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The climate crisis is a way out of monetary orthodoxy

The European Central Bank has completed its first strategic review in 18 years. As modest as the conclusions may be, it has broken new ground — on climate

On 8 July the European Central Bank announced the results of the Monetary Policy Strategy Review initiated by its president, Christine Lagarde, in January 2020. Delayed by the pandemic, its deliberations had been kept tight. But, with striking haste, Lagarde shepherded the ECB's General Council into unanimous agreement on a terse statement about the bank's policy regime.

The review's conclusions are technical but have wide implications. The ECB is Europe's most powerful federal institution. At moments of financial stress it holds Europe's fate in its hands. In normal times, interest rates are a key parameter for decision-making of all kinds.

The results of the review, modest though they may seem, are highly revealing not just about the ECB but the broader politics of eurozone. It is 18 years since the bank last conducted a strategic review and there has been plenty in the interim to digest. What is more telling than what appears in the final *communiqué*, however, are those aspects of the ECB's experience which could not be assimilated into official doctrine.

Repeated crises

If the ECB's first decade was marked by relative calm, since 2008 it has faced repeated crises. It is not alone in that — all over the world central bankers have been forced to become crisis-fighters. They face deflationary headwinds which invert the terms of the economic-policy debate that in the 1980s spawned the model of independent central banks. Whether in the advanced economies or emerging markets, central banks now engage in policies, such as large-scale asset purchases, once considered anathema. On top of that, over the last ten years social inequality and climate change have been thrust to the forefront of central-bank policy. Against this backdrop, in the United States the Federal Reserve launched

a policy review which concluded in August 2020, leading to a redefinition of its inflation target. This spring the Bank of England was told to focus on climate change. In 2018 the Reserve Bank of New Zealand, once the paradigm of the single-minded, inflation-targeting central bank, had full employment added to its objectives; in February 2021 house-price stability was also inserted. In March 2020 the Reserve Bank of Australia decided to follow the Bank of Japan in adopting 'yield-curve control', capping the growth of medium-term borrowing costs. We are in a period of unprecedented experimentation in central-bank policy.

In an interconnected world, the ECB faces many of the same challenges as other central banks. But it does so against the backdrop of the eurozone's peculiar architecture and history. A centralised monetary policy, led by the ECB, is counterposed to a decentralised fiscal apparatus, in which deficits and debts are the responsibility of nation-states — which cultivate mutual suspicion and jealousy.

In the early years of the euro, the ECB relished its responsibility as the conservative referee of national fiscal policy. But between the spring of 2010 and the summer of 2012, facing the eurozone sovereign-debt crisis, this lopsided structure revealed its dysfunctional potential.

'Whatever it takes'

By far the most important innovation of any European central banker in recent decades came in July 2012 when Mario Draghi, then president of the ECB, said it would do 'whatever it takes' to defend the integrity of the euro. Draghi's promise was hedged with conditions, including the prior commitment to banking union and a strict line of fiscal austerity.

That conditionality hangs over Europe, but the basic commitment to backstop government debt was made. The alternatives, then as now, are so bad it seems impossible to imagine the ECB would not, *in extremis*, honour Draghi's words. If sovereign-debt markets are in panic mode, normal monetary policy cannot operate.

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Faced with the pandemic, after an initial wobble in March 2020 the ECB confirmed that belief. The Pandemic Emergency Purchase Programme put a ceiling on Italian yields, the weakest link in the eurozone chain, and first and foremost the ECB's bond-buying is an emergency response. And prominent voices within the ECB have justified it in those terms. The board member Isabel Schnabel has been particularly

clear on the need to maintain favourable financing conditions for all borrowers until recovery is achieved. This promise appears to include European governments. It is bold but also restrictive: it links the bond purchases to the crisis.

But in the markets the PEPP is received as something more — as a vindication of 'whatever it takes'. By adopting its emergency measures the ECB has *de facto* confirmed its commitment to stop any return to a sovereign-debt crisis. There will be no exits from the euro; there is no reason to price in redenomination risk. As a result, in 2021, despite a huge surge in debt, Greece and Italy can borrow at rates close to zero or even at negative yields for short-term debt.

Remaining unspoken

Reading the ECB's statement on the review, however, one would never know any of this had happened. The *communiqué* starts by acknowledging that relying on policy interest rates alone is no longer enough. But asset purchases are mentioned only in passing. The issue of lender of last resort and debt-market stability is not even hinted at. There is no mention of the 'outright monetary transactions' facility set up in 2012. It is as though 'whatever it takes' never happened.

The suspicion must be that a franker engagement with the eurozone's recent history would have resulted in a damaging conflict. The most basic strategic shift must remain unspoken.

Price stability is the aspect the ECB can talk about. Once upon a time its mandate was clear. Holding down inflation across Europe was the bank's purpose. In 2003 this was defined as inflation 'below, but close to 2 per cent'. With that anti-inflationary stance in mind, the ECB was one of the loudest voices pushing for maximum fiscal discipline.

But in the wake of the eurozone crisis it discovered that the far bigger macroeconomic risk was *de*flation. And since 2014 the ECB has reinterpreted its price-stability mandate, in symmetrical terms. Its principal concern has been to prevent undershooting of the 2 per cent target. Price stability in the literal sense of zero inflation would be regarded as dangerously close to deflation.

Yet while a central bank has the means to stop inflation, by raising interest rates, it is not obvious that it has that power with regard to deflation, as rates reach the zero bound. In the conventional assignment

of economic-policy instruments, this demands active *fiscal* policy. And so the ECB, which had long argued for fiscal restraint, has become an advocate of fiscal loosening.

Deeply embedded

The response was frustrating. With the ECB's backing, fiscal restraint had been deeply embedded in the EU's architecture. It was anchored by Germany's commitment to the 'debt brake' and the 'black zero'.

That left the ECB no option but in 2015 to embark on massive asset purchases, via 'quantitative easing' (QE). These were highly politically contentious. A complaint by orthodox economists in Germany to its constitutional court was not settled until the summer of 2020. To satisfy objections from conservative member states, the asset purchases were hedged with provisions. Risk-sharing was limited by ensuring that default risk remained on the balance sheet of national central banks. Fixed ratios governed how much of each country's bonds the ECB could buy.

These provisos helped secure the ECB's QE programme in political terms but undermined its effectiveness in confidence-building. Economists remain divided about how QE works, but one of the main channels is through signalling long-term expectations about bond prices and thus interest rates. High bond prices boosted by central-bank purchases imply low rates. The trick, as Paul Krugman once put it, is to credibly commit to being irresponsible. But when it comes to reflationary monetary stimulus, the ECB has a credibility problem.

The ECB has not helped its cause with forecasts which have consistently exaggerated the inflation risk.

The bank's anti-inflationary history is well known. Even in the spring of 2011, in the midst of the eurozone crisis, rather than focusing on sovereign-debt markets and bank balance sheets, the ECB chose to raise rates to counter the supposed risk of rising inflation — a policy error of historic proportions. Draghi's own record was that of a fiscal hawk.

In 2018, as soon as the eurozone's recovery seemed secure, the ECB moved to wind up its asset purchases. This was premature. Faced with a renewed risk of deflation, in the autumn of 2019 Draghi's last move was a U-turn — resuming asset purchases and triggering another flurry of opposition from Europe's monetary conservatives. Rather than establishing a secure foundation for monetary expansion, it exposed the faultlines within the eurozone.

The ECB has not helped its cause with forecasts which have consistently exaggerated the inflation risk. If the aim is to fight deflation, this is profoundly counterproductive.

Judgement call

The big news from the strategy review is that the ECB is now formally committed to pursuing 2 per cent inflation: 'the Governing Council considers negative and positive deviations from this target as equally undesirable'. If the risk is of sliding into the deflation danger zone, one might though wonder why the ECB did not choose a higher target — say 3 per cent.

In August 2020 the Federal Reserve dedicated itself to a mean inflation target (also 2 per cent): if it undershoots, this commits it to pursue an overshoot. There was no majority for that in the ECB. But the *communiqué* does recognise that hitting 2 per cent and avoiding the perils of low inflation may 'imply a transitory period in which inflation is moderately above target'. How exactly that will be interpreted will be a judgement call but the basis for the debate has been shifted. At the very least it should make the premature tightening that blighted Europe's prospects in 2011 somewhat less likely.

The problem, however, is that it is no more clear than before how the ECB intends to achieve this objective. Though transient factors such as energy are currently boosting prices, the medium-term pressures are all deflationary.

Fiscal policy key

As ever, the key is fiscal policy. In 2020 the Maastricht rules were suspended and fiscal policy and monetary expansion worked hand in hand. Lagarde, Schnabel and the bank's chief economist, Philip Lane, have all called for a sustained fiscal response. But there is no mention of this in the review.

Schnabel coyly tweeted a cartoon, showing fiscal and monetary policy as two rowers in perfect harmony. But 'co-ordination' of fiscal and monetary policy remains unmentionable — so deep is the conservative hostility to anything that might appear to infringe the independence of monetary policy.

One is left to read between the lines. In 2021-22 the pace of new fiscal

initiatives has slowed dramatically. The timeline now seems set for a return to some version of the fiscal rules in 2022-23. There is a real risk, therefore, of a premature tightening, which would leave the ECB once again struggling to contain deflationary pressure. Perhaps it is significant that the *communiqué* promises a further review as soon as 2025.

Climate core concern

On the terrain of classical macroeconomics, the debate in Europe remains frustratingly stilted, hemmed in on all sides, overshadowed by the legacy of the eurozone crisis, threatened by the outrage of conservatives and national populism. The room for action is minute. But the Lagarde review has broken new ground — on climate.

The one area where there is a large majority in Europe for action is on the energy transition. That is the perspective of Next Generation EU and Lagarde has been quick to spot the opening. Two years ago, green central banking was still an *outré* corner of the policy field. In 2019 Lagarde made it a key to her campaign for the presidency. The review comes with an annex on climate policy — thereby defined as a core concern of the ECB.

In a recent speech she declared that the aim is no longer to preserve but to transform the economy. That is strong stuff from a central banker: central banks are not supposed to do industrial policy. From the point of view of the ECB, the key is in the policy mix necessary to pull off the transformation. Public investment has to be twinned with private investment.

Ultimately, the most significant thing about this review may turn out to be that it happened at all.

Private investment requires the creation of deep European capital markets for green bonds. If open talk about central banks monetising deficits causes panic, perhaps the same effect can be achieved by focusing on 'good' spending (for climate and digitalisation) and 'good' debts (green bonds). Taken together, they provide an answer to the deflation problem. Aggregate demand is indifferent to the complexion of the spending.

Bolder steps

Of course, the devil here too is in the detail. The ECB's proposed steps to evaluate climate risk and address it, through its collateral framework and

asset purchases, are not as bold as those now envisaged by the Bank of England. They are, however, far bolder than anything so far contemplated by the Fed. And they are a huge step beyond what was imaginable in 2019.

Most remarkably, the ECB is proposing an in-depth review of its corporate-bond purchase programme, to ensure that market underpricing of climate risk is properly taken into account. The results will not be delivered for some time. But the ECB has committed itself to opening the black box of 'market neutrality', which previously constrained its engagement with the climate question. It will no longer take for granted that existential risks are properly priced. This will most likely result in a reduction in its holding of triple-AAA fossil-fuel bonds — a small but significant step.

Most fundamentally, what is missing from the ECB's embrace of climate policy is an acknowledgement of the financial system's own agency. The ECB is admitting climate as a concern because it may affect price stability and financial stability, and because the climate policies of other agencies may devalue assets held on bank balance sheets. It is not addressing the fact that the financial system itself funds the fossil-fuel economy and thus drives the climate crisis.

Lagarde's speech on the need for transformation makes clear this point is not lost on her and her team. But here too there are limits to how far such matters can be squeezed into the corset of the ECB's operating code.

Work in progress

The adjustment of the ECB to the challenges facing Europe is, thus, a work in progress. Ultimately, the most significant thing about this review may turn out to be that it happened at all — and that the Governing Council now recognises the need to 'assess periodically the appropriateness of its monetary policy strategy'.

As modest as the conclusions reached may be, this commitment to regular review unfreezes the ECB. It makes clear that policy is not set in stone. It will energise the remarkable leap forward in public debate about monetary policy that we have seen across Europe since the 2008 crisis.

That the ECB has moved as far as it has in recent years it not simply a response to the 'facts on the ground', nor the result of technocratic reasoning. Credit for moving the debate also belongs to all those activists who have demanded a more creative approach to monetary policy. Both the advances made in the 2020-21 review and its limits make clear how

crucial the democratic politics of money is to progressive politics in Europe.

Also clear is the need to widen the fronts. Monetary policy cannot achieve even its classic objectives without incorporating an active fiscal policy — with the energy transition at its heart.

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