland and the Office of Financial Research *https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp201119_1~4a1ff0daf9.en.html*

8 Vestergaard, Jakob and Quorning, Stine (2020): Establishing a European Financial Supervision Agency, Foundation for European Progressive Studies. FEPS Policy Brief March 2020. *https://www.feps-europe.eu/attachments/publications/vestergaard%20establishing%20a%20european%20financial%20supervision.pdf*

9 Sissoko, Carolyn (2020): The Collateral Supply Effect on Central Bank Policy, SSRN. *https://ssrn.com/abstract=3545546*

TACKLING CLIMATE CHANGE

Climate risks are a major threat to financial stability. Natural disasters induced by climate change can bring down the entire financial system[10]. It is good news that central banks increasingly acknowledge such risks and discuss measures to increase resilience, for instance in the Network for Greening the Financial System (NGFS). Here, the European Central Bank could use its supervisory role and the envisioned climate stress tests for banks to penalise polluting.[11] This in turn would make green lending more attractive. However, central banks should do even more. We believe that **there is a role for central banks that goes beyond price stability**. Central banks need to acknowledge the distorting effects of their policies and counter them. It has been shown, for instance, that the ECB's asset purchases are biased towards carbon-intensive companies.[12] Market neutrality is a myth.[13] The EU taxonomy for sustainable activities could be used as a guideline for an alternative framework.[14]

The good news is: concrete proposals on how to align the ECB's monetary policy with the low carbon transition are ready to go. European central bankers already agree that the asset portfolio that the ECB owns for monetary policy purposes should better reflect climate risks.[15] The ECB should start implementing this policy now. The ECB could, in addition, incentivize private banks to lend more money for green investments. By tweaking its Targeted Longer-Term Refinancing Operations (TLTROs) programme, **the ECB could make green lending much more affordable for small businesses and households**[16] **and assure that polluting companies do not benefit from low interest rates.**[17]

Similarly, they could **start reducing the carbon footprint of their corporate quantitative easing (Q.E.) programmes**[18]. The ECB could stop buying bonds issued by fossil fuel companies and by companies with relatively high carbon intensity that belong to the energy-intensive, non-renewable utilities and carbon-intensive transportation sectors. Instead, the ECB would purchase bonds of potentially green and renewable sectors, as well as green bonds and bonds of 'other' non-carbon-intensive sectors. Implementing this would not only be in line with the climate emergency we are currently facing, but would also support climate-related financial stability objectives.

10 Financial Stability Board (2020): The implications of climate change for financial stability. *https://www.fsb.org/2020/11/the-implications-of-climate-change-for-financial-stability/*

11 Lehmann, Alexander (2020): Climate risks to European banks: a new era of stress tests, Bruegel Blog Post. *https://www.bruegel.org/2020/02/climate-stress-test/*

12 Dafermos , Yannis, Gabor, Daniela, Nikolaidi, Maria, Pawloff, Adam and van Lerven, Frank (2020): Decarbonising is easy - Beyond market neutrality in the ECB's corporate QE, New Economics Foundation. *https://neweconomics.org/2020/10/decarbonising-is-easy*

13 van 't Klooster, Jens and Fontan, Clément (2020). The Myth of Market Neutrality: A Comparative Study of the European Central Bank's and the Swiss National Bank's Corporate Security Purchases. New Political Economy. *https://doi.org/10.1080/13563467.2019.1657077*

14 European Commission (2020): EU taxonomy for sustainable activities: Works in view of the establishment of an EU classification system for sustainable activities, i.e. an EU taxonomy, European Commission Website, accessed 10/03/2021. *https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en*

15 Weidmann, Jens (2020): Combating climate change – What central banks can and cannot do, Speech at the European Banking Congress *https://www.bundesbank.de/en/press/speeches/combating-climate-change-what-central-banks-can-and-cannot-do-851528*

16 Colesanti Senni, Cihara (2020): The Case for Climate Objectives in Central Banks' Targeted Refinancing Operations, Council on Economic Policies. *https://www.cepweb.org/the-case-for-climate-objectives-in-central-banks-targeted-refinancing-operations/*

17 van 't Klooster, Jens and van Tilburg, Rens (2020): Targeting a sustainable recovery with Green TLTROs, Positive Money. *https://www.positivemoney.eu/2020/09/green-tltros/*

TEMPERING INEQUALITY AND TARGETING THE REAL ECONOMY

Similar to fighting climate change, the ECB needs to acknowledge how its policies affect inequality and take action in this regard. When the ECB implements an expansionary monetary policy, it wants to stimulate demand in order to raise prices and ensure price stability. However, the ECB is heavily relying on financial markets to pass on lower interest rates. This indirect mechanism arguably leads to massive distortions by rising stock and real estate prices which increase inequality. This explains why stock markets recovered so quickly after March 2020 in comparison to the real economy.[19] **The transmission channel via financial markets disproportionately raises financial wealth**, as it drives prices of financial assets and real estate, which arguably increases wealth inequality.[20]

There are multiple ways that this inequality through monetary policy could be tempered; all of them focus on transmitting monetary policy more directly to households, by supporting employment and wages. These policies are the most effective when they reach **lower income households**, which are the most likely to increase their demand after a monetary stimulus. This direct impact on demand through wage income, especially through low-income households, would increase the ECB's ability to fulfil its inflation target and decrease inequality at the same time. Direct monetary transfers are the shortest way for central banks to reach households. Technically, such direct transfers can be done through the government or via commercial bank accounts as well as by using the newly discussed central bank digital currency.

Another way of targeting the real economy instead of the financial sector is **to focus on the productive sector and increasing employment.** This could be done via **government owned development banks such as the European Investment Bank (EIB).** These banks can steer investment in infrastructure projects such as a trans-continental European railway system, new Europe-wide electric grids, or hydrogen infrastructure.
If the ECB bought a large amount of the EIB's bonds, it would finance sustainable projects in the real economy, which would not only stimulate growth and rising prices, but also help pave the way towards the social-ecological transformation.[21] In this way, the ECB could support the creation of sustainable projects that pay decent wages. But how are these new tasks compatible with the democratic legitimacy of these powerful institutions?

18 Dafermos , Yannis, Gabor, Daniela, Nikolaidi, Maria, Pawloff, Adam and van Lerven, Frank (2020): Decarbonising is easy - Beyond market neutrality in the ECB's corporate QE, New Economics Foundation. *https://neweconomics.org/2020/10/decarbonising-is-easy*
19 Bank for International Settlements (2020): Markets rise despite subdued economic recovery, BIS Quarterly Review, September 2020. *https://www.bis.org/publ/qtrpdf/r_qt2009a.pdf*
20 Bikas, Konstantin and Livingstone, Zack (2020): Money We Trust: Designing Cash's Digital Counterpart, Positive Money. *https://positivemoney.org/wp-content/uploads/2020/04/Positive-Money-Money-We-Trust.pdf*

SPECIFYING THE MANDATE AND ENSURING DEMOCRATIC ACCOUNTABILITY

The European Central Bank has become the key actor in the EU's economic policy. National governments and the European Commission are increasingly reliant on its policy decisions. Its growing influence has raised questions regarding the ECB's democratic legitimacy. Whereas the ECB's independence in implementing monetary policy should not be changed, its growing influence requires an improved democratic legitimation.

The ECB lacks a clear mandate as to how to support the EUs core policies as specified in the treaties, in line with the EUs commitments under international law in the Paris Agreement. Its programmes derive their democratic legitimacy from a decades-old mandate, which does not address many choices it faces today. Going forward, it is **unlikely that the ECB will be able to contribute effectively to the EU's environmental and employment objectives without more formal backing**, setting it up for new legal challenges. However, there are tools within the existing EU Treaty to provide ECB operations with a formal legal basis.[22]

THE PARLIAMENT COULD USE THIS OPPORTUNITY TO FORMALIZE ITS ROLE IN INTERPRETING THE ECB MANDATE.

To add legitimacy for the ECB acting on its secondary objectives, a formal procedure should be developed in order to specify and prioritise the policy goals that the ECB should pursue. Both the Council and the European Parliament should be involved in such a process. **The Parliament could use this opportunity to formalise its role in interpreting the ECB mandate**, for example through provisioning that it should vote on a ranking of the most important secondary objectives of the ECB every five years. It could also conclude that the annual parliamentary resolution on the ECB as well as the quarterly parliamentary hearings with the ECB president should function as regular checks on the delivery of the thus-interpreted mandate.

21 Van Tilburg, Rens and Simic, Aleksandar (2020): The new unconventional: fiscal and monetary policy options for the eurozone in times of economical, political and climate crisis, Sustainable Finance Lab. *https://sustainablefinancelab.nl/wp-content/uploads/sites/334/2020/04/SFL-The-New-Unconventional-2.pdf*

22 van't Klooster, Jens (2020): The ECBs conundrum and 21st century monetary policy: How european monetary policy can be green, social and democratic, Transformative Responses Policy Brief *https://transformative-responses.org/wp-content/uploads/2021/01/TR_Report_vant-Klooster_FINAL.pdf* and
de Boer, Nik and van , t Klooster, Jens (2020): The ECB, the Courts and the Issue of Democratic Legitimacy After Weiss. Common Market Law Review, volume 57 issue 6, 2020. *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3712579*

Furthermore, the appointment process for the ECB and the national central bank governors requires a stronger role for the European Parliament in order to improve gender-balance and legitimacy of decision-makers. As a starting point, the European Parliament should live up to its own decisions and insist on gender-balanced shortlists of at least two candidates wherever its consent is required and otherwise veto the nomination[23].

THE MACRO-FINANCIAL ROLE OF GOVERNMENT DEBT

It is crucial to **revisit the ECB's role in light of the social-ecological transformation**. As its influence has massively expanded and its balance sheet grown, we should ask for the precise reasons for its interventions. Is there lack of regulation? A lack of fiscal policy? Central banks are once again buying large amounts of government debt. While currently borrowing costs remain low, it is unclear what the ECB will do once inflation returns. Will quantitative easing continue? Or will debt servicing costs limit any room for discretionary fiscal spending?

The macrofinancial regime we live in requires central banks to play an active role in markets, especially sovereign bond markets, to meet their price stability mandate. Central bank reviews of monetary policy frameworks – ongoing in the Eurozone and the United States – must recognise that the macro-financial role of government debt requires an explicit framework for coordination between the monetary and fiscal authorities.[24] The rise in government debt will only increase the interdependence of monetary and fiscal policy. Sovereign debt and monetary policy are not to be conceived as independent from one and another. Coordinating monetary and fiscal policy along green objectives could provide a path forward.

CONCLUSION

The ECB has become a key economic actor faced with a wide range of challenges and decisions. The current strategy review is the moment to establish a comprehensive agenda for the ECB in light of the social-ecological transformation towards a resilient, equitable and climate friendly economy.

23 European Parliament (2019): Resolution of 14 March 2019 on gender balance in EU economic and monetary affairs nominations (2019/2614(RSP)) *https://www.europarl.europa.eu/doceo/document/TA-8-2019-0211_EN.html*

24 Daniela Gabor (2020): Revolution without revolutionaries: Interrogating the return of monetary financing, Transformative Responses Policy Brief *https://transformative-responses.org/wp-content/uploads/2021/01/TR_Report_Gabor_FINAL.pdf*