

ECB's Discretion vs Legitimacy: In Defence of a Limited Central Bank

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Abstract

The European sovereign debt crisis, and later the pandemic, led the ECB to take unconventional monetary policy measures to restore confidence in the Euro. While these measures were necessary to preserve Europe's financial and economic stability, they also resulted in an increasing accumulation of power by the ECB, which may warrant a rebalance of the framework that underpins its legitimacy. While independent central banks are widely recognised as essential to avoid manipulation in favour of short-term political interests, it is also crucial to ensure that they remain legitimate in the eyes of constitutional democracies. This balance seems increasingly challenging to achieve, especially when the ECB's actions imply value judgments that may be outside its technocratic scope. Moreover, doubts arise as to whether it can effectively deliver on its mandate in the current high inflation context. Against this background, this paper assesses how the ECB's increasing scope of action may threaten its legitimacy. To carry out this analysis, we first focus on the concept of discretion, illustrating how some of the ECB's current policies fall outside its technocratic sphere, entering a political dimension. Then, we reflect on the consequences of this behaviour, arguing that the ECB needs to reduce its scope of action to remain relevant in the future.

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It is this danger of substituting authorities for rules which especially deserves attention among students of money (...) An enterprise system cannot function effectively in the face of extreme uncertainty as to the action of monetary authorities or, for that matter, as to monetary legislation. We must avoid a situation where every business venture becomes largely a speculation on the future of monetary policy (Simons 1936, 3–4).

Almost 90 years later, Simons' warnings on the risks of discretionary monetary authorities seem even more striking, especially at a time when central banks have considerably increased their scope of action. In that regard, implementing unconventional monetary policies is a clear turning point. Likewise, new challenges emerging from the pandemic crisis or even climate change or digitalisation have led central bankers to expand, or plan to expand further, their role in society.

As the most independent of independent central banks, with no direct fiscal counterpart, the ECB is a very special case. In this context, to achieve the main goal of this paper of studying the link between the ECB's discretion and its legitimacy, it is thus necessary to study the ECB's changing role, especially after the European sovereign debt crisis (second chapter), to then understand to what extent the institution's actions may go beyond its technocratic scope, potentially threatening its. In the conclusion, we make some considerations about the future of the ECB.

ON POWER AND DISCRETION

Facing a Sovereign Debt Crisis: Unconventional Monetary Policies and the SSM

Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough (Draghi 2012).

Facing a Pandemic: Expansion and Flexibility

The stabilisation function of the PEPP is ensured by its flexibility, which is crucial given the unpredictable course of the pandemic and its uneven impact across economies (Lagarde 2020).

Facing a War and Inflation: The ECB is “no hostage to anyone”

So when the Governing Council will determine that a country is eligible (...), it will activate TPI, and, as I said earlier on, there is no ex-ante limit to that programme. (...) the ECB determines in its own discretion, not being hostage to anyone. So the four criteria that it will use will be indicative, will be elements of information that it will take into account in order to make its decision (Lagarde 2022)

WHILE...Facing a “Changing World” of Climate Change and Digitalisation

“Price stability, price stability, price stability ... I must have heard it 1,000 times in my first couple of months. So you are riveted to that. But at the same time, the world changes around you,” (...) Climate change is an example, digital euro is another one. We are riveted to our price stability objective, and we are the custodian of the euro, but we have to be attentive to the big developments around us as well.” (Lagarde 2021)

The famous Draghi’s “whatever it takes” commitment materialised in a set of unconventional monetary measures during the European sovereign debt crisis (e.g., APP - Asset Purchase Programme), followed by a substantial expansion of asset purchases to face the Covid-19 pandemic (e.g., through the PEPP – Pandemic Emergency Purchase Programme), and the more recent Transmission Protection Mechanism (TPI) launched in a period of war in Europe to prevent market fragmentation (European Central Bank 2022; n.d.; n.d.). These examples reflect increasing additions of discretionary tools to help solve emerging challenges in the Euro Area, alongside ongoing works addressing climate change or the potential setup of a Digital Euro. These measures were, in part, quite successful in meeting the short-term main goal of preserving the stability of the Euro. However, they also have potential costs, making the ECB’s quest to balance power, independence and legitimacy very challenging.

POWER AND DISCRETION VS. LEGITIMACY AND INDEPENDENCE

Describing it as “one of the most enduring concepts in modern political science”, Bruce Gilley (2011) associates the idea of legitimacy with the “rightfulness of a political object”, which fundamentally refers to the capacity of a political object (e.g., government or institution) to exercise its power in conformity “with a set of norms prevalent in a given political community”. In this sense, to assess whether power is legitimate, it matters to understand what “generates legitimacy”, in other words, what supports the rightful application of power by an authority (Gilley 2011, 946).

David Beetham outlines the main components of legitimacy (each one, as seen, then subject to different interpretations). These components are used to structure the proposed research, which aims to apply the concept of legitimacy to the specific case of central banks. In concrete, Beetham (1991) argues that power can be legitimate if it embodies three dimensions (i) “it conforms to established rules”, (ii) “the

rules can be justified by reference to beliefs shared by both dominant and subordinate” and (iii) “there is evidence of consent by the subordinate to the particular power relation” (Beetham 1991, 15–16). When applying to central banks, focusing on Beetham’s first dimension (on conformity with the law), we see that there is a vast literature focusing on the legality of central banks’ decisions, namely on the ECB’s application of unconventional tools in the aftermath of the global financial crisis (Fabbrini 2015; 2016; Pennesi 2016; Hofmann 2015; Beck 2014). Indeed, the most relevant legal contest to central banks’ policy innovations came from the German Constitutional Court, which sought guidance from the European Court of Justice on the legality of ECB’s measures. A legal challenge that created many controversies and ended-up being dismissed by the highest German court on the grounds “that the European Central Bank demonstrated in a sufficiently comprehensible manner that it had conducted a proportionality assessment of the Public Sector Purchase Programme (PSPP) and thus satisfied the requirements set forth in the judgment” (Bundesverfassungsgericht 2021).

The legal dimension is unquestionably open for discussion, especially considering new developments after the pandemic that expanded the ECB’s scope of action before a forced monetary contraction to contain unprecedented inflation levels in the single currency’s history. However, considering the absence of this or other successful legal actions, we mostly focus on Beetham’s second and third dimensions. Indeed, legitimacy goes beyond legality, and doubts arise on the justification for the power acquired and exercised by central banks (Beetham’s second dimension).. On this matter, the author claims that to be justified, the structure of power must have the appropriate qualities to serve a recognizable general interest (e.g., in which we could highlight price stability) (Beetham 1991, 17). In this point, we may infer that central banks’ capacity to deliver positive results could be perceived as a necessary condition for ensuring their legitimacy. Thus, if ECB’s policies prove to be ineffective, the legitimacy of the central bank may also be challenged. In addition, on the evidence of consent (Beetham’s third dimension), we may also find some concerns about the legitimate transition of power from governments to independent central banks. Indeed, although having a mandate that is delegated from an elected power, the recent application of unconventional measures raises uncertainties as to the legitimacy of central banks in taking decisions that contain distributional choices. In this regard, Tucker argues that independent agencies, such as central banks, should not take decisions “that entail making big distributional choices or big value judgments on behalf of society” (Tucker 2018, 558). When considering central banks’ increased responsibilities after the crises, this research focuses precisely on the consequences of the increasing judgemental decisions that have been taken by the ECB, namely after the European sovereign debt crisis.

When considering the topic under investigation, it is relevant to study the existing literature on the relations between politicians and bureaucrats. From a normative perspective, Alesina and Tabellini (2007, 2008) argue that bureaucrats/technocrats tend to be preferable when the state is pursuing a generally accepted social preference (such as preserving price stability) that benefits from the ability of

experienced independent specialists (like central bankers) to achieve that interest. The delegation to independent bureaucrats also helps to avoid compromising the long-term with short-term policies motivated by electoral gains. On the other hand, politicians tend to be preferable to take decisions in which social preferences are uncertain and where flexibility is therefore valued (Alesina and Tabellini 2007; 2008). In these papers, the authors conclude that there is a difference between what is the normative benchmark and what is really delegated by politicians.

Complementary, focusing on the delegation of power from the political to the unelected (technocratic) power, the book of Paul Tucker *Unelected Power* (2018) presents a detailed reflection on the principles that should guide a legitimate delegation of power from democratically elected politicians to independent agencies, in particular central banks. Tucker develops his argument based on a context in which the border between technocratic and political power is becoming less and less evident, especially in central banks, which have significantly increased their scope of action in the aftermath of the financial crisis. In his book, the author argues that the existence of agencies isolated from politics is beneficial to society and compatible with liberal democratic values as long as their power is properly contained, held accountable and legitimised. In this context, Tucker proposes establishing a series of principles that determine when and under what conditions the delegation of power to independent agencies is appropriate. Namely, in “when” to delegate, the author argues that delegation is beneficial if it resolves the need to maintain a credible and socially necessary commitment, which would be difficult to ensure by the elected power (such as maintaining low inflation). However, it is fundamental to prevent independent agencies from making big distributional choices or value judgments (Tucker 2018, 558). As for the “conditions” for delegation, Tucker proposes a series of precepts to be fulfilled, emphasising, for example, the need for objectives, powers and responsibilities well defined by the legislature, the search for transparency that allows democratic scrutiny and public debate, as well as the need to establish clear procedures that allow elected politicians to determine the extent to which, in an emergency, an extension of the powers of a given agency is justified (Tucker 2018, 570–72).

Moreover, the concept of legitimacy cannot be disassociated from the concept of independence. Several authors demonstrate that greater central bank independence is associated with the desired price stability (Barro and Gordon 1983b; 1983a; Kydland and Prescott 1977; Rogoff 1985; Alesina 1988; Alesina and Summers 1993; Posso and Tawadros 2013). From these assessments, the pursuit of central bank goals is contingent on isolation from political interests, usually motivated by short-term electoral gains. In this vein, we see that independence is a pre-condition for having central banks capable of delivering price stability. In this framework, Condon (2019) stresses that after the big inflations in the 60s and 70s, many central banks have increasingly won more freedom to conduct monetary policy without political interference.

In this respect, while acknowledging that central bank independence is “one of the most effective policy innovations of the past four decades, one that has led to a dramatic fall in inflation worldwide” Kenneth

Rogoff (2019) argues that this important institutional innovation “risks being seriously undermined”, emphasising that independence “has to be earned every day” and is “rarely granted by constitutional decree, and even where it is, the letter of the law has little meaning if political support is lacking” (Rogoff 2019, 19). Again, in line with the concept of legitimacy, we see that independence goes beyond the respect of the law. Regarding the risks undermining independence, the author describes a crossroads where “the public has come to expect central banks to shoulder responsibilities far beyond their power, and even farther beyond their remit” (Rogoff 2019, 1).

Moreover, when assessing independence and its consequences on legitimacy, it also matters to understand how it may be affected by populism. Looking at this phenomenon, Zakaria (2019) stresses that the visible attacks against central bank independence worldwide, with a highlight for the United States, “might end up being the most damaging and long-lasting consequence of this era of populism”. On this topic, Goodhart and Lastra (2018) highlight that central bank independence is threatened not only by the expanded mandates of central banks but also by the rise of populism. According to the authors, “attacks on central banks or central bankers exceeding their mandate or remit (or not performing their mandate as expected by politicians) are often disguised attacks on central bank independence”. In that regard, while this research focuses on the consequences from the ECB’s increasing scope of action, it is therefore relevant to bear in mind whether arguments opposing to central banks’ interventions originate from valid concerns about their legitimacy or whether they originate from populist attacks against their independence. At a time of growing populism, it is therefore crucial to differentiate between the desired political accountability and the undesired political pressure. For that purpose, it is relevant to understand accountability and how it interacts with legitimacy and independence. In this respect, Goodhart and Lastra (2018, 54) stress that while the law “legitimizes” the creation of central banks, it does not legitimate their ongoing exercise of delegated powers, “being in the continuing life of that entity that accountability becomes necessary to ensure legitimacy”. In the post-2008 crisis framework, more accountability and transparency mechanisms have been pointed out as needed to ensure ECB’s independence and legitimacy e.g., (Claeys, Hallerberg, and Tschekassin 2014; Braun 2017; Fromage et al. 2019).

From the analysis above, we may perceive a significant interdependence between power, independence and legitimacy. Notwithstanding, some fundamental ideas may be withdrawn from this review. The first is that legitimacy goes beyond legality, being a non-binomial concept, which means that we are not dealing with a simple distinction between having or not having legitimacy (there are various degrees, while the concept itself is subject to different interpretations). We have also seen that to be legitimate, an institution must be effective in delivering on its mandate. Following this reasoning, we may also conclude that if, as seen, independence is a pre-condition for central banks delivering on their mandates, independence is, therefore, a necessary (although not sufficient) condition for having

legitimate central banks. In short, power is legitimated if it serves its purpose and for that, in the case of central banks, it requires independence.

In this framework, the understanding of these interactions gets more complex to assess when we refer to a delegated power, especially when this delegated power takes decisions in which, by implying value judgments, it is not entirely clear what social preferences are. This uncertainty is in part explained by what Rogoff (2019, 5) describes as a “crippling confusion over the conceptual distinction between monetary policy and fiscal policy” in which the author considers that “alternative monetary instruments” are “really better thought of as quasi-fiscal instruments”. Having developed this idea in his book *The Curse of Cash*, Rogoff (2016, 137–40) explains that what most policy literature and press as labelled as quantitative easing (QE) should be “more accurately called fiscal QE” as these operations have a significant element of fiscal policy. In addition, when addressing the topic of the ECB’s legitimacy, two additional features must also be considered. The first relates to establishing a Banking Union, which includes the creation of a Single Supervisory Mechanism led by the ECB. The second relates to the ECB’s supranational nature.

Regarding the Banking Union, the global financial crisis made clear the risk of contagion between banks’ financial situation and the public accounts of the States, which constituted the main argument in favour of its establishment (Van Rompuy 2012). In this topic, some research helps to understand the functioning, the benefits and some of the risks inherent to the new European institutional framework e.g. (Schoenmaker and Véron 2016; Howarth and Quaglia 2016; Viterbo 2017; Grundmann and Micklitz 2019). We conclude that adding a supervisory leg to the ECB was perhaps the best solution to accommodate such a relevant project with the urgency that was required by European decision-makers. The institution had the infrastructure and resources to do so, being the natural solution when considering that most central banks in the Euro Area also incorporate the supervisory function (European Central Bank n.d.).

In addition, the Banking Union is still (and maybe forever) an incomplete project. On top of the harmonisation of rules through the development of a Single Rulebook, the creation of the SSM headed by the ECB as mentioned above, and the establishment of a Single Resolution Mechanism (SRM) for resolving non-viable banks, the initial design of this project also envisaged the set-up of a European Deposit Insurance Scheme (EDIS) (Consilium 2023). Although the need for an EDIS was part of the initial conception of the Banking Union, its implementation was always controversial and has faced several obstacles, with some member-states, such as Germany, resisting a greater mutualisation of banking risks (Brunsdon 2015). Accordingly, an incomplete Banking Union undermines the objective of preventing financial fragmentation and breaking the nexus between bank and sovereign risks. It also poses legitimacy concerns. In fact, under the current framework, the responsibility for the supervision and resolution of banks is now collective (at the European level). At the same time, the eventual

consequences of the decisions taken by the SSM or SRM may revert to the national authorities, namely through their national deposit insurance schemes (Ferreira 2018).

Furthermore, given the supranational nature of the ECB, the discussion around ECB's legitimacy goes beyond understanding the relationship between a central bank and its respective domestic government. Decisions on monetary policy and banking supervision are taken by the ECB together with the National Central Banks (NCBs) of the Euro Area member-states, with the Governing Council (represented by all these institutions) constituting the main decision body (Paternoster 2019). This background places our discussion at a transnational dimension in which the issues of power, its delegation framework, independence and legitimacy go much beyond the domestic dimension. In this respect, Anne-Marie Slaughter (2004) describes an emerging new world order comprising a set of government networks, including financial regulators, judges, or even legislators, that interact with each other domestically and internationally. According to the author, these networks may help solve a globalisation paradox, in which there is a need for more government on a transnational scale to solve global problems, but at the same time fear of an over-centralization of power that may threaten individual liberty (Slaughter 2004, 8). As such, Slaughter sees a high potential for a global disaggregated form of state (in opposition to a global unitary state), as it could help address the need for "global rules without centralized power but with government actors who can be held to account through a variety of political mechanisms" (Slaughter 2004, 10–11). However, ensuring that these government networks do not materialise in promoting global technocracy is necessary.

It is also necessary to remember that ECB, as the central bank of 20 different countries, is the most advanced example of the emerging new world order as described by Slaughter. In this regard, Giulio Peroni (2017, 255) outlines that contrary to the reality of other countries, in which "monetary policy includes balancing Parliamentary and the Government control on the one hand and the central monetary authority on the other", the case of the ECB is different as it "does not have equivalent counterpart, and moreover it is not obliged to interact with national Governments". When considering the ECB's response to the crisis, the question of whether the ECB holds an excessive concentration of power, unaccountable to the democratically elected power, is more striking (Peroni 2017, 259). On this issue, although acknowledging the risk of a democratic deficit, Peroni argues that most of the criticism of ECB's interventions is moved by "populist traits" and that the institution has successfully managed, in a time of great need, to safeguard the Euro, while "receiving a formal investiture at European political, institutional and legal level" (Peroni 2017, 256). Notwithstanding, more accountability and transparency mechanisms are recommended by Peroni to avoid, or at least limit, a democratic deficit and also preserve the independence of the ECB (Peroni 2017, 259–61). Peroni's views, however, are not consensual. Some authors, namely Giannone (2015), argue that the ECB's democratic deficit is present at the very origin of the institution. The author defends that in the "the output-oriented legitimacy model of the EU", a lower control by the elected representatives "can even be accepted as

economic efficiency is rated higher than democracy in the economic and political situation at hand” (Giannone 2015, 112). The author argues that this output legitimacy is based on the belief that ECB’s legitimacy is solely connected with the institution’s capacity to achieve good results, in which independence is a crucial feature as it provides more credibility to ECB’s actions. However, Giannone sees that this form of legitimacy, under the existing treaties and statute, does not necessarily involve democratic accountability, as the institution is completely isolated from political influence, mainly given its limited accountability to the European Parliament and lack of responsiveness to the people who are really affected by its decisions (Giannone 2015, 111).

CONCLUSION

The recent crises led central banks to make judgemental decisions, making balancing their delegated power with legitimacy and independence increasingly challenging. Indeed, this renewed framework led central banks to take decisions that imply value judgments on wealth transfers between creditors and debtors, different generations, or even within countries, as in the case of the ECB. Discretionary decisions, by their nature, would ideally be taken by politicians. However, history has proven that politicians' control of monetary policy is not ideal, as it would certainly lead to inflation.

Today, the problem is amplified by rising inflation, compromising ECB's “output legitimacy”. Indeed, independence requires a proper justification, namely the capacity to keep prices controlled. Political pressure is inevitable if this premiss fails, regardless of whether central banks are to blame. In truth, while complying with their price stability mandates, central banks need to take unpopular measures with direct consequences on the day-to-day life of citizens, affecting their purchasing power and capacity to service debt. Ultimately, these citizens can drive governments to pay the respective electoral price. In the words of Shapiro (2005, 347), “it is utopian to expect that politicians, who will ultimately be held responsible for the costs imposed by regulation, will wait until after regulation has done the damage”. Most likely, as the author claims, politicians will “rather seek to prevent the damage by intervening in the regulatory process”.

Whereas taking unpopular decisions may be part of central bankers’ work, which justifies their job security and independence from politicians, ensuring that such measures are perceived as primarily grounded in technical and unbiased judgments is crucial. When central banks’ measures are increasingly based on discretionary judgments, it becomes harder to justify delegating power to independent central banks, especially when they cannot control inflation. In this connection, this paper argues that the only way to keep independent and politically legitimised central banks is to reduce their scope of action in the future. But for that, the ECB needs to survive what we anticipate could be a credibility crisis. Without keeping its credibility, the ECB will struggle to remain relevant. It may even struggle to remain independent.

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