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TRANSFORMER L'ESPRIT ÉCONOMIQUE EUROPÉEN · FAIRE FACE AU DÉFI DE LA TRANSITION ÉCOLOGIQUE

THE EUROPEAN CENTRAL BANK AND THE POLICY MIX

Sebastian Diessner

INSTITUT AVANT-GARDE

TRANSFORMER L'ESPRIT ÉCONOMIQUE

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ABSTRACT

This piece reviews how the European Central Bank can contribute to facilitating the green transition and then discusses how the ECB's approach to policy coordination should be improved, in light of the recent review of the central bank's operational framework for monetary policy. **In a nutshell, the ECB needs to: dare to differentiate and care to coordinate**.

1. Dare to differentiate: the ECB and the green transition

The European Central Bank has both the responsibility and the tools to play an important role in facilitating the green transition, despite persistent arguments to the contrary and despite an increasingly polarized debate on the topic (see the recent critiques of Frank Elderson; Politico 2024). While the central bank has explicitly acknowledged this responsibility in the 2021 review of its monetary policy strategy (ECB 2021), it still needs to follow up on its commitment with a more proactive use of its various policy instruments. Generally speaking, the ECB can draw on two types of tools within its operational framework which can (also) be geared towards facilitating necessary green investments: conducting asset purchases (and specifying the conditions for these purchases) and setting interest rates (including on its deposit facilities as well as large-scale lending operations).

The ECB – like most other major central banks, with the notable exception of the Bank of Japan – has been in tightening mode over much of the past two years, in response to the inflationary shocks of 2021 and 2022. It has raised its main interest rates by 450 basis points in the span of just under 14 months. It has also started to unwind its balance sheet by phasing out reinvestments under its asset purchasing programmes and by incentivizing commercial banks to repay their long-term loans early. The context of monetary policy tightening has commonly – if wrongly – been perceived as not being conducive to greening central banks' monetary policy operations further. Supporting the green transition, some observers seem to suggest, is a luxury that can be afforded in times of expansionary monetary policy only, if at all (Bloomberg 2021; Rajan 2023). This is a fallacy, however, not only when it comes to conducting asset purchases, but also in terms of setting interest rates (Monnet and van 't Klooster 2023). A guiding principle for both types of tools should be: differentiation.

First, with regard to asset purchases, even though the ECB is currently in the process of reducing the size of its balance sheet, there are strong arguments that it should maintain a structural bond portfolio in the long run, not only for liquidity purposes (Lane 2023) but also to be 'targeted using climate criteria' (Välimäki 2024). In particular, the ECB's current and future asset purchases could – and should – be differentiated much more towards buying green debt instruments. Purchases of 'supranational' bonds issued by EU institutions and investment banks, for example, have been limited to 10% of net purchases under both the Public Sector Purchase Programme (PSPP) and the Pandemic Emergency Purchase Programme (PEPP) in the past. This limit is at the ECB's discretion and could be increased (or lifted) to enable Eurosystem central banks to purchase green bonds issued by national development banks and the European Investment Bank (EIB) on a larger scale, in light of the fact that the EIB has long been the largest supranational issuer of green bonds on the globe (Batsaikhan and Laurentjoye 2020; De Santis et al. 2018)[1].

[1] A more far-reaching measure would be for the ECB to lend directly to the EIB, accepting green loans as collateral (see Monnet and van 't Klooster 2023).

Second, when it comes to setting interest rates, the ECB has far more room for maneuver than is commonly acknowledged as well, both in terms of the rates it offers on its loans and those that it sets on deposits. On the one hand, the ECB should gear its refinancing operations more towards promoting green investment, by offering relatively lower rates to banks for financing firms' and households' green projects, as has recently been demonstrated by the Bank of Japan's Climate Response Financing Operations, for example. In return for low refinancing costs, the BOJ requires eligible banks to select adequate 'targets and actual results for their investment or loans' (Bank of Japan 2021; see van 't Klooster 2022). On the other hand, the ECB should differentiate its deposit rates much more as well, tiering the remuneration of reserves that commercial banks hold with the central bank. While lowering the remuneration of reserves can help improve the transmission of monetary policy and reduce the large-scale transfers that banks have enjoyed throughout the current tightening cycle in general (De Grauwe and Ji 2023), doing so for banks with a low proportion of green lending would help incentivize these and other banks to provide more financing for the green transition in particular (Monnet and van 't Klooster 2023).

In a nutshell: the ECB should dare to differentiate its monetary policy operations much more toward supporting the green transition. This should involve both its asset purchasing programmes and its main interest rates, and should ideally be done in closer coordination with other key stakeholders (as discussed in the following).

2. Care to coordinate: The ECB and the policy mix in the euro area

Since its inception in 1998, the ECB has shown a skeptical attitude towards coordinating its policies with other policy-making bodies in the EU, and it initially refused to think in terms of a policy mix for the euro area altogether. This attitude was laid bare by ECB president Wim Duisenberg in one of his first speeches to the European Parliament, which made clear that the central bank should not be expected to care much about policy coordination: 'the Eurosystem supports the idea of a dialogue between monetary policy and other policy areas (…) However, such a dialogue should be clearly distinguished from any attempts to coordinate policies ex ante, so as to achieve a certain policy mix' (Duisenberg 1999; see Braun et al. 2024; Diessner 2022). This view reflected an overly strict interpretation of EU Treaty provisions on central bank independence which stipulate that the ECB 'shall not seek or take instructions' from other European or national institutions (Art. 130 TFEU), wrongly suggesting that independence is incompatible with policy coordination (Diessner 2019; 2023; van 't Klooster and de Boer 2023: 740, and sources cited therein).

Over the years – and especially since the Eurozone crisis of 2009-14 and the COVID crisis of 2020 – this position has become increasingly untenable. The idea of a neat separation between monetary and fiscal policy in particular can hardly be deemed credible in light of the deep entanglements between the two policy areas due to the central bank's large-scale purchases of government debt (Diessner and Lisi 2020), which have contributed to an eight-fold increase in the Eurosystem's balance sheet between 2007 and 2021. And yet, the notion that the ECB's independence ultimately precludes coordinating its policies with other actors can be found in the ECB's thinking, and more importantly in its actions, to this day (see, for example, Schnabel 2020). Indeed, it can be identified right now with regard to the recent review of its operational framework, for which the ECB had initially announced to unveil its plans sometime 'in the spring' of 2024 but ended up doing so on March 13 already – a move which has been perceived as premature by veteran observers (ECB 2024a; Demertzis et al. 2024).

While seemingly mundane and technical on the surface, the way the ECB sets up its operational framework is highly consequential for its capacity to conduct monetary policy in the coming years, including for its flexibility in purchasing assets and for its ability to differentiate interest rates to support the green transition (Positive Money Europe 2024). Given the ever closer interactions between monetary and fiscal policy, this is bound to have implications for macroeconomic governance in the euro area more broadly as well. However, the recent review of the framework has barely been politically discussed at all and thus seems to have taken place without much scrutiny by – let alone input from – key stakeholders like the European Parliament[1]. That it is possible and indeed necessary to foster public engagement with a central bank's operations without jeopardizing its independence can be seen by the example of the United Kingdom. In the UK, both Houses of Parliament have engaged closely with reviewing past balance sheet policies of the Bank of England and have formulated guidelines and recommendations for how to conduct such policies again in the future (House of Lords 2023; House of Commons 2024). The next European Parliament's ECON Committee should embark on a similar exercise and conduct an inquiry into the ECB's operational framework with a focus on how the central bank's operations can foster the green transition through better differentiation, thereby also laying the groundwork for the ECB's strategy review in 2025[2].

In a nutshell: the ECB should care to coordinate its policies more with other stakeholders *ex ante* in order to contribute to a better policy mix in the euro area, including to facilitate the green transition. This should start from a more open public debate about the review of its operational framework, followed by the periodic review of its monetary policy strategy in 2025.

[1] A similar tendency can be observed with regard to the issue of central bank losses, which the ECB recently decided to deal with unilaterally by carrying losses forward on its balance sheet in the future (Diessner 2023; ECB 2024b).

[2] Note that while several briefing papers ahead of the Monetary Dialogues between the ECB and the European Parliament have touched upon the topic of the ECB's operational framework review (see, e.g., Whelan 2023; Reichlin et al. 2024), the Parliament's involvement in the issue did not amount to the in-depth investigations and dedicated reports seen in the UK.

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TRANSFORMER L'ESPRIT ÉCONOMIQUE

Institut Avant-garde – 73 rue de Vaugirard 75006 Paris

Directrice générale : Clara Leonard

Directrice de la publication : Mathilde Viennot

Contact presse : Juliette de Pierrebourg, juliette.depierrebourg@institutavantgarde.fr

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