



**Erik Nielsen**  
INSIGHT

## Debate over role of the ECB hits the wrong note

The discussion of the European crisis and the appropriate policy responses have gone off track. We all agree that governments need to address the long term issue of sustainability of the eurozone, and work is in progress to that effect. But what about the short-term crisis management?

Some call for the European Central Bank to take out the bazooka and announce its unlimited use to bring down sovereign spreads. Chancellor Angela Merkel and President Nicolas Sarkozy seemed to give the green light for a more aggressive approach by the ECB by expressing confidence that the ECB will do what it has to to calm markets, and by promising not to comment on specific actions taken by the ECB. However, the ECB points to the treaty which prohibits direct financing of member states, or privileged access to the ECB, and it notes, therefore, that anything resembling quantitative easing would have to be undertaken simultaneously for all member states in proportion to size; an approach hardly called for. As the pressure on the ECB has built up in recent months, its

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president Mario Draghi felt obliged last week to state that the ECB would act only within its legal mandate and that it would obey the spirit of the treaty. This is where the discussion has gone off track. Better communication from all sides is called for. Of course the ECB will act only within the letter and spirit of the treaty; that goes without saying. But what does the treaty say (and what does it not say), and what is the spirit of the founding fathers? Let's take them in turn.

As stated on the first page of the ECB's website: "The ECB's main task is to maintain the euro's purchasing power and thus price stability in the euro area." For a central bank to secure price stability, it needs a well functioning transmission mechanism, and - since the transmission mechanism tends to break down during financial crises - the ECB, like other central banks, is granted a wide degree of freedom to introduce extraordinary measures to restore this vital mechanism

when necessary.

In line with this basic idea, on May 10 last year the ECB announced the Securities Markets Programme (SMP) with which it would intervene in public and private debt markets "to ensure depth and liquidity in those market segments which are dysfunctional. The objective of this programme is to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism". This was a clear case of the ECB doing its job, namely to implement a policy aimed at

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restoring the poorly functioning transmission mechanism.

Curiously, the ECB added what sounded like a condition for its decision, namely that when deciding on the scope of the interventions the governing council

has "taken note of the statement of the euro area governments that they will take all measures needed to meet [their] fiscal targets this year and in the years ahead in line with excessive deficit procedures and of the precise additional commitments taken by some euro area governments to accelerate fiscal consolidation and ensure the sustainability of their public finances". Clearly, the ECB's job would be facilitated by good fiscal and structural policies, but the treaty does not give it a free pass with respect to its mandate in situations where other policymakers fail to meet their commitments in full.

So what about the spirit of the treaty? By definition, that is a matter of interpretation, but one would think that it includes the idea of broadly similar monetary conditions across the eurozone. And as the ECB implied in May last year, the restoration of such a state of affairs was indeed the objective of the SMP.

Unfortunately, 19 months of "leaning against the wind" with relatively modest purchases in the sovereign debt market has not restored the transmission mechanism. And with the ECB having lost its power over monetary conditions, the playing field for businesses with respect to financing costs - which should be relatively even across a currency union - is now even more skewed than when the SMP was introduced. Maybe the (sometimes ill-informed) pressure from so many sides caused the ECB to divert too much energy towards the task of educating the public on the treaty and its interpretation, rather than focus on its undisputed obligation to restore the transmission mechanism?

The good news is that finally last week the ECB took more decisive steps in this direction. Unfortunately, it did not take the direct road of stepping up the SMP (still apparently blocked by a confused legal argument). Instead it took "the long way around" by making unlimited longer-term liquidity available to the banks against collateral now defined more broadly. This is a good second-best way of doing it; the effect should be the same as if it had taken the direct road - but it'll take a bit longer and include a few more risks. With a little luck we'll get there - eventually.

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