New central banking calls for a European Credit Council

Eric Monnet 26 March 2021

Since 2008, a new central banking model has emerged. Monetary authorities increasingly engage in targeted lending, hold large amounts of public debt, and focus on climate change. This column argues that the new practices of central banks call for an updated institutional framework in order to maintain democratic legitimacy. It proposes the creation of a European Credit Council, which would provide impartial assessments of the ECB's decisions, particularly those with large distributional consequences. In addition, it would develop proposals for coordinating monetary policy with other EU policies and reinforce the role of the European Parliament.

There is a growing consensus that a new central banking model is emerging, with no possibility of returning to the supposedly normal framework of the pre-2008 era of globalisation (Goodhart and Lastra 2018, Braun and Downey 2020, Tooze 2020, Eichengreen 2021). The fin de siècle central banking of the 1990s, based on interest rate management, inflation targeting, and the rejection of credit policy, is now gone. Targeted lending has become normal. Much of the public debt is held by the monetary authorities. Central banks have committed to policies to support the ecological transition. Coordination between fiscal and monetary policies is called for (Bartsch et al. 2020). These actions have important distributional consequences and can interact closely with other economic policies. Changes are therefore needed to make the institutional framework and practices of central banks compatible with their new role. It is essential to maintain their democratic legitimacy. The issue is not to replay an old debate about whether central banks should be independent, but rather to define this independence in new terms.

In this column, I present a solution to enrich the democratic framework of the Eurosystem and the ECB, without denying their independence. The EU currently lacks an institution that would assess the consequences of the central bank's decisions in other areas, including credit allocation. Based on the examples of 'credit councils' that played such a role in the past, I suggest the creation of a European Credit Council, under the authority of the European Parliament. It would put this council on the same level of expertise as the ECB to discuss the now broad implications of monetary policy decisions in Europe and to debate the interpretation of the central banks' mandate. While respecting the operational and political independence of the ECB, this institution would be responsible for discussing how (and whether) the Eurosystem can "support the general economic policies in the Union", as laid down in the Treaty on the Functioning of the European Union, Article 127 (1). It is important for the ECB to be concerned with general policy issues such as climate change, but the ECB does not have the legitimacy to decide on its own on policies with major distributional consequences.

Before central bank independence

Shaken by recent changes in the monetary policy framework, it is tempting to look at the past for solutions, considering the days when central bank intervention in credit allocation and coordination with fiscal policy was the norm. Such a historical comparison is useful but also potentially disappointing.

In the three or four decades following WWII (notably in Japan and most European countries during years of rapid economic growth), central banks faced problems and used instruments that bear similarities to the current situation. They played an active role to "promote economic and

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social welfare programs" (Thurow et al. 1971, Monnet 2018). As in China today, coordination of fiscal policy, inflation control, priority sector financing, economic planning, banking regulation, and subsidised credit for export promotion was at the heart of this system. To ensure this coordination, several countries set up a special organisation, usually called a 'credit council'. The name and form varied from country to country; it was either directly dependent on the central bank or on the government (Monnet 2018: Chapter 7).

Designed as a response to the market and policy failures of the 1930s, these institutions were supposed to make the management of money and credit more democratic. But their actual functioning would pale in comparison with today's European democratic standards of governance. They lacked transparency and effective parliamentary control. In France, for example, it was supposed to be a powerful institution (a '*petit parlement*') designed to represent all key sectors of the economy and coordinate fiscal and monetary policy. In practice it mostly implemented decisions already taken by the central bank management (Monnet 2018). The lack of transparency of these institutions fuelled criticisms of vested interests and inefficiency in the 1970s and 1980s. Therefore, it would be a mistake to revive them without maintaining central bank independence, strengthening parliamentary oversight, and isolating the administration from the central bank management.

The legitimacy of central bank independence

Political theories of democracy justify the legitimacy of central bank independence in two different ways. The first, rooted in public choice theory, limits the framework of independence to the central bank's mandate, based solely on principles of delegation (Tucker 2018). The mandate should be as precise as possible, considering all possible situations and indicating what the central bank should do in each of them. In return, the central bank should never deviate from its mandate.

A second and different view (Rosanvallon 2011, Vauchez 2016, Van't Klooster 2020) argues that the democratic legitimacy of independence cannot be based solely on the definition of the legal mandate (since it is never precise enough to consider all situations) but should rather be based on the quality of the debate and the balance of power surrounding the decision of the independent authority. In other words, the central bank should be able to justify that its decision was the best one for all and, in line with its general mandate, acknowledge that other choices were possible and debated. For this justification to be legitimate, it must be impartial and reflexive. It requires the independent authority to show that it has considered the criticisms and alternative options. It requires that these different options be presented on an equal footing. For this to be possible, the elaboration and evaluation of the different options cannot take place only within the central bank. The current monetary dialogue between the ECB and the European Parliament does not put the two institutions on an equal footing, as many observers have documented (Curtin 2017, Diessner and Jourdan 2019). The Committee on Economic and Monetary Affairs does not have sufficient staff and expertise to construct alternative scenarios or assess the consequences of monetary policy decisions.

A European Credit Council

One consequence of the current imperfect situation is that it is mainly the ECB that presents its own interpretation of its mandate, as well as its own quantitative assessment of its policies. As we have seen on several occasions, the final say ultimately lies with the Court of Justice of the European Union. A sound democratic practice would be to strengthen the parliamentary discussion on the interpretation of the mandate before going to the Court of Justice. The ECB would still make its decision completely independently, but it would first know how the Parliament interprets (and documents) how its actions could support the general policies of the EU. This discussion should not take the form of 'instructions' or 'influence' of the representatives to the ECB (as forbidden by the EU Treaty in its definition of central bank independence) but of open questions based on alternative scenarios.

The presentation of alternative scenarios and statistics could significantly change the modus operandi of ECB policy decisions as the central bank would have to justify whether its price stability objective prevents it from following other scenarios in line with its general mandate. The ECB's expertise and policy argumentation should therefore be refocused on monetary policy implementation, financial stability, and price stability. Policies aimed at making the ECB's actions consistent with supporting general EU policies will still be approved and implemented independently by the ECB, but they would first be developed outside the ECB and discussed by the Parliament.

A straightforward case of the application of this new democratic process is the role of the ECB in financing the green transition. The European Credit Council may present different scenarios to the [illegible] considering interactions with other EU policies, the Parliament's views and expertise on [illegible]nance – and the ECB would then justify its choice based on arguments focused on price [illegible] objective and issues of monetary policy implementation.

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The European Credit Council would not in itself be more democratic than the central bank. The aim is neither to add bureaucracy to European politics nor to create a hierarchy of institutions, but to strengthen the democratic legitimacy of ECB decisions. It should not be a watchdog of the central bank but should be responsible for discussing potential coordination of European policies related to financial issues more generally. It will be important to implement an effective strategy to finance the green transition and public debt, coordinating the efforts of the European Commission, the European Investment Bank, the ECB, the European Systemic Risk Board (ESRB), and private actors. For this reason, it should avoid the intergovernmental forms taken by the ESRB and should depend directly on the Parliament, while being non-partisan.

The Parliament should be able to ask the European Credit Council for studies on the long-term financing of public and private investments and on the economic and distributive consequences of the monetary and financial policies of the European institutions. The European Credit Council should also act on its own initiative to develop proposals and implement policy assessments. Thus, the European Credit Council would have a dual role: to provide impartial expertise to the Parliament on macro-financial issues (like the Congressional Budget Office in the US) and to develop proposals for coordinating policies between several European institutions, which could then be discussed by the Parliament and approved by the competent institutions involved.

With regard to monetary policy, it should conduct independent analyses of the distributional consequences of monetary policy instruments (longer-term refinancing operations, quantitative easing, tiering, negative rates, etc.). It would also organise discussions on the need to amend, if necessary, the relevant articles on the implementation of monetary policy by the European Parliament and the Council, in accordance with Article 40 of the Statute of the European System of Central Banks.

The legitimacy of the European Credit Council would rest on three pillars: (i) the members of its executive board are appointed by the Parliament, (ii) it would be committed to reflecting the diversity of (national and partisan) views in its assessment and proposals, and (iii) the final decisions will always be taken by the competent European institutions. The European Credit Council could be staffed by reassigning experts already working in the European institutions (including the ECB). The analyses of policy coordination and evaluations of various credit policies undertaken in the already existing institutions would thus be centralised in the European Credit Council.

Conclusion

Central banks like the ECB-Eurosystem have in fact a very broad mandate that is open to many interpretations. The monetary policy decisions taken over the last decade have certainly gone much further than those who conceived them could imagine. Exploring all interpretations of the mandate now seems necessary to address the climate crisis and make public debt sustainable. Yet it is becoming increasingly clear that the legal mandate is not enough to give actual legitimacy to central bank independence, given the enormous political and distributional consequences of current monetary policy decisions. This requires two important changes to the current practical definition of central bank independence: an impartial assessment and parliamentary discussion of the distributional consequences of central bank policy, and coordination of monetary policy with other EU policies (especially those related to credit, investment, and budget). The European Credit Council proposed in this column should be an essential step to achieve these.

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