

Current and Future European Central Bank Monetary Policy

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Abstract

This contribution examines the operations of the European Central Bank (ECB) with respect to monetary policy, along with its effects on inflation, exchange rate and financial stability. It also discusses how the regulatory role of the ECB should be improved in the future. The contribution discusses the involvement of the ECB in regulatory policy towards the financial sector, and the responses of the ECB to the financial crisis. It begins with the current set up of the European Monetary Union (EMU) along with the theoretical principles of the EMU model, and the extent to which it conforms with the theoretical framework of the New Consensus Macroeconomics (NCM) and its policy implications, namely inflation targeting. Problems with the current EMU arrangements are then discussed, followed by required ECB changes, before we finally summarize and conclude.

Keywords: ECB, Monetary Policy, NCM, Current Problems, Future Developments

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1. Introduction

The purpose of this paper is to examine the operations of the ECB with respect to monetary policy and how the regulatory role of the ECB should be improved in the future. The involvement of the ECB in regulatory policy towards the financial sector, and the responses of the ECB to the financial crisis are discussed along with recommendations for relevant future policy changes.

We begin with the current set up of the European Monetary Union (EMU) along with the theoretical principles of the EMU model. This is followed by considering the consistency of the ECB model with the NCM theoretical framework (see, for example, Arestis, 2007, 2009, for an exposition of the NCM theoretical framework along with a comprehensive critique of it). Problems with the current EMU arrangements are then discussed, followed by changes in view of the August 2007 financial crisis and the 'great recession'. Required ECB changes, and of course changes in monetary policies are discussed before we finally summarize and conclude.

2. Current Theoretical Underpinnings of the EMU Model

This section comprises of two sub-sections. We discuss in sub-section 2.1 general theoretical principles that underpin the EMU model and the ECB monetary policy. Sub-section 2.2 examines the consistency of the ECB Model with NCM.

2.1 Theoretical Principles of the EMU Model

The theoretical framework and economic policy implications of the EMU should be viewed as embedded in the NCM paradigm. The approach can be viewed as NCM through its emphasis on the supply-side determined equilibrium level of unemployment (the 'natural rate' or the non-accelerating inflation rate of unemployment, the NAIRU), its neglect of the long-run aggregate demand, the downgrading of fiscal policy, and the elevation of monetary policy. We argue that the EMU approach is indeed of the NCM variety, although differences exist (see, for example, Arestis and Sawyer, 2008; also Arestis and Sawyer, 2013). As such, its key elements are as follows.

The market economy is viewed as essentially stable, and that macroeconomic policy (particularly discretionary fiscal policy) may well destabilise the market economy. Markets, and particularly the financial markets, make well-informed judgements on the sustainability of economic policies, especially so in the current environment of open and globalised financial markets. The transversality condition, which means in effect that all economic agents with their rational expectations are perfectly credit worthy, so that all debts are ultimately paid in full, implies that all credit risks and defaults are removed; no agent would ever default. All IOUs in the economy can, and would, be accepted in exchange. There is, thus, no need for a specific monetary asset. All fixed-interest financial assets are identical so that there is a single rate of interest in any period. Over time the single rate of interest may change as borrowing and savings propensities change. Under such circumstance no individual economic agent or firm is liquidity constrained at all. There is, thus, no need for financial intermediaries (commercial banks or other non-bank financial intermediaries) and even money (see, also, Goodhart, 2007, 2008). The ECB, nonetheless, emphasises a long-run role for money as we discuss below.

The major economic policy implication of the NCM is that monetary policy has been upgraded in the form of interest rate policy, where a major objective of policy is "maintaining

price stability" (King, 2005, p. 2). The ECB (2008) puts it as follows: "price stability is the best – and, ultimately, the only – contribution that a credible monetary policy can make to economic growth, job creation and social cohesion. This reflects the fact that a policy-maker who controls only one instrument cannot meet, and be held accountable for the fulfilment of, more than one objective. The pursuit of additional objectives would risk overburdening monetary policy, and would ultimately result in higher inflation and higher unemployment. Over the longer term, monetary policy can only influence the price level in the economy; it cannot exert a lasting impact on economic activity. This general principle is referred to as the 'long-run neutrality of money'" (p. 34). It is the case that monetary policy has emerged as one of the most critical government responsibilities. It is a most flexible instrument for achieving medium-term stabilisation objectives: it can be adjusted quickly in response to macroeconomic developments. Indeed, monetary policy is the most direct determinant of inflation, so much so that in the long run the inflation rate is the only macroeconomic variable that monetary policy can affect (ECB, 2008, p. 34). And to quote ECB (2008), there is the "the fundamental economic principle that, over the longer term, inflation is a monetary phenomenon" (p. 37).

This type of monetary policy is undertaken through inflation targeting (IT), which requires Central Banks to look at inflation as an indicator of when to expand or contract monetary policy; this policy should be operated by independent Central Banks, whose decisions and actions should not be affected by politicians and the treasury. The ECB (2008) puts it as follows: "Economic theory and historical examples from previous decades represent strong evidence that central bank independence is a precondition for achieving and maintaining price stability. Against this background, the multi-dimensional independence of the ECB is stipulated in the Treaty, which legitimises its independence" (ECB, 2008, p. 22). The ECB is the most 'independent' central bank in the world when judged in terms of immunity to political and democratic control.

Fiscal policy is no longer viewed as a powerful macroeconomic instrument. Fiscal policy should only rely on automatic stabilisers; more importantly, though, it should be concerned with broadly balancing government expenditure and taxation, effectively downgrading its importance as an active instrument of economic policy. This is a conclusion based on the usual assumption of crowding out of government deficits and the Ricardian Equivalence hypothesis and thus the ineffectiveness of fiscal policy as a stabilisation instrument (see, however, Arestis and Sawyer, 2003, 2004, for a critique and a different view; see also Arestis, 2012; 2015).

Monetary policy has, thus, been upgraded and fiscal policy has been downgraded. Fiscal policy can only serve to achieve a balanced budget. Monetary policy can be used to meet the objective of low rates of inflation (which are always desirable in this view, since low, and stable, rates of inflation are conducive to healthy growth rates). Such policy operated by an independent central bank would also have greater credibility in the financial markets and be seen to have a stronger commitment to low inflation than politicians do. Credibility is recognised as paramount in the conduct of monetary policy to avoid problems associated with time-inconsistency.

The EMU theoretical framework entails the view that inflation is best tamed through interest rate manipulation without at the same time forgetting money supply: there is, thus, the 'close to 2 per cent from below' and the reference value of 4.5 percent for M3 money supply in place. This, it is hoped, improves communication between the public and policy-makers and provides discipline, accountability, transparency and flexibility in monetary policy. The EMU model contains two features: an economic analysis and a monetary analysis.

The ECB economic analysis is an assessment of price developments and the risks to price stability over the short to medium term. The range of indicators includes: "developments in overall output; aggregate demand and its components; fiscal policy; capital and labor market conditions; a broad range of price and cost indicators; developments in the exchange rate; the global economy and the balance of payments; financial markets; and the balance sheet positions of euro area sectors" (ECB, 2004, p. 55). It is, thus, a broad outlook of price developments and the risks to price stability over the short to medium term. These factors and the analysis that accompanies them "help to assess the dynamics of real activity and the likely development of prices from the perspective of the interplay between supply and demand in the goods, services and factor markets at shorter horizons" (ECB, 2008, pp.35-36).

The ECB monetary approach analyzes monetary developments for the information they contain about future price developments over the medium and long term. It focuses "on a longer-term horizon, exploiting the long-run link between money and prices" (ECB, 2004, p. 55), an approach thought to be "sufficient to hedge against the risks of both very low inflation and deflation" (ECB, 2008, p. 35). Deviations from the 4.5 percent reference value for the M3 monetary growth would 'signal risks to price stability'. Monetary analysis is utilized by the ECB as a 'cross check' for consistency between the short-term perspective of economic analysis with the more long-term perspective (see, also, Issing, 2003).

The rationale for the 'two-pillar' approach is based on the theoretical premise that there are different time perspectives in the conduct of monetary policy that require a different focus in each case. There is the short to medium term focus on price movements that requires economic analysis. There is also the focus on long-term price trends that requires monetary analysis, with the strong belief in the long-term link between money (M3 in this case) and inflation. This focus, of course, reflects the notion that inflation is a monetary phenomenon to be tackled by both manipulating the rate of interest and watching movements in M3. Short-term volatility of inflation is allowed but not in the long run, reflecting the view that monetary policy affects prices with a long lag.

The level of economic activity fluctuates around the NAIRU, whereby unemployment below (above) the NAIRU would lead to higher (lower) rates of inflation. The NAIRU is a supply-side phenomenon closely related to the workings of the labour market. In the long run there is no trade-off between inflation and unemployment, and the economy has to operate (on average) at the NAIRU if accelerating inflation is to be avoided. In the long run, inflation is viewed as a monetary phenomenon in that the pace of inflation is aligned with the rate of interest and the money stock.

The essence of Say's Law holds, namely that the level of effective demand does not play an independent role in the (long run) determination of the level of economic activity, and adjusts to underpin the supply-side determined level of economic activity (which itself corresponds to the NAIRU). Shocks to the level of demand can be met by variations in the rate of interest to ensure that inflation does not develop (if unemployment falls below the NAIRU).

2.2 Consistency of the ECB Model with NCM

It is clear from the analysis of sub-section 2.1 that the ECB macroeconomic model is consistent with the NCM. But there are differences, which are elaborated further in the rest of this sub-section.

It is clear from this discussion that although the ECB analysis is embedded within the NCM framework, there is still one important difference that relates to the treatment of monetary aggregates as elaborated above. This makes the policy implications of the ECB monetary policy analysis different from those of the NCM. In other words, ECB monetary policy is not strictly speaking of the inflation targeting type. Especially so in view of the 'two-pillar' approach, which is clearly very different from that of the NCM, which pays very little, if any at all, attention to monetary aggregates.

There are, also a few problems in the case of the ECB macroeconomic model worth elaborating upon. The ECB's M3 growth, and over the period January 1999 to May 2009, was consistently above the 4.5 per cent reference value for most of this period (since June 2009 and due to the 'great recession' M3 has been consistently well below the 4.5 per cent reference value); and yet not much inflation was produced over that period nor dangerous deflation either since May 2009. It would appear that over the period 1999-2009 the ECB was caught between the economic analysis that suggested low or unchanged interest rates and the monetary analysis that implied higher interest rates for the entire period. In other words, while the euro area inflation rate was hovering just above the 2 per cent mark over the period 1999-2009, the euro area M3 was growing at rates well above the reference value of 4.5 per cent. The period since 2009 has been very different in view of the 'great recession' and the euro crisis, and we discuss the relevant changes in section 4. The two-pillar approach sends different and contradictory signals more frequently than might be acceptable. The credibility of the strategy is obviously at stake (see CEPS, 2005, p. 29, which reaches a similar conclusion). It is also true to say that the ECB's special emphasis on the importance of monetary aggregates has been subjected to further criticism. Woodford (2006) offers a rigorous critique of this approach from the NCM perspective, suggesting that there is total lack of a theoretical foundation of the ECB monetary analysis. There is also the argument that money is an unreliable indicator of inflation in view of frequent shifts in its velocity (see, for example, Estrella and Mishkin, 1997; Begg et al., 2002; De Grauwe and Polan, 2005).

The sole emphasis on price stability cannot be justified. History is replete with examples of relevant episodes when price stability had been achieved only to witness macroeconomic instability subsequently. These examples (see Angeriz and Arestis, 2007, for example) clearly demonstrate that price stability was followed by unsatisfactory economic performance. The price stability of the 2000s (even though inflation was not completely within the 2 per cent target) contained within it the seeds of a financial crisis, which became apparent from August 2007 onwards.

Finally in this sub-section, we note that the proposition that "Over the longer term, monetary policy can only influence the price level in the economy; it cannot exert a lasting impact on economic activity" (ECB, 2008, p. 34) does not conform to reality. In Arestis and Sawyer (2004, 2008), we have argued that even the own macro-econometric model of the ECB does not seem to support this proposition. Empirical evidence drawn from the relevant ECB macro-econometric model, and reported in Arestis and Sawyer (op. cit.) suggests a relatively weak effect of interest rate changes on inflation. We also show in the same studies, on the basis of the evidence adduced, that monetary policy can have long-run effects on real magnitudes. This particular result does not fit comfortably with the theoretical basis of current thinking on monetary policy by the ECB.

3. Problems with Current EMU Arrangements

It is true to suggest that much of the academic literature on currency and monetary unions has been dominated by the optimal currency area (OCA) literature (Mundell, 1961). It is doubtful, though, whether that literature and the associated considerations had much impact on the formation of the EMU. This is so in view of the criteria for the formation of a single currency appear not to have been applied when decisions were made on the formation of the single euro currency and on who would be a member. The political imperative for most, though not all, national governments and the EU itself was the formation of the EMU as the next stage of European economic integration. Vieira and Vieira (2012) in an ex post analysis of the EMU's first decade in existence, and utilizing the OCA index first proposed by Bayoumi and Eichengreen (1998), conclude that "the OCA index could have been a better indicator of countries' readiness to join the single currency than were the Maastricht criteria, as the latter were not able to identify the ill-prepared countries. The recent troubles of some euro area members make this clear" (p. 90).

More problems from the point of view of monetary policy can be highlighted. The management, operation, communication and potential efficacy of monetary policy within the ECB institutional arrangements have entailed many problems. In terms of the management aspect, the timing of monetary policy decisions has been very slow. The ECB's methods of operation and communication have been confusing to the financial markets. In the 'two-pillar' strategy, there is uncertainty as to the value attached to the M3 reference value. The target has rarely been met, and yet this does not seem to impact on official strategy. This may well have undermined the ECB's credibility, rather than added to it. There is, indeed, the question of whether the ECB inflation target is not too restrictive, and it suffers from not being symmetrical. The problem with the ECB's methods of operation and communication is partly the bank's secretiveness, for it does not publish minutes of its meetings.

A number of reservations may be raised in terms of the efficacy of this monetary policy. First, changes in interest rates have only a limited impact on aggregate demand. We have surveyed elsewhere the results of simulations of the effects of monetary policy using the ECB macroeconometric model as well those of the Bank of England and of the Federal Reserve System (Arestis and Sawyer, 2004). The conclusion of that investigation is that the effects of interest rate changes on inflation tend to be rather small – typically a 1 percentage point change in interest rates may dampen inflation by 0.2 to 0.3 per cent after two years, while the impact on long-run economic activity, especially investment, is significant. Consequently, there are questions in terms of the impact of interest rates on expenditure and questions relating to the magnitude of the impact, timing and variability of the time lags involved.

Second, it is the case that monetary policy is of the 'one policy fits all' approach; but there are differences in inflationary experience across the euro area countries. Still another problem with the ECB approach is that the two-pillar approach sends different and contradictory signals.

Third, if inflation is of the cost or supply shock variety, then there are problems; current arrangements are meant to tackle demand inflation. Consequently, cost or supply shock variety of inflationary pressures cannot be tackled via targeting inflation of the ECB type.

Fourth, since interest rate policy has a range of effects, such as on aggregate demand, on the exchange rate, on distributional effects etc, the objectives of monetary policy should

reflect that, and should, thus, be recast to include growth and high levels of employment alongside inflation.

Related issues are concerned with the exchange rate policy. It may be that the poor performance of some of the EMU countries since its formation can be attributed to an inappropriate exchange rate. The euro has become the second major currency in the world after the dollar; thereby the exchange rate between the euro and the dollar has become particularly important for a large proportion of international trade. The volatility of the euro/dollar exchange rate becomes significant not only for the euro area and the USA, but also for those countries who have linked their currency to either the euro or the dollar. These problems strongly point towards the development of mechanisms, which could help to stabilise the euro exchange rate.

4. Changes in View of the Great Recession

A number of changes have been introduced as a result of the financial crisis of August 2007 and the 'great recession' that are worth discussing. The most important ones are the following.

The ECB pumped limited liquidity into commercial banks after the August 2007 emergence of the financial crisis. Nonetheless, the ECB raised its rate of interest twice before it started reducing it from 4.25 percent in September 2008 (after the Lehman Brothers collapse on 15 September 2008) to an all-time low of 0.05 per cent in September 2014. In May 2009 the ECB enhanced credit support to euro area banks at very low interest rates through the introduction of the Long-Term Refinancing Operations (LTROs). Sovereign debt is used through this scheme as collateral on the loans provided. Initially LTROs were offered monthly and typically repaid in three months, six months or one year. In December 2011, however, the ECB offered a three-year type of LTROs, which had a significantly immediate higher demand than previous operations. From December 2011 to February 2012 the ECB provided €1trillion to the euro area banks.

The European Union (EU) summit meeting, 28/29 June 2012, took a number of decisions: banking licence for the European Stability Mechanism (ESM), discussed further below, which would give access to the ECB funding and thus greatly increase its firepower; banking supervision by the ECB; a 'growth pact', which would involve issuing project bonds to finance infrastructure; two long-term solutions are proposed: one is a move towards a banking union and a single euro area bank deposit guarantee scheme; another is the introduction of eurobonds and eurobills. Germany has resisted the latter, arguing that it would only contemplate such action only under a full-blown fiscal union.

A more recent proposal is the Single Resolution Mechanism (SRM), agreed by the relevant finance ministers at their meeting on the 18th of December 2013. This agreement proposes a new system that will centralise control of failing euro area lenders. It will be responsible for restructuring the 130 biggest euro area banks if and when they are faced with problems, as well as 200 or so cross-border banks. It is also given the right to intervene in any of the 6000 euro area lenders. An important development on this score is the ECB President's promise to 'clean' the euro area banks, made on the 9th of January 2014 after the relevant rate setting of the ECB governing council. This is under the Comprehensive Assessment of 130 euro area banks across the 18 member states. This will cover 85 per cent of the region's bank assets. A regulatory check of the banks' key risks and vulnerabilities followed by an in-depth asset quality review of their loans and bad debts, collateral valuations and trading book exposures. In 2014 a stress test is undertaken by the European Banking Authority, which is

expected to establish banks' resilience to possible shocks. The aim of the whole exercise is to instil health into the 130 euro area banks and to clean-up their balance sheets as necessary.

The SRM is planned to be a single resolution board, made up of representatives from euro area governments plus five permanent officials, and responsible for any decisions reached. However, relevant recommendations would have to be approved by the relevant finance ministers. This procedure could hold up controversial decisions. National governments could form national resolution funds by imposing levies on banks, which over 10 years would be merged into a single European pot, estimated to be around €55 billion. All this intends to stop expensive banking crises from ruining the finances of the relevant countries. It would bring to an end the use of the European taxpayer's money as a last resort, thereby ending the era of massive bailouts. But there are problems. The proposal may be too complex and its financial buffer is too small to safeguard against a major crisis. Furthermore, the SRM could face further problems, even a legal challenge at the European Court of Justice (ECJ). The European Parliament and the European Commission have already expressed concerns that the SRM agreement does not follow the 'community method'.

Further proposed changes are as follows. The ECB announced in July 2012 that it would do 'whatever it takes' to save the euro, as the President of the ECB promised then. This is considered as a turning point in the euro area sovereign debt crisis. This was confirmed by the ECB President after the ECB's first meeting in 2014 (Thursday 9th of January) of its rate-setting governing council: the ECB is willing and able to act quickly and decisively if inflation or money market rates gets out of line. Indeed the President reiterated that monetary policy would remain ultra loose and accommodative 'for as long as necessary', with the key ECB interest rates to be kept at low levels for an extended period of time. The key ECB lending rate was left unchanged at the meeting of its Governing Council on the 9th of January 2014, even though euro-zone inflation rate was well below the ECB's 2% target, at just 0.8%, and unemployment was near record highs at 12.1 per cent (November 2013). The key ECB lending rate was also left unchanged at the ECB's meeting of the 6th of February 2014. The implication of those decisions could be that the EMU area might fall into outright deflation in view of the inflation rate across the 18-country euro area slowing to a 0.7 per cent in January 2014, from 0.8 per cent in November 2013. Deflation is a particular worry for the euro area in view of the high debt, both private and public, in its most vulnerable economies. This eventuality implies of course that deflation raises its debt burden in real terms, thereby stifling spending by business and households. It could also stymie the current feeble EMU recovery as economic agents delay purchases in view of expected further price falls. The ECB was expected to take further action in response to this possibility. The expected ECB action is reduction in the ECB interest rate, rather than quantitative easing (as explained below). However, the Governing Council of the ECB at its 6th of February 2014 meeting decided that no action on this score was needed since deflation was not a threat to the euro area economy. The ECB President in answering a question at the relevant press conference declared that "There is certainly going to be subdued inflation, low inflation for an extended, protracted period of time, but no deflation".

Unlike the Federal Reserve and Bank of England, the ECB does not provide 'forward guidance' in the same way. Its own version of 'forward guidance' (adopted in July 2012) is the promise to keep interest rates at their current levels for an extended period, with the adamant statement that the ECB stands ready to maintain the high degree of monetary accommodation and even undertake more decisive action if conditions worsen. This, however, needs reinforcing along the lines of the Federal Reserve and the Bank of England, which pledge to explicit 'forward guidance'. However, the ECB developed the 'Outright Monetary Transactions' (OMT) bond-buying tool, only in secondary markets though, to back up that pledge, which was

unveiled in September 2012. There is also the condition that under OMT the ECB could buy unlimited amounts of short-maturity bonds in the secondary market of any country that signed up to fiscal conditions; it is also conditional for the relevant government that signs up for austerity-and-reform programme.

The European Stability Mechanism (ESM), the euro area's permanent bailout fund, was established in September 2012 as a permanent firewall for the euro area. It is designed to safeguard and provide instant access to financial assistance programs for member states of the euro area in financial difficulty, with a maximum lending capacity of €500 billion. The existing European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) remained active until mid-2013. The EFSF and EFSM continued until then to handle money transfers and program monitoring for the previously approved bailout loans to the relevant euro-area countries.

Since September 2012, further details have emerged: the programme that might help those countries that were regaining market access shifted into a strict condition that they do have complete market access, so that a relevant candidate could be allowed access; instead of publishing OMT's legal documentation 'soon' after September 2012, the ECB has shifted stance to 'only publish when a country applies'. The Bundesbank opposes OMT on the ground that it is close to monetary financing, namely direct borrowing by governments from their central banks, which is claimed it is banned by the Maastricht treaty; although the treaty does permit the ECB to buy public debt in the secondary markets.

It is the case that Germany's Central Bank, the Bundesbank, has never warmed to the OMT. In any case, the matter was referred to the German constitutional court, which in its turn referred the ECB OMT scheme to the European Court of Justice (ECJ), the highest legal court in the EU, on 7 February 2014. The view of the German constitutional court is still that the OMT programme is not covered by the mandate of the ECB; it is, therefore, 'incompatible with primary law' (as reported in the Financial Times, 8 February 2014), and it violates the German constitution. It would deprive the German government of its fiscal sovereignty for it would force it to accept any generated losses. The court considers OMT as 'monetary financing' or 'debt monetisation', whereby the Central Bank prints money to finance sovereign debt; this in this view is outlawed under European treaties. This incident raises questions over the OMT's legality thereby providing ammunition to the ECB's critics and prolonging legal uncertainty over the OMT. The German constitutional court seems to have concluded that only the ECJ could decide on the matter. Be that as it may, whatever the outcome of the ECJ's decision, problems are inevitable. For if the ECJ's decision is to uphold the ECB's defence of bond buying, which would imply squarely that it is consistent with the ECB's monetary policy mandate, the EMU will then be in the awkward position: the highest court in the EU is not in agreement with the highest constitutional court's decision of one of the most powerful EMU countries. If the ECJ does not uphold the ECB's defence of bond buying, the ECB then will be in a very awkward position. It is clear, though, that both the Bundesbank and the Germany's constitutional court have registered their strong objection to monetary policies underpinning the euro. Whether another crisis is thereby in the offing, it is an interesting question.

Be that as it may, on the 14th of January 2015, the ECJ released an Advocate General opinion on the legality of the ECB's OMT. The ECJ found OMT in line with EU law, with a final ruling to be issued in the coming months. The ECB at its meeting on the 22nd of January 2015 decided to undertake QE. The ECB would purchase €60 billion of eurozone bonds and other safe financial assets, every month between March (2015) and September (2016), or until inflation is back to the ECB's inflation target. This implies total purchases worth around €1.1

trillion, equal to around 10% of the EMU's GDP. The ECB started the QE on 9 March 2015. Whether it would be successful is an interesting and relevant question. QE requires the ECB to buy sovereign or high quality bonds. But EMU banks, insurance groups and pension funds need these assets to meet their capital requirements. This could imply that the ECB would have to pay higher price to encourage institutions to sell their bonds, which would imply lower if not negative yields. So banks and other relevant institutions may not be persuaded to buy riskier assets, such as equities, to boost the economy. ECB may thus not be successful (see Financial Times, 'European QE may not be live up to Draghi's hopes', David Oakley, 9 March, 2015).

'Asset-Backed Securities' (ABS), mortgage-backed securities (MBS), 'Collateralised Debt Obligations' (CDO), 'Collateralised Loan Obligations' (CLO), and other similar 'securitised' financial assets, but clearly with a lower credit rating, would be accepted as collateral in return for the liquidity provided by the ECB; and at a lower haircut (a write down of the asset's value to reflect its riskiness) than it had done previously. In fact that took effect in October 2013 in view of required legal changes. This is only for banks from countries with difficult economic circumstances. The ECB is not willing to buy these assets directly – only as collateral. Indeed, and as reported in the Financial Times (28 January 2014) the President of the ECB criticised at a panel of the World Economic Forum, in the January 2014 Davos gathering, 'Quantitative Easing' as not being a 'magic tool' in view of the EU treaty that prohibits 'monetary easing'. The President argued for the ECB to buy instead a package of bank loans to the private sector if economic conditions worsened.

Further changes have occurred more recently. In June 2014 the ECB introduced new steps to counter deflation: reduced its benchmark interest rate from 0.25 percent to 0.15 percent; introduced a negative deposit rate, whereby the ECB would be charging commercial banks 0.1 percent on their deposits with it. As from September 2014, the 'Targeted Long-Term Refinancing Operation' (TLTRO) is introduced whereby banks can borrow for up to four years so long as they use the funds to lend to households and companies (exclusive of mortgages); the ECB announced that it would study the possibility of security purchases. Furthermore and in September 2014 the ECB reduced further its benchmark interest rate to 0.05, and changed its deposit rate to minus 0.2 per cent. The Bank also announced that it would begin purchasing private financial sector assets in October 2014; this is a broad purchase programme of private sector assets, essentially 'simple and transparent' asset backed securities and covered bonds. The aim of this initiative is to improve credit intermediation and thereby help the non-financial real-orientated EMU sector.

It is clear from the analysis in this section that the ECB intervenes in secondary markets only; it is subject to the conditionality of EFSF and ESM and acts as a Lender of Last Resort (LOLR) to banks and other financial institutions but not to the state-members of the EMU. These and the other problems discussed above suggest that significant changes are necessary in terms of the ECB and its monetary policy. A number of relevant suggestions are proposed below.

5. Required ECB and Monetary Policy Changes

Reformulation of the objectives of the ECB to include high and sustainable levels of employment and economic growth, in addition to price stability (and indeed these objectives should also be firmly embedded in the European Constitution). The two-pillar strategy should be abandoned to avoid the serious problems discussed above, which can easily lead to loss of credibility, especially when the two pillars provide contradictory signals. The ECB must be made accountable to the European Parliament; the ECB statutes should be changed so that it

can clearly be involved in the co-ordination of fiscal and monetary policies. Ultimately ECB should be ready to take instructions from other European bodies, such as the ECOFIN. It is very important that the minutes of its rate-setting Governing Council are regularly published like the other major Central Banks, as for example the Bank of England case. Furthermore, and perhaps most importantly, the ECB should undertake explicitly and fully the role of lender of last resort, and should be made responsible for the stability of the EMU financial system. In this respect, the ECB should be responsible for all deposit insurance.

Full co-ordination of monetary policy, especially with fiscal policy and financial stability, is important. Monetary and fiscal policies both affect the level of aggregate demand, exchange rate and perhaps the rate of inflation, and this aspect points clearly towards coordination between monetary and fiscal policies. It is also important to note that the main operations of any Central Bank should be directed towards financial stability, so that prudential authorities take a system-wide perspective in regulation and supervision. The focus on the solvency of individual institutions as the case had been prior to August 2007 is simply not enough. The events leading to the 'great recession' testify to this important requirement; financial stability has not been addressed properly, and as such it requires further investigation and proper policy initiatives to account for it. The focus of financial stability should be on proper control of the financial sector so that it becomes socially and economically useful to the economy as a whole and to the productive economy in particular. Banks should serve the needs of their customers rather than provide short-term gains for shareholders and huge profits for themselves. In this system-wide attempt by Central banks, co-ordination of financial stability with monetary and fiscal policies becomes paramount.

But for the ECB to be able to manage what we have just suggested, further changes should be initiated, most important of which is the objectives of the ECB. Such changes should include that of the external value of the currency, and the rate of interest should be set with regard to its effect on the exchange value of the euro. The target exchange rate should be set by the Council of Ministers of the Eurogroup, and the ECB should be required to support that policy (through its interest rate and interventions in the foreign exchange markets). Under such circumstances the ECB rate of interest would have to be set with regard to its effect on the exchange value of the euro. It is very important for the EMU to formulate an official exchange rate policy and abide by it.

Finally, the achievement of full employment without inflationary pressures should be the ultimate objective. This does require an appropriate high level of aggregate demand, and the creation of sufficient capacity to support full employment. And as the President of the ECB stated recently "we need action on both sides of the economy: aggregate demand policies have to be accompanied by national structural policies"; indeed "aggregate demand policies will ultimately not be effective without action in parallel on the supply side" (Draghi, 2014). The ECB President went further to suggest that "it would be helpful for the overall stance of policy if fiscal policy could play a greater role alongside monetary policy, and I believe there is scope for this, while taking into account our specific initial conditions and legal constraints. These initial conditions include levels of government expenditure and taxation in the euro area that are, in relation to GDP, already among the highest in the world. And we are operating within a set of fiscal rules – the Stability and Growth Pact – which acts as an anchor for confidence and that would be self-defeating to break" (Draghi, op. cit.). This is an overdue proposal but it has limitations for the suggestion refers to the flexibility within the Stability and Growth Pact rules, which are extremely restrictive. The suggestion requires significant changes, which amount to abandoning the Stability and Growth Pact, and undertaking of course the kind of changes suggested in this section.

Substantial reduction of regional disparities is also necessary. The enhancement of the functions of the European Investment Bank (EIB), or a similar institution, to ensure high rates of capital formation across the EMU, becomes relevant. This suggestion is further enhanced when proper consideration is given to the present disparities in regional unemployment levels (and also in labour market participation rates) within the EMU. These disparities would suggest that even if full employment were achieved in some regions, there would still be substantial levels of unemployment in many others. There is, thus, a need for regional economic policies; a revamped EIB would be very important on this score.

6. Summary and Conclusions

We have discussed and assessed monetary and related policies of the ECB. In this way we have elaborated on the current economic policies in the EMU. A number of changes have been suggested, which require proper co-ordination of them. Without these significant changes the future of the EMU and the euro is not bright at all. Most important of it all is for the ECB to adopt fully the lender-of-last-resort function and move towards a banking union along with political integration as we have argued in another relevant publication (Arestis and Sawyer, 2013).

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