CHAPTER 7

Conclusion: Going Forward—What Are the Political and Economic Challenges Ahead?

7.1 Introduction

In this chapter, we discuss the future economic and political pressures on the ECB, by picking up on the tensions laid out in the preceding chapters of the book. First, we identified significant policy challenges and how the ECB has resolved these post crisis (Chaps. 2 and 4). Second, we identified tensions between the principles of democratic legitimacy and the ways they have been challenged in the EU’s multi-level system of governance, particularly during the financial crisis (see Chap. 3). Third, we identified tensions between popular opinion and the macroeconomic policies carried out in the EU (see Chaps. 5 and 6). These latter two dimensions refer to the two aspects of legitimacy mentioned previously, that is, the accountability and transparency of monetary policy-making (throughout legitimacy) and the accordance with citizen’s values (perceived legitimacy). On this basis, after a detailed discussion of the major economic and political challenges ahead, we argue that the current approach to crisis management cannot be sustainable. We argue that a technocratic and complicated European Union (EU) and—even more so Economic and Monetary Union (EMU)—cannot operate successfully when populist forces in its member states increasingly seek to assert their sovereignty and mobilise against the monetary union. Going forward, this may require filling the institutional void at the E(M)U level and equip it with a more democratic framework. In this chapter, we specifically discuss the possible scenarios
going forward in both economic terms and regarding the basic institutional design, all of which may warrant a more defined role of the ECB and an eventual normalisation of monetary policy.

### 7.2 Political Challenges for the ECB in the Post-Draghi Era

With Mario Draghi bowing out from the ECB presidency in November 2019, a new era under the aegis of Christine Lagarde, former French minister of finance and managing director of the IMF, has officially begun. While the new president has widely been expected to pursue similar policies to her predecessor, the politics surrounding her presidency may well play out quite differently throughout her eight-year term at the central bank. Indeed, as became clear already in the final days and weeks of Draghi’s presidency, the euro area’s monetary policy has become more contested and politically salient than hardly ever before.

The nomination of Lagarde—brokered by French President Emmanuel Macron as part of a wider nomination package in the aftermath of the 2019 European Parliament elections—caught most expert observers off-guard, who had already placed their bets on an all-male group of national central bank governors, including Jens Weidmann (from the German Bundesbank), François Villeroy de Galhau (from the Banque de France), Erkki Liikanen, and Olli Rehn (from Finland’s Suomen Pankki). In the end, however, a former politician made the cut, and so the search was on instantaneously to identify Lagarde’s potential monetary policy preferences (see, e.g., SPIEGEL 2019). A consensus emerged that the new president was likely to favour the expansive monetary policies of her predecessor and be willing to act as decisively and pragmatically in case of another shock, brokering the necessary support coalitions within and beyond the central bank; the latter also given her political nous and close contacts with the key European heads of state and government. Lagarde herself appeared to confirm this view during a well-prepared and convincing performance at her nomination hearing in front of the European Parliament’s ECON Committee (European Parliament 2019).

The crucial question, however, may not so much be about the incoming president’s willingness—or better yet courage (Bernanke 2015)—to act, but about whether the technical and political circumstances will allow

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1 This section draws substantively from Diessner (2019a) and, in particular, Diessner (2019b).
her to do so. On the technical side, observers are increasingly wondering whether the ECB’s policies are running out of ammunition and whether the scope for future innovation is exhausted (see Sect. 7.2), in the face of stubbornly subdued inflation far from the central banks’ self-defined target of “below, but close to, 2%” (see Macchiarelli et al. 2019). During the final months of his presidency, Mario Draghi’s most poignant farewell message has thus been that the activation of other policies, most notably fiscal policy (Begg 2019), is needed to help the ECB reach its aims as well as revive growth “faster and with fewer side effects” (Draghi 2019a, c), thereby relieving the central bank from being “the only game in town” (Diessner 2018a).

While such nudging of euro area governments already played an essential part in the ECB’s signalling at the height of the crisis—despite the central bank’s widely assumed preference for fiscal austerity—these calls have further intensified now that the problem is not anymore one of near-imminent financial collapse, but of persistently low inflation and growth (see Diessner and Lisi 2019). The crux for the technocratic ECB, however, is that fiscal and other government policies remain firmly in the realm of national electoral and executive politics. Habitually churning out advice on such delicate matters may thus easily be perceived as undue meddling by the central bank in political affairs—which, in turn, could invite political interference (Jones and Matthijs 2019). On top of this, it remains uncertain whether governments will ultimately feel compelled to listen to the central bank’s pleas or not (Jones 2019).

Arguably the most pressing political-economic challenge for the future ECB, then, is neither the central banks’ preferences for monetary nor their preferences for fiscal policy alone, but its views on the extent to which monetary-fiscal coordination can be achieved in light of its far-reaching political independence (see Alloza et al. 2017; Diessner 2019a). Indeed, it is expected that future crisis interventions by major central banks across the globe will require such coordination given the exhaustion of both conventional and unconventional tools (Bartsch et al. 2019a, b; Roubini 2019). The ECB is likely to contemplate these challenges in a strategic review of its policy framework to take place during the first year of Lagarde’s term, which was first confirmed at Mario Draghi’s penultimate press conference (Draghi 2019b).

With ever more stakeholders coming to the fore and voicing preferences for the conduct of monetary policy, the ECB’s strategic review will have to achieve a careful balancing act between being as inclusive as
possible while maintaining the central bank’s (formal) independence. Besides, the ECB will likely need to engage not merely with monetary policy experts, but also with the wider general public and civil society. Here, the engagement with the political establishment and general public of the euro area’s largest economy, Germany, will be one to pay particular attention to. To be sure, this is not simply a task for the ECB president alone, but also for her counterparts in the Executive Board and Governing Council as well as beyond. To this end, president Lagarde can be expected to increasingly rely upon the German nominee for the Executive Board, financial economist Isabel Schnabel, who has not shied away from public debate in the past and who has put forward both a measured defence and critique of the ECB’s actions through various channels (including her Twitter feed). However, whether the national central banks and their governors on the ECB Governing Council will act as translators and defenders of the ECB’s policy stance or as amplifiers of national disagreements will need to be watched very closely (as we have highlighted in the previous chapters).

As discussed in Chap. 5, one significant supranational political counterpart of the ECB—or perhaps even ally, not least since the crisis (Torres 2013)—has been the European Parliament and its ECON committee. While exchanges between successive ECB presidents and MEPs during the Monetary Dialogues have been seen as a cornerstone of the ECB’s accountability (Fraccaroli et al. 2018), these arrangements leave ample room for improvement and should come to be reviewed and overhauled during Lagarde’s tenure as well. A key challenge here will be to balance two seemingly opposing needs. On the one hand, the ECB has broadened its policies and is actively nurturing discussions about non-monetary policy issues. On the other hand, a further specialization of the Committee’s work has repeatedly been identified as important for holding the central bank to account more succinctly (see, e.g., Claeys et al. 2014). Striking this balance between generalization and specialization—for example by means of forming a sub-committee on monetary policy (Jourdan and Diessner 2019)—will be a task for the newly elected ECON committee and its chair, Italian economist Irene Tinagli from the Socialists & Democrats group.

Despite the comparatively large size of the ECON committee (ibid.), Collignon and Diessner (2016) suggest that in the past the success of the Monetary Dialogue for the ECB’s political accountability has tended to hinge on the active engagement of only a few committed MEPs. Who, then, are the parliamentarians whom Christine Lagarde will be facing throughout
the first half of her presidency (i.e., until the EP elections in 2024)? In addition to some of the veterans of the Monetary Dialogue (such as the Green MEPs Philippe Lamberts and Sven Giegold or Conservative MEP Markus Ferber) the 2019 EP elections swept in a number of new members who are worth watching and who may well give the ECB staff preparing Christine Lagarde an interesting time ahead of the hearings.

While a number of former ECON committee members have gone on to become central bankers themselves (such as Sylvie Goulard at the Banque de France, Burkhard Balz at the Bundesbank, and Elisa Ferreira at the Banco de Portugal), the reverse seems true this time around, with former president of the Bank of Poland (and former prime minister), Marek Belka, as well as former Czech National Bank, deputy governor Luděk Niedermayer, among the MEPs facing Lagarde (the latter now being vice-chair of ECON committee). Another expert member to be reckoned with is economics professor Luis Garicano, who also coordinates the committee’s liberal Renew group. On the far-right end of the spectrum, law professor Gunnar Beck is taking over from ex-MEP and AfD founder Bernd Lucke as chief europhobe of the committee.

Political accountability, however, is a multi-way street (Collignon and Diessner 2016). While these MEPs and their colleagues will formally be in charge of scrutinizing the ECB politically, citizens and civil society organisations will need to do likewise with MEPs. It remains to be seen whether, in addition to a review of the ECB’s policy framework, the ways in which the central bank is held to account will evolve in the process as well. In light of the mounting political challenges ahead, it seems wise for the new ECB president to be proactive in this regard. Finally, it will prove decisive if the institutional setting in the EU’s fiscal, economic, and monetary policies can be reformed in such a way as to enable a better legitimacy and more democratic accountability, as we argue.

7.3 Monetary Policy Challenges and the ECB’s Ammunition in the Post-Draghi Era

During Mario Draghi’s presidency, the range of tools and measures the European Central Bank has adopted expanded significantly. On top of the necessary macro-financial adjustments since 2008–2009, there have been several downward revisions in inflation and inflation expectations in recent

2 This section draws, for the most part, on Macchiarelli et al. (2019).
years (Lane 2019). In this context, the ECB has found itself forced to expand its standard toolkit even further, including extending the range for the policy rate into negative territory; enhancing communication and forward guidance to focus on the medium-term inflation goal (see Blinder et al. 2008; Eser et al. 2019); buying private and public debt securities as part of the Expanded Asset Purchase Programme (EAPP); and finally, Targeted Long-Term Refinancing Operations (TLTROs) mainly to enhance bank lending to the real economy (Chap. 2).

The observed extent of stubbornly low inflation expectations certainly poses a challenge in terms of consistently and proactively responding to changes in macroeconomic conditions that might delay convergence to the ECB’s (medium-term) inflation objective. To this end, in a world of subdued growth prospects (i.e., secular stagnation, as popularised by Harvard economist Larry Summers), forward guidance is regarded as a crucial ingredient to providing the necessary state-contingency of policy to revive the euro area economy (for a discussion, see Chap. 2 and Carney 2019). It is vital, at the same time, that the central bank maintains the most effective tools to deliver on its mandate, including the possibility of using its balance sheet proactively whenever necessary. The decision of Draghi’s Governing Council of 12 September 2019, before passing the torch to Christine Lagarde, to restart its net purchases under the asset purchase programme “for as long as necessary to reinforce the accommodative impact of its policy rates” underscores this necessity.

Once these measures have been implemented, however, the question will be which other instruments the ECB still has in its arsenal and which limits to the monetary policy stimulus may exist. Indeed, the euro area is continuing to face significant uncertainties (including a looming trade war, the implementation of Brexit, the ECB’s future stance, the current/future US macroeconomic stance and, lastly, COVID-19). The ECB has done much to improve the monetary policy transmission mechanism and reduce financial market volatility. Yet, it seems that pessimism, reinforced by political risk, is still on the high-side, as confirmed by inflation expectations and other standard indicators for confidence. Some even see a looming threat of “Japanification” for the euro area (see Lenoël et al. 2020).

While the financial side of the EMU looks more stable—that is, banks have continued the deleveraging process—on the real side, there is a consensus that reforms are needed at individual member state level, in order not to waste the opportunity created by the ECB’s ultra-accommodative support. Over recent years, policy seems to be mainly focusing on
government spending, which in turns raise the issue of public debt sustainability and compliance with the fiscal rules of the EMU, as suggested by the recent Italian stand-off with the European Commission over its deficit (see Macchiarelli 2018). Whenever and if the ECB will phase out quantitative easing, we should reflect on the fact that demand stimuli alone will not resolve the situation of having the euro area stuck in a slowing growth environment. Without further structural and fiscal reforms, the euro area’s economic activity risks to remain relatively anaemic—also in the context of demographic and “secular” factors. In this vein, it will be important to ask whether (some) member states missed an opportunity for reform (hence, the risk of a “lost decade”) and, if so, what is the role of fiscal policies in the euro area. The suspicion is that although the ECB’s monetary policy instruments will not change “in principle”, the ECB president Christine Lagarde may want to pass the ball more strongly to national governments.

In any scenario, and in light of increasing difficulties to reach its medium-term inflation target in a self-sustained fashion, the ECB is likely to face calls for continued monetary stimulus. In this context, Lilley and Rogoff (2019), as well as previously Goodfriend (2000), have called unconstrained negative interest rate policy “the most elegant and stable” solution to the zero lower bound constraint to monetary policy (i.e., the idea that nominal rates should not be allowed to fall below zero; see also Demiralp et al. 2017; Woodford 2012). The ECB could embark into ever more negative interest rates and, by so-doing, potentially relieve the government from using national fiscal policy (public expenditure or taxation). In fact, as discussed in Chap. 3, should the central bank pour liquidity into the system, this may relieve national fiscal policies from intervention, at least as long as the monetary stimulus persists (see Baldo et al. 2017). The appropriateness of these and any risks, however, shall be discussed below.

On the other hand, in August 2019, a Blackrock proposal has pushed the discussion in a different direction, reviving the debate about the proposal of “helicopter money” evoked in 1969 by Milton Friedman. Outright money creation to support aggregate demand is understood as an effective way of providing liquidity directly to households and businesses without generating new debt. This hypothesis would mean the disbursement of funds by the ECB, either directly, or indirectly through intermediate bodies such as the European Investment Bank (EIB), to firms and consumers. This is a discussion that has long been ongoing but it strongly clashes with
the Treaty on the Functioning of the EU (TFEU): since the ECB does not have the mandate to give money away directly to institutions other than banks, merely exchanging one asset for another (in respect of Article 123 TFEU which prohibits direct monetary financing of public debt), helicopter money would presumably need to be backed by an explicit fiscal agreement (see Sect. 7.4).

Finally, an aspect to discuss will be whether low inflation targets create the risk of persistence of recessions and low growth, thus requiring a lift of the optimal inflation target to achieve the anchoring of expectations and stabilization in a context of structural changes and demographic shifts.

In the previous chapters, we have outlined the effectiveness of the measures adopted so far. Next, we reflect on how the effectiveness—as well as limits—of these instruments could provide leeway for further easing. In all of this, we note that limits, both political and credit-risks’ related, do exist which may discourage a more aggressive use of quantitative easing (QE). To this end, this section first reviews the frequently held assertion that monetary policy is “out of ammo” and then discusses different policy options still available to independent central banks (Sect. 7.3.1). The next sub-section explores the potential credit and political risks associated with these options (Sect. 7.3.2). In doing so, both sub-sections also take the experience of other major central banks into account, where appropriate.

7.3.1 Expanding the Monetary Stimulus by Increasing the Risks: Several Alternatives

An assertion that is often heard in both academic and public debates is that monetary policy has been “stretched to the limit” since the financial and euro area crises and that central banks therefore increasingly find themselves ‘out of ammo’ (e.g., Bartsch 2019). At least in theory, however, the ECB’s toolkit is arguably far from exhausted (see also De Graauwe and Diessner 2020). Generally speaking, the majority of policy options that are currently still available to central banks may fall into the following three categories, namely

1. further cuts to interest rates,
2. a resumption and extension of asset purchases as well as changes to the technical rules governing those purchases, and

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3 See, for example, Van Riet (2017).
3. direct cash transfers to economic agents or other measures of outright finance via the central bank’s balance sheet (also referred to as “helicopter money” or central banks “going direct”, respectively).

The first two have been announced with the September 2019 Governing Council decision, and this sub-section focuses on the second category, in particular, renewing and extending asset purchases as well as amending the rules which govern these purchases. Nevertheless, some of the consequences of a further expansion of the Eurosystem’s consolidated balance sheet discussed in the next section equally apply to the question of outright cash transfers as well (“helicopter money”).

In the context of the euro area, in particular, the second category entails two main avenues which merit further scrutiny:

- the extension of asset purchases—particularly in the realm of corporate sector bonds—as well as the purchase of other risky private assets, including equities; and
- raising or lifting the issuer and issue limits of the Public Sector Purchase Programme (PSPP) as instated by the ECB Governing Council and/or deviating from the Eurosystem’s so-called capital key.

In June 2018, the ECB Governing Council announced that it would seek to end net purchases under its Asset Purchase Programme (APP) at the end of 2018 (see ECB 2018a). In December of the same year, it further specified its intention to “continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when we start raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation” (ECB 2018b). This is illustrated by the cumulative net purchases discussed in Chap. 2, which displays how the pace of net asset purchases had already gradually declined throughout 2018. As a result, the size of the Eurosystem’s consolidated balance sheet had essentially stagnated since the beginning of 2019.

The meeting of 12 September 2019 confirmed that the ECB Governing Council had the discretion to resume net asset purchases at any point in time, if warranted in light of its primary objective to maintain price stability. This view has been vindicated not least by the ruling of the Court of Justice of the European Union of December 2018 (CJEU 2018). A potential obstacle to a further expansion of net asset purchases in the future, however,
may lie in the ECB’s very own limits which it had placed on the PSPP. In light of this self-limitation, a conceivable alternative would be to focus on expanding net purchases in the other facilities of the APP as well as venturing into different asset classes. The most obvious candidates in this regard—given the relatively wide range of assets already purchased by the ECB—would be equities (such as Exchange-Traded Funds, ETFs) on the one hand, as well as bank bonds on the other. This leaves monetary policymakers with at least two broad avenues in terms of future iterations of QE.

First, with regard to expanding purchases in APP facilities other than the public sector, most of the potential seems to lie in bond purchases under the Corporate Sector Purchase Programme (CSPP). The ECB’s holdings of around €178 billion of corporate bonds, as of November 2019, indeed remained far below the universe of eligible, investment-grade assets, which are currently estimated at around €700 billion with an additional €150 billion to be issued per year in the future (van den Broek and Brzeski 2019). Similarly, in terms of purchasing bank debt in particular, research conducted by ING suggests that the universe of eligible bank bonds currently stands at around €300 billion, with annual issuance projected to be at around €100 billion (ibid.). In past reports, the ECB has repeatedly signalled a preference for corporate bond purchases (see ECB 2018c, d), while civil society and academics have suggested that these should be geared more directly towards investments in green bonds (Jourdan and Kalinowski 2019; Battiston and Monasterolo 2019). Importantly, market participants seem to increasingly expect CSPP purchases to play a greater role in future constellations of euro area QE (Reuters 2019).

Second, with regard to equity/ETF purchases, these would mark uncharted territory for the ECB, whereas other central banks have already embarked on such operations in the past, including, most prominently, the Bank of Japan, the Bank of Israel and the Swiss National Bank. While the jury is still out as to the effectiveness of increased stock-buying by central banks (see also Chap. 2; Altavilla et al. 2014, 2015; Nangle and Yates 2017; Shirai 2018), global purchases have reached around €1 trillion over the past years, notwithstanding a bout of stock market corrections particularly during 2018 (OMFIF 2019a, b). Similarly to the above, the purchase of equities is generally considered “riskier” for central banks than QE programmes (when restricted merely to the purchase of government securities) and hence, to date, such purchases have not been contemplated by the ECB.

Importantly, when announcing the Public Sector Purchase Programme in January 2015, the ECB Governing Council specified that the total
amount of bonds purchased would be capped at 25% of a given issue and that there would be an aggregate holding limit of 33% per issuer (see, e.g., Van Riet 2017: 16). Interestingly, the issue limit was subsequently raised to a total of 33% as well, namely in November 2015. The main idea behind the instalment of these ceilings was twofold. On the hand, the issue limit was deemed to ensure that the ECB would not have a blocking minority in a debt restructuring event, in which case collective action clauses in government bond contracts would be activated. On the other hand, the issuer limit was seen to ensure that the ECB would not become a dominant creditor in any one government bond market in the euro area (ibid.). This meant that the APP purchases interacted with previous purchases, so that the allowance for some countries who previously benefited from the SMP, for instance, was reached earlier rather than later.

Another striking feature of the PSPP is that it is, for the most part, conducted through the balance sheets of euro area National Central Banks (NCBs), broadly in accordance with the Eurosystem’s capital key which underwent its most recent quinquennial adjustment in December 2018 (see Diessner 2018b). Hence, the ECB’s own exposure to those acquisitions was limited to 8% at the beginning of the programme, by exploiting the federal nature of the Eurosystem: the capital keys were meant to serve as a guidepost for the allocation of monthly purchases between member states (with the notable exclusion of Greece; see also Gerba and Macchiarelli 2016a, b). In reality, however, public sector bond purchases have come to deviate from the key to some extent, and in a number of cases substantially, as illustrated in Fig. 7.1. The ECB has explained these deviations by pointing to the increasing unavailability of bonds in a number of jurisdictions, which consequently had to be offset by increased purchases in other jurisdictions (ECB 2019a).

Nevertheless, the Governing Council has faced calls to raise or even overthrow the self-imposed issue and issuer limits on the PSPP and to reconsider its adherence to the capital key. The ECB itself assumes to have broad discretion over these limits.\(^4\) Indeed, the central bank exercised

\(^4\) In the words of ECB Executive Board member Benoît Coeuré: “the ECJ has also affirmed the principle that we should have broad discretion in designing our instruments. (…) We already have some degree of freedom across securities. For instance, we already buy up to 50 per cent of supranational bonds, while for individual sovereigns the limit is lower” (ECB 2019b).
such discretion both when instating the thresholds in January 2015 and when raising the issue limit from 25% to 33% later on in November 2015.

After the ECB Governing Council meeting of 12 September 2019, ECB president Mario Draghi revealed that there was “no appetite” among members of the Governing Council to raise the limits despite a resumption of asset purchases on an open-ended basis (ECB 2019c), which raises pertinent and unresolved questions about the actually feasible duration of these purchases (Collomp 2019). Moreover, the president also communicated during the Q&A on 12 September that the composition of asset purchases would remain broadly unchanged—or, in other words, that there would be no larger role for private asset purchases in the APP than there had been before. Considerations about the potential risks associated

Fig. 7.1  Deviation in the share of net cumulative purchases from ECB capital key in January 2020 (%). (Source: Own elaboration based on ECB Economic Bulletin 2020)
with these and other purchases could well have been among the factors that played into this decision.

### 7.3.2 Credit and Political Risks

A key question for central banks across the globe is how to provide a necessary degree of monetary stimulus while signalling prudence with regard to risk-taking. As the crisis has underlined, central banks perform a crucial function as risk-takers and “balance sheets of last resort” in times of financial distress (Cour-Thimann and Winkler 2016). At the same time, central banks seem keen to avoid the impression of taking on excessive risk. Purchasing private securities or venturing into other asset classes is often perceived as carrying more risk than public sector purchases, not least in case a private entity defaults. Against this backdrop, most central banks have installed operational frameworks which pay increased attention to managing risks.\(^5\) Nevertheless, as former president Draghi warned during the Q&A after the ECB’s December 2018 press conference, “accidents may happen and they have happened in the past” (ECB 2018a). One example of such an accident were the losses accrued by the Eurosystem on bonds issued by South African retailer Steinhoff in January 2018, which were never fully disclosed.

Even though central banks generally do not see themselves as profit maximizers, avoiding balance sheet losses has been a conspicuous feature of independent central banking post-crisis (Diessner 2019a). The reasoning behind such loss aversion seems to be that posting losses would entail political risks.\(^6\) However—as we have pointed out in Chap. 6—, the actual political risk which a central bank faces is hard to assess and even harder to predict, and might at best be approximated as a combination of the political levers that exist to exert pressure on the central bank as well as the

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5 For an overview and discussion, see Bindseil (2016).

6 In the words of ECB Executive Board member Yves Mersch, for example: “First, central bank revenues are public funds, meaning any losses by central banks are losses for the public purse in each euro area country. Second, losses can affect the financial independence of central banks and therefore, potentially, their operational independence. Third, losses can harm our credibility and reputation in the eyes of the public, and thus their confidence in the central bank to maintain price stability” (ECB 2018e).
likelihood, and, even more so, willingness that these levers will actually be used.\footnote{In the case of the US Federal Reserve, for instance, the general assumption appears to be that if the central bank were to post a sizeable balance sheet loss, the political reaction on behalf of Congress would be far from favourable and eventually provoke retaliation.}

In order to protect themselves from political risks that may stem from posting losses in the first place, central banks across the globe have engaged in a range of strategies to safeguard their balance sheets. In the US, policymakers rely on an accounting procedure which enables them to book losses as a negative liability in the form of a so-called deferred asset (Federal Reserve Act, Section 7, 12 USC 290) which can be offset by future earnings, to the effect that the central bank will always post a profit in each given period. In the UK, the Bank of England received an indemnity during the crisis which ensured that QE operations would be conducted on a separate balance sheet fully backed by the Treasury. This arrangement was later formalized in a Memorandum of Understanding which includes an explicit recapitalisation scheme (HM Treasury 2018). In the euro area, the matter is less straightforward. Member State finance ministers have not provided the ECB with an explicit recapitalisation guarantee. The central bank instead relies on profit retentions and capital buffers, amongst others (Diessner 2019a).

While for some observers balance sheet and capital losses ought to be seen as accounting fictions which should not cause too much concern, others deem a situation of prolonged losses and negative capital unacceptable, as exemplified not least by the seemingly never-ending discussion around TARGET2 imbalances in the euro area (see, e.g., De Grauwe 2013; De Grauwe et al. 2017; Fuest and Sinn 2018; Whelan 2017). At a more general level, these questions tap into fundamental debates about the nature of central banks and the scope of central banking, as discussed further in the following sections.

7.4 The Future of the E(M)U

As emphasized throughout this book, while confidence and stability may slowly be returning to the euro area, the internal equilibria of the currency union remain fragile. The legacy of the last ten years is that, while some real economic convergence has been observed, the euro area has become more politically heterogeneous than before. This is because the crisis has
exposed the existing weaknesses of EMU, resulting in a “confidence crisis” that is much more profound than initially thought. Correlating with these factors, as we explored in Chap. 6, is the higher unemployment and inequality levels in stressed countries, particularly among younger generations, a heavier debt load for the private and public sector of several countries, and, until recently, a sizeable “deleveraging challenge” in various countries, as observed by the high levels of non-performing loans in the euro area banking sector (Macchiarelli et al. 2019).

One result of continued scepticism about the single currency has been the idea of a “fixed but not-irreversible” exchange rate regime, echoed by talks about a “two-speed euro”, one for the core countries and another for the periphery (see Campos and Macchiarelli 2018); the latter sometimes seen as an intermediate solution before complete disintegration (i.e., reverting to national currencies). Yet, as the ECB has emphasized several times, last after the Governing Council meeting of June 2018, the euro should be deemed “irreversible”. Indeed, even though there exists a complex institutional procedure for exiting the European Union (granted under Article 50 of the Lisbon Treaty), there is no explicit provision for relinquishing the euro as official currency. Moreover, the evidence suggests that while the euro may be associated with costs on the real economic side, particularly during the last decade (Puzzello and Gomis-Porqueras 2018), the (re-)introduction of another legal tender would deal a blow to the national banking system and have a severe scarring effect on sovereign access to finance, given the economic and, mostly, political implications the decision to leave the euro would entail—de facto and de jure a default.

Weighing the benefits and costs of membership in the EMU clearly depends on one’s preference for mutualisation. The costs and benefits of policies at the euro area level should be evaluated in terms of how they maximise the utility of the area jointly, beyond individual countries’ needs, as opposed to the utility of the euro area in the aggregate (i.e., Germany, plus France, plus Italy, plus Spain, etc.). The latter (aggregate) approach is what currently characterises the path to European integration. Debates around mutualisation have re-emerged forcefully at the onset of the 2010 sovereign debt crisis, with the rise of “debtor” and “creditor” nations (see De Grauwe et al. 2017; Chap. 3); the former seeing their market access

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8 Particularly as domestic assets and contracts would be redenominated, while foreign liabilities would remain in euros.
put at risk by financial speculation, the latter opposing any unconditional bail-outs in fear of moral hazard. In this sense, while the recent reforms of the European governance framework discussed in Chaps. 3 and 4 may not represent the “first-best” economically in terms of what would be needed for the euro area jointly, they represent, at the same time, what is currently feasible given the political constraints.

As we discussed in Chap. 2, due to the ECB’s exceptional support, financial fragmentation is overall receding even if rebalancing is yet to fully manifest itself in the real economy. In addition, some gains in competitiveness and exports have been observed, even though in many instances this happened through painful internal devaluation, that is, cuts in nominal unit labour costs (ULC), particularly in the periphery of the euro area (De Grauwe 2018). Against this backdrop, there is ever-growing debate about whether austerity has worked or whether it has in the end been self-defeating, as clearly fiscal restraint have come with social, political as well as economic costs (as discussed in Chap. 6). What is clear now is that there has been insufficient discussion about the trade-offs between fiscal consolidation and growth-oriented interventions, including reforms (see Blanchard 2019). At the time when austerity measures were adopted and internal devaluations of wages agreed—including the aforementioned MoU in the programme countries (Chap. 3)—, the risk of a euro area meltdown meant that decisions had to be taken rapidly. The persistent imbalances in several euro area countries spurred the Eurosystem into preventing an illiquidity (then insolvency) spiral, effectively leaving the ECB as the only executive able to “preserve the euro”. As argued previously, while consolidation is starting to work, deflation risks are still on the high side, and it remains doubtful whether the single currency would be able to survive without the ECB’s ultra-accommodative policies now.

7.4.1 What the ECB Can and Cannot Do

Christine Lagarde’s ECB will continue to play a pivotal role in the immediate to medium-term future of the euro. Indeed, the fate of the euro hinges on an autonomous central bank underpinning a single currency which can act as a shield against both external and internal (asymmetric) shocks, foster growth rebalancing and internal stability, and become a credible international reserve currency. Having said that, however, continued support by the ECB is a necessary but far from sufficient condition to sustain the euro area, which is still very different from the US or the UK
as a currency union. Since the centralised budget capacity remains small, the Union continues to have limited fiscal and financial backstops through the ESM, subject to conditionality, and the Single Resolution Fund, as part of the European Banking Union. Will these suffice?

Given the political resistance to full risk-sharing, the EMU is bound to remain focused on the monetary and financial side for the time being, and a large part of the risk-sharing will thus still have to come from financial markets. In this respect, access to finance and financial stability will remain key for the future viability of EMU. This is why the ECB under Lagarde is set to continue what Draghi has started. In other words, the availability in principle of monetary policy beyond the conventional stimulus is essential for the stability of the single currency. This, however, should not come at the expense of responsible national policies and further reforms. Some of those reforms have taken place under the impetus of the crisis in some countries. Going forward, however, the current inconsistent approach to crisis management leaves little alternative than a new coordinated fiscal approach in the long run (see Schlosser 2018), in combination with the strengthening of existing democratic institutions both at the EU level and in the member states, as we demonstrate in the next section.

We have argued that since the ECB ventured beyond its monetary policy role, this has opened a debate about what the ECB can and cannot do. We have illustrated that not only poor macroeconomic conditions but also a general poor understanding of what the ECB does (not least as the result of a lack of transparency) might be contributing to low popular support. In this regard, the recent Eurobarometer data suggest that, while a majority of euro area citizens supports the single currency, the ECB still enjoys little support. This constitutes a paradox: the lack of a shared political vision in the EU (what De Grauwe 2018, calls the “deep variable”) has made European citizens question the only institution which has stepped forward with policies geared at preventing a euro area meltdown: the European Central Bank. As such, the resolution of such a paradox will lie, primarily, not in reforming the ECB, but in complementing the single monetary policy with other macroeconomic tools and institutions that are better legitimised and show higher accountability. Certainly, if the EMU is to survive as an economic and not merely monetary project, this will require governance reform beyond the monetary realm.
7.4.2 Completing the Euro Area: From Austerity to Democratic Fiscal Integration?9

As an entity *sui generis*, the E(M)U is stuck in the middle between an international organisation and a nation-state. In fact, elements of a federal Europe, such as the Eurosystem which is federal in nature, coexist with elements of a confederal one, such as the European Council, which brings together the heads of state and government. The EU’s political system has been developing not only via Treaty changes but also in smaller and often incremental steps that created non-transparency and legitimacy deficits (see in detail Wiesner 2019). Our discussion in previous chapters has highlighted several deficiencies regarding the democratic legitimacy of the so-called crisis governance of the multi-level EU system. These are related to a significant imbalance in integration, with economic integration being more advanced than political and especially social integration, and with the euro area being differentiated from the EU non-euro member states. As discussed, the problematic effects of crisis governance on representative democracies and balances of powers in the EU are complemented by apparent deficits in effective management. Is there a way to resolve these problems of both effectiveness and legitimacy (for an early discussion of this tension, see, e.g., Scharpf 1999)? Can sustainable representative-democratic structures and institutions be kept or even strengthened under post-crisis conditions and austerity rules, instead of merely preserving deficient intergovernmental crisis governance mechanisms? Finally, is it possible to limit or avoid the political side-effects of internal adjustments in a currency union, such as the German parliament intervening in the budgetary competencies of Greece, for example?

These questions touch upon a subject of principle: how to treat policy areas that are not directly ruled by the EU and the EU Treaties but still intervene into the E(M)U’s policies, as well as into each individual member states and their representative systems. In simple terms, there are two broad ways to approach this subject (see in detail Wiesner 2019):

1. There is a partial, narrower solution in which the EU and its Treaties continue to rule only a part of the policies that affect the multi-level system and the Union’s member states. This is the approach currently in place, where, for instance, the EU budget would remain

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9 Parts of this section draw on Wiesner (2016) and Wiesner (2019).
small and contingent on the three main priorities of the Common Agricultural Policy, Innovation and Competitiveness and Cohesion Policy. In this scenario, the checks and balances that this equilibrium establishes would naturally leave space for a defensive component consisting of each member state aiming to safeguard and protect its national representative system. As explained by Begg et al. (2014), a “limited” approach implies that a state-centric governance model will prevail, as opposed to a supranational model entailing a progressive pooling of sovereignty at the EU level. This scenario would thus assume “maintaining a setup where the individual Member States will remain ultimately responsible for fiscal policy and public sector debt, even though measures ensuring economic and policy coordination towards the goal of convergence and balancing competitiveness will have to be in place” (Begg et al. 2014: 68). This will mean limiting the extent of co-decisions on individual member states budgets, for example, under fiscal consolidation programmes such as Troika-negotiated MoUs, to an extent that democratic legitimacy is not explicitly safeguarded and recognised in the EMU.

2. There is a broader solution that would instead consist of broadening the policy areas of the EU rules to include many or all of the policies that are currently ruled by democratic nation-states. This system of deeper integration would stop differentiated integration and subject all policy areas to one mode of legitimation. The deepening of governance implied by this scenario would also mean the realisation of what the Five Presidents Report issued in 2015 by the presidents of the European Commission, European Council, Eurogroup, European Parliament, and European Central Bank called a “Genuine” Economic and Monetary Union (GEMU) (Juncker et al. 2015).

But, notably, the Five Presidents Report does not focus on safeguarding representative democracy at the EU level or in the member states. It only suggests that national parliaments should be heard and that they should use the existing means of intergovernmental cooperation. Among the most plausible forms of what they call “complete GEMU” are (Begg et al. 2014): (i) a move towards significantly more intrusive oversight of Member State policies, building on the provisions already in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), the Two-Pack and the Semester process. If so, the latter would have to be accompanied by more accountability and legitimation. (ii) Swift
completion of the banking union, including both a more comprehensive resolution mechanism (see also Macchiarelli 2016) but also common deposit insurance. (iii) The adoption of a larger supranational fiscal capacity, not only with the scope for coping with asymmetric shocks but also for the sake of providing an EU backstop to (ii). And (iv), lastly, further debt mutualisation.

When discussing which of these solutions is plausible, as well as politically feasible in the short-to-medium term, it soon becomes apparent that the first solution will be much easier to obtain politically than the second one. Hence, the possible solutions are limited to the question of how the consequences of austerity governance on representative democracies and balances of powers can be limited. The following scenarios seem likely.

First, changes to financial aid governance in the narrow solution and the protection of national representative democracies. Some of the EU-led policies discussed in Chap. 3 threaten democratic standards in the member states. To this end, transparency, accountability and vertical balance of powers need to be better protected. Learning from the past, the substance of legislative decision-making competence needs to be safeguarded also under austerity conditions, that is, competencies and accountability should be made transparent. This means that adjustment programmes could, for instance, identify the overall headline figures to comply with the Union’s fiscal rules, but not intervene in the details of the budget itself. Furthermore, the results of national elections and referenda ought to be respected (even if they contradict EU policies), as well as the core powers of national parliaments and governments. While governments have subscribed to macroeconomic stability and fiscal discipline, through the Fiscal Compact, the Two-Pack and Six-Pack, a decision-making margin needs to be preserved, and explicit or implicit mutual interventions of national parliaments into each other’s areas of competencies should be regulated. It does not seem plausible to exclude this element in the current system of financial aid, at least as long as donor state parliaments vote on the conditions for support. It does seem possible, however, to define more explicit rules and limits for these interventions—such as fixing, for example, overall government expenditure, but not detailed expenditure items. This should be the case as long as a system for check and balances of democratic legitimacy is in place in the E(M)U. This will be a challenge, moreover, for the reform of the European Stability Mechanism (ESM) (see Vallée et al. 2019). One important shortcoming of the ESM is that it is bound to remain—for now—an intergovernmental organization, unaccountable to the European
Parliament. As stressed by Vallée et al. (2019), the idea that MoU will need to be signed by the ESM in the future not only fails to improve the EMU crisis governance, but makes the situation worse by entailing a sovereignty transfer in favour of the ESM without commensurate democratic accountability.

Second, in the broader version or “complete GEMU”, the governance of financial aid would need to be submitted to the EU Treaties’ framework. In that case, the EP, the EU’s legislative arm, should be included. It is important to underline, however, that non-euro area countries in the EU should not decide upon policies carried out in the euro area countries. This means that a Euro-Parliament could be created ex-novo to become the democratic co-legislator for the Eurogroup (Piketty and Vauchez 2018; Hennette et al. 2019; cf. Moravcsik 2019). Besides, a democratically legitimized transfer union in the EU could be created—even if it must rightfully be discussed whether such a transfer union would be politically sustainable given the persisting economic differences in the EU (Streeck 2014). Finally, the most far-reaching solution would be to stop differentiated integration and re-integrate the EU. Differences between fully and partly integrated policy fields and different modes of regulation, law- and policy-making could be reduced and ultimately abolished. At the same time, co-decision should become the legislative procedure in all of the EU’s policy fields.

Such a far-reaching solution could have other positive effects on what has been discussed as drivers for populism and scepticism as well. If the EU were to vote laws that create positive integration and re-regulation, both internally and externally, this could lead to the creation of the EU as a “public good” (Collignon 2004, 2017); which would possibly enhance economic and social participation. The establishment of a pan-European labour market (with EU-wide active labour market policies and unemployment insurance, in turn requiring a fiscal agreement) could contribute to this transition.

Considering globalization, the role of financial markets, or the struggle to contain climate change, there are many good reasons to claim that it is only the EU that can help regulate financial capitalism, rather than any EU nation-state alone (see in detail Wiesner 2016, 2017). While one might be tempted to think that Germany could be large enough as an economic power to be a global player, most (if not all) EU member states are far from it. Therefore, a return to the nation-state in a globalised economy—a solution put forward among others by Streeck (2014)—would not help
protect democracy against capitalism, at least not as long as globalised capitalism would not itself be re-embedded in an encompassing regulatory framework. This latter idea seems, for now, far more remote than the possibility of the EU championing regulation of financialised capitalism or protection of environmental sustainability (as the EU Commission’s proposal for a European Green Deal underlines). The E(M)U can become an influential actor in a globalised capitalist world. This would include enhancing the role of the euro as a world reserve currency (see Macchiarelli 2020). Crouch (2015) makes this argument explicit:

I am forced to argue that to reassert democracy against global capitalism requires a move from a more democratic (national) premium to a less democratic (European) one. But this is because the former simply cannot tackle the task required at the necessary level. If the neoliberal direction of travel of European integration cannot be turned, I see no level of action powerful enough to do the task at all. (Crouch 2015: 71)

There is, however, also a more optimistic reading into this (Wiesner 2016). The EU could become a regulating player in globalised financial capitalism because of its sheer size: the EU’s internal market is big enough to be a rule-maker, given that the EU’s economy is the second largest in the world (i.e., only behind the US economy in nominal terms, or behind the Chinese economy in terms of purchasing power parity). Moreover, the EU has repeatedly provided proof of this strength, dealing with global players such as Microsoft and Google. It was also under the initiative of the Commission’s Directorate-General for Competition that the abolishment of roaming tariffs was adopted. In the same vein, the EU data protection rules were successfully defended by the ECJ against Facebook. There is proof that the EU is capable of creating positive integration as well, such as the directives on anti-discrimination: the EU’s non-discrimination rules were pushed forward by the Commission, Council, European Parliament, and ECJ acting in unison, and they are so far-reaching that member states such as Germany had to improve their existing rules in this matter considerably (see Wiesner 2019). The ways to proceed for the EU to become a bulwark against financialised capitalism, or even a player in favour of its re-regulation, might seem surprisingly simple at first sight. However, the complexity of the EU’s institutional framework and decision-making procedures underscore this continued difficulty.
The future of the euro, as well as the future of the European Union as a whole, will depend on whether the euro area’s leaders are willing to join their mutual economic understanding with a sense of European solidarity, and whether they are eager to re-democratise decision-making structures in the multi-level system. Historically, more integration in a “federal” sense was limited to the extent that the interests of the EMU itself (or, joint EMU utility) did not necessarily match the sum of the utility of individual Member States (or, aggregate utility). This lack of a political will has had significant implications for the extent of the ECB’s interventions, which have been both forceful and limited in light of the incompleteness of EMU. In reflecting on the last ten years of the ECB and the extraordinary challenges it had to overcome, we have argued that the availability in principle of monetary policy beyond conventional remains an essential tool for the stability of the Union in the medium term. Going forward, however, the current approach to crisis management leaves no alternative than a coordinated new fiscal approach, i.e. in the form of a Fiscal Union, in combination with the strengthening of existing democratic institutions both at the European level and in the member states, thus enhancing the EMU’s first, and the EU’s then, democratic legitimacy.

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