

ROUNDTABLE: MONETARY POLICY IN THE EU

Opening up ECB's Black Box and Painting it Green – the Monetary Policy Mandate in the Age of New Challenges and Uncertainty

February 18, 2021

dr Agnieszka Smoleńska, European Banking Institute

How to assure sufficient democratic control of central banks, in particular those in advanced economies? This question is becoming ever more pertinent as institutions such as the European Central Bank (ECB) seem to veer ever further off the orthodox monetarist path and become increasingly concerned – and rightly so – with the great challenges we face as societies, be it climate change or inequality. Amid calls for greater politicisation of central banks in response, particularly in the context of the ECB, this post draws on the jurisprudence of the Court of Justice of the EU (CJEU) to draw attention to the limitations of existing mechanisms of judicial control of the central bank's mandate perimeter. Such limitations, however, become opportunities where they shed light on the types of choices which the central banks are likely to make as they become increasingly active in combating climate change.

Keeping track of the ECB's expanding mandate

Changes in the theory and practice of monetary policy over the last decade have challenged how we think about the accountability and legitimacy of central banks. The new objectives and tools wielded by these institutions in an increasingly uncertain world – one where the assumptions of

many economic models are being called into question – undermine the idea that monetary policy is a technocratic and mechanical instrument, one which must be insulated from politics and political processes. Though the process of transformation has affected central banking globally, it has rattled especially our thinking about the ECB due to its tenuous democratic anchoring and the ambiguous role it played in the last economic crisis. The first step in thinking about adjusting mechanisms of control must begin with acknowledging how the mandate evolved.

The ECB, established at the time when the monetarist approach appears to have been at its peak, was held up as a paragon of independent narrow central banking.[i] Its primary mandate is price stability (Art. 127(1) TFEU), defined by the Governing Council in 1998 to be in the range of close to 2 % inflation. Since the Great Financial Crisis of 2008, however, the ECB has broken new ground with regard to its role in the financial sector with the stabilising effects of Mario Draghi's "whatever it takes", followed by the establishment of a centralised system of euro area bank supervision under the ECB (Banking Union). Further, the ECB acquired new responsibilities vis-à-vis the Member States through an array of rescue programs implemented both as part of monetary policy, and also through its role in the euro area's sovereign debt stabilisation programmes in the context of the highly controversial "troika."

At the same time, the ECB's internal perception of its role in the economy changed. First, concerns about "protecting" and "enhancing" the transmission of monetary policy in the context of market turbulence became omnipresent in the speeches of central bankers and in decisions on individual asset purchase programmes as the key to explaining why the ECB was determined to act. Second, financial stability, once a contested objective of central banking (or at least one that is substantially shared with other – national – institutions),

now is omnipresent in the language of the ECB. Third, and in tandem with the evolution of the markets more broadly, the ECB reached increasingly for oversight over those financial institutions which were proving to be of critical importance in how (and where) the market operated (e.g. Central Clearing Parties (CCPs)).[ii]

Reigning in the ECB

As the ECB ventured further afield from the narrow mandate of monetary stability, the debate about its democratic anchoring erupted. Calls for increased transparency and accountability are ever louder, in particular those from the European Parliament.[iii] It was judicial accountability, however, which became the control mechanism of choice, and called upon by many interested parties – states, citizens and corporations – to question the legality of the decisions taken by the ECB.

The CJEU in a series of high-profile cases (e.g. examining the legality of the sovereign bond purchase programmes *OMT* and *PSPP*) applied a two-step test to determine, first, whether the ECB had competence in a particular area, and second whether the instrument chosen was implemented in a proportionate manner. Yet even with the test being applied, so far deference to the technical knowledge ensconced in Frankfurt has been the hallmark of the jurisprudence of the CJEU in this area. This has provoked a rich debate, not only among EU scholars, but also national courts, ranging from ardent defence of the CJEU's cautious approach, to outright criticism, most notably from the German Federal Constitutional Court in Karlsruhe. [iv]

Given this controversial nature of the court's test, what could it ever tell us about the ECB's power to green its monetary policy? So far, the CJEU's approach has been only applied to matters of economic nature – monetary and fiscal

policies, financial stability, financial infrastructures. Given the controversies, could we ever expect the test do any better in the context of climate change action? Such a question appears pertinent as the ECB is clearly preparing itself to take the plunge and take monetary policy action explicitly in light of climate change considerations.[v] Below I sketch the questions that would arise in the context of an instrument of ECB's monetary policy and which have to be answered to meet the criteria of legality laid down by the CJEU.

Testing the ECB's mandate

The first part of the CJEU's test asks whether the ECB's mandate includes climate change at all. The emerging scholarship in the field of sustainable central banking, drawing on CJEU jurisprudence as well as teleological interpretations of the Treaty, suggests that a route to reading climate change mitigation into the ECB's mandate can be found.[vi] In fact, such a path leads not only – as would perhaps be most obvious – through the auxiliary, secondary mandate of the ECB (i.e. its general obligation to contribute to the economic policies of the Union), but as also through the ECB's primary mandate, namely that to ensure price stability in the euro area. After all, climate change may cause supply shocks and destabilise financial markets, while the way in which governments' policies seek to mitigate it create further risks for the bank's balance sheets (so-called transition risks). Climate change considerations must become part of the scenario within which the ECB conducts its monetary policy. The fact that not only climate activists, but increasingly central bankers themselves, argue that the ECB's mandate must include the power to design asset purchase programs in a manner so as to exclude significant CO2 emitters, suggests that this view is steadily entering

mainstream.[vii]If asked, the Court may well confirm such a mandate, given the route which climate considerations have taken into the central banks areas of interest, namely methods of scenario building and extending the time horizon for considering factors relevant to monetary policy formulation. This is likely all the more so, given the general effort of EU institutions in mitigating climate change (Green Deal).

Once the existence of a mandate is confirmed, there are a variety of tools which the ECB may use to pursue it. These range from how the ECB manages its own funds (where greening would pose little controversy) to unconventional measures such as asset purchases (where greening would raise eyebrows due to market impact and how far apart it appears from traditional monetary policy). For any instruments to be deemed in line with the EU Treaties following the CJEU's approach, they need to be appropriate, necessary and proportionate to the aim.

Questioning the ECB instruments' design

In reviewing the instrument chosen by the ECB the CJEU asks specifically about its appropriateness (*is it the right tool?*), necessity (*is the intervention kept to a minimum?*) and proportionality (*has it been balanced against other objectives/goals?*).

The answer to the first question allows us – external observers of ECB action – a glimpse into the types of proof that the ECB uses to make its decisions and the logic it employs in determining the link between the instrument chosen and the expected results. But what results could be expected in the context of a climate action objective? Could the ECB ever measure its results by how they contribute to keeping the Earth's temperature steady, or to reducing emissions? The

appropriateness question drives home the importance of translating climate change concerns into the financial language of risks, but as well that of the type of expertise required to identify such aims, namely climate expertise. This in turn raises the question of whether the manner in which monetary policy draws on such areas of science warrant specific scrutiny. Or do we trust that economists know better, and at least if they do not know themselves, that they know who to ask?

The second question of the CJEU verifies the self-restraint of the ECB by testing whether the intervention in the market was kept to minimum and whether market incentives were kept in place. In other words, this step is oriented at ensuring that the actions taken by the ECB do not go beyond what is necessary to achieve the stated aim, whilst limiting the interference ECB in the market processes. In the past, at this stage, the CJEU assessed the conditions attached to the policy instrument, e.g. those which imposed quantitative or time limitations. Yet in the context of climate change action, how could the ECB simultaneously remain “neutral” yet help steer the market in such a way that it delivers greener outcomes? The necessity test, if it is applied treating the ECB as an intervenor but non-participant in the market, reinforces the principle of “market neutrality” which acts as a significant constraint on ECB action. Arguably, necessity test could only be met in the case of climate change action on the part of the ECB, if a recalibration of the EU’s “open market economy” model with regard to objectives such as climate change action is acknowledged.

The third question of the CJEU in turn strives to ensure that there is a balancing of interests affected by the instrument chosen by the ECB. So far, the CJEU has limited itself to confirming that the ECB has performed such an exercise and has done so only in the context of fiscal and monetary policies. Introducing the climate change dimension, which has a

significant bearing on economic policies at EU and Member State levels, energy policies as well as social (cohesion) ones, will necessarily alter the nature of the task. Therefore, it appears warranted that the balancing the ECB conducts include consideration of the impact of its actions in other areas of EU competence, for example for the internal market as a whole. The process of balancing and the sources of knowledge for the ECB in acting become paramount here. However, if such a balancing exercise can be done in a transparent manner, it provides an enormous opportunity for a greater understanding of the distributive effects of choices ECB makes.

Opening up the ECB's black box

As this post has argued, in the light of the ongoing discussion about democratic control of ECB's action it is useful to think about the prospects of greening of ECB's monetary policy (as the most recent expansionary trend) through the lens of the CJEU's proportionality test. This constraint on how the ECB exercises its mandate allows us to formulate specific questions about how the ECB makes its decisions, what type of information it draws on, what issues it considers relevant and how it understands (or projects) its role in the market. Crucially, in the context of greening of monetary policy, these questions allow us to think about the evolution of the ECB not in isolation, but as an element of a general transformation of the EU's economic constitution. In an increasingly complex and uncertain world this is no small thing.

Such an approach does not solve the question of whether outright politicisation, such as subjecting central banking to electoral processes, is needed. However, it helps understand that the problems that lie at the heart of many criticisms of

ECB arise from how today's capitalist economies operate, in particular with the advancing financialisation of all aspects of our lives, from climate to societal well-being.

When we return to the question of exercising democratic control over the ECB, it is clear that an adaptation of the tools used to monitor the perimeter of its mandate is needed especially with regard to the interdisciplinary questions. Nonetheless, the Court's test can – by requiring transparency which the ECB may well offer even before it is even challenged before the courts – help us citizens better understand the choices being made, and therefore also weigh in.

Based on a working paper presented with Paweł Tokarski "The Greening of the ECB- a legal-economic analysis" prepared for the "Shining a Light on Energy: 10 Years of the Lisbon Treaty" College of Europe (Natolin) conference, 17-18 June 2020.

[i] Johnson, J. (2016). *Priests of prosperity: How central bankers transformed the postcommunist world. Priests of Prosperity: How Central Bankers Transformed the Postcommunist World*, Cornell University Press. doi:10.1080/13876988.2020.1804299

[ii] Smoleńska, A. and Héritier, A. (2021). Political Accountability and effects: Capital Markets Union' in *Regulating finance in Europe: Policy effects and political accountability*, A. Héritier and J. Karremans (eds.), Edward Elgar Publishing.

[iii] Curtin, D. (2017). 'Accountable independence' of the European central bank: Seeing the logics of transparency. *European Law Journal*, 23(1–2), 28–44.

[iv] Feichtner, I. (2020). The German constitutional court's PSPP judgment: Impediment and impetus for the democratization of Europe. *German Law Journal*, 21(5), 1090–1103, Sarmiento, Daniel; Weiler, Joseph H.H.: The EU Judiciary After Weiss: Proposing A New Mixed Chamber of the Court of Justice,

VerfBlog, 2020/6/02,
<https://verfassungsblog.de/the-eu-judiciary-after-weiss/>, Van
Der Sluis, M. (2019). Similar, therefore different: Judicial
review of another unconventional monetary policy in Weiss
(C-493/17). *Legal Issues of Economic Integration*, 46(3),
263–284., De Boer, N., & Van't Klooster, J. (2020). The ECB ,
the courts and the issue of democratic legitimacy after Weiss.
Common Market Law Review, 57(6), 1689–1724.

[v] Lagarde, C. (2020). Climate change and the financial
sector, Speech at the launch of the COP 26 Private Finance
Agenda, London, 27 February 2020.

[vi] Solana, J. (2020), A reminder from the courts for the
European Central Bank to take climate change seriously
Commentary on 20 May, 2020
[https://www.lse.ac.uk/granthaminstitute/news/a-reminder-from-t
he-courts-for-the-european-central-bank-to-take-climate-
change-seriously/](https://www.lse.ac.uk/granthaminstitute/news/a-reminder-from-the-courts-for-the-european-central-bank-to-take-climate-change-seriously/), De Serière, V. (2020). Idealism or
realistic approaches? Regulatory possibilities to require
financial institutions to more substantially contribute to
achieving climate goals? An overview. *Journal of International
Banking Law and Regulation*, 35(3), 94–106.

[vii] Financial Times, Christine Lagarde expected to make ECB
a climate change pioneer, 2 January 2021,
[https://www.ft.com/content/00d5dc18-b95d-4a15-b936-e87c98fb17f
c](https://www.ft.com/content/00d5dc18-b95d-4a15-b936-e87c98fb17fc); Schabel, I. (2020). Never waste a crisis: COVID-19, climate
change and monetary policy

Speech by Isabel Schnabel, Member of the Executive Board of
the ECB, at a virtual roundtable on “Sustainable Crisis
Responses in Europe” organised by the INSPIRE research
network, 17 July 2020.
[https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp20071
7~1556b0f988.en.html](https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp200717~1556b0f988.en.html)