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WHAT REFORMS FOR A GREENER AND MORE DEMOCRATIC ECB?

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EXECUTIVE SUMMARY

In this contribution, we put forward two policy proposals aiming to make the European Central Bank's (ECB) monetary policy both greener and more democratic.

On December 2, 2023, at the COP 28, French President Emmanuel Macron proposed "introducing an interest rate for green and an interest rate for brown". The authors show that sectoral differentiation of interest rates policies have already been implemented by several central banks, and that they have been compatible with preserving independence and the central banks' price stability mandate. **In this contribution, they propose different ways how this proposal could be implemented in the context of the green transition.**

However, technical reflection on policy tools cannot do without a debate on associated institutional reforms. **Rethinking the role of the ECB in the context of the transition must go hand in hand with the creation of a European Credit Council to strengthen the control and democratic legitimacy of the policies influencing credit conditions in Europe**. This Credit Council would be a deliberative body that would reinforce the expertise and legitimacy of the European Parliament in controlling independent authorities (ECB, European Investment Bank, etc.), and would be a forum for thinking about policy coordination and the main orientations of European credit policy.

1. First proposal: differentiating rates for green and brown investments

Central banks face a dilemma when it comes to preserving the environment. Rising interest rate must not jeopardise the investments needed for the transition – in renewable energies, for example – which can also limit inflation in the long term. Under-investment in the transition could however delay reaching our emission reduction targets, and even worsen the environmental crisis by preventing us from phasing-out of polluting activities.

A delay in transition investments could lead to higher inflation, thus making the task of central banks even more delicate. Firstly, in the long term, the combination of a rising carbon price and insufficient transformation of high-carbon emitting sectors (such as transport, industry, or agriculture) would lead to a rise in consumer prices. Secondly, as illustrated by events such as droughts or fires, which affect agricultural production, extreme weather events linked to rising temperatures can also be the source of inflationary episodes. The failure of central banks to consider the environmental impact of their monetary instruments may also jeopardise the wider role of monetary policy in supporting financial stability, public economic policy, employment stability and other objectives which are also assigned to the ECB according to the European Treaties.

The potential reforms put forward by the ECB are still too conventional and rooted in a conception of monetary policy which ignored ecological constraints; in other words, they do not resolve this dilemma.

Other reforms would enable the ECB to play a greater part in resolving the dilemma: for example, differentiating between green rates and rates for polluting investments. The ECB could create a special interest rate (lower than its main interest rate) to refinance banks, provided that their loans finance investments compatible with climate sustainability. In this way, green sectors would be less affected by rising financing costs during periods of rising interest rates. In more concrete terms, private banks would borrow at lower interest rates when financing investments compatible with the transition. This technique consisting of differentiated rates is not unprecedented, and has already proved its effectiveness. Historically, the aim was to ensure that rising rates would not lead to a decrease in activity in certain sectors which could threaten price stability in the medium term (see Box 1 on export credits). This is not a new or heterodox policy; it has been adopted both by other countries (Japan, Malaysia or China) and by European central banks up until the mid-1990s.

The ECB has the necessary tools to allow this differentiation. Today, when banks take out long-term loans from ECB, the latter imposes certain conditions to prevent credit from fuelling a rise in real estate prices. There are many institutional and legal arrangements that would also enable environmental conditions to be imposed on these loans (Monnet & van 't Klooster 2023)[1]. Any financial institution that can borrow from the ECB, including the European Investment Bank, could also benefit from special rates. This differentiation could be made while preserving the ECB's independence and its ability to fulfil its price stability mandate.

Box 1 – An example of interest rate differentiation: export credits

Under a fixed exchange rate system, central banks would raise their interest rates to avoid a depreciation of the exchange rate. However, this would penalise exports and weigh on the trade balance, rendering the policy ineffective, since the exchange rate would continue to depreciate.

To resolve this contradiction, central banks have historically granted banks preferential refinancing terms for export credits. These policies were compatible with economic liberalism and central bank independence.

Two models emerged:

- That of the Banque de France, which set an interest rate for export credits lower than its main rate until 1995.
- That of the Bundesbank, until 1996, which set refinancing quotas for each bank and increased these quotas for banks granting export credits when it pursued an anti-inflationary policy. This meant that the rest of the banks reduced their lending volumes, but not those supporting exports.

However, reflection on the greening of monetary policy cannot be confined to a technical debate on the policy tools that should be used. It must go hand in hand with a reflection on the governance of these policies. The last fifteen years have shown that central banks' decisions on the cost of credit affect different sectors of the economy in different ways, and can have impacts on inequalities, public debt or the climate, without the democratic framework of their actions having been questioned. What's more, the European Central Bank is not the only European institution to have an influence on credit conditions, and the question of how to coordinate public policies in this area arises. What institutional reforms are needed to ensure that European credit policy is democratic?

[1] Lending, for example, to a public investment bank or public body, creating a special status for debt guaranteed by these institutions; green refinancing credits; green asset purchase programs and green reserve requirements.

2. Second proposal: giving the European Parliament a greater role by setting up a European Credit Council

The ECB is an independent institution; if it were to green its monetary policy, it would find itself conducting credit selection policies without having the legitimacy to define what is or is not sustainable for the environment ("green"). The ECB cannot and must not choose the ecological criteria for these investments itself. It is now obliged, under the requirements of the European Union (EU) treaties, to "support the EU's environmental policies" and, consequently, to demonstrate the alignment of its strategy with these initiatives, in terms of both goals and means.

There are two approaches to ensuring the democratic legitimacy of central bank credit policies. These approaches differ in the degree of political coordination required (van 't Klooster et de Boer, 2022 ; Monnet, 2023 ; Smoleńska, 2023). The former relies on purely legal legitimacy, while the latter also derives its democratic legitimacy from the balance of power in economic policy coordination and the associated deliberations and forms of parliamentary control.

- **First approach: central bank governance of credit policy.** This would require a legal framework defining what green investments are, such as a taxonomy established by the EU. Central banks could use this taxonomy as a basis to exclude specific types of investment that pose a risk to price stability[1]. The discretionary role of the central bank should be reduced to a minimum.

- **Second approach: delegate to a new body, the European Credit Council, the task of verifying the consistency and conformity of central bank policy with other financial bodies and with European Union treaties.** This approach would involve explicit coordination with governments and other European decision-making bodies. This coordination would be formalised through the creation of a permanent body (van 't Klooster et de Boer, 2022 ; Smoleńska, 2023 ; Monnet, 2023). This body would not be a decision-making body, but a deliberative one. It could ensure that the ECB's credit decisions took account of all points of view; they would be subject to evaluations that analyse their effects in a broad sense (inequalities, bank profits, credit and investment etc.).

We propose to favour this second approach, which bases its legitimacy on deliberation and delegation. It allows us to draw on a wide range of expertise, and seems to be the most appropriate approach to the complex decisions involved in credit policies. It would reinforce coordination between the EU's various economic policies (monetary, budgetary, investment, industrial, etc.), between different interest groups and between different European institutions (EIB, European Development Fund, European Guarantee Fund, Commission, etc.).

[1] Green investments, but in a sector already at full industrial capacity.

Box 2 – The European Credit Council

Several institutional arrangements are possible:

- It could be an administrative agency reporting directly to Parliament, on the model of the Congressional Budget Office in the USA;
- It could be an administrative agency reporting directly to Parliament, on the model of the Congressional Budget Office in the USA;
- Or an agency that would sit jointly with the European Commission and Parliament; some of the economists currently working at the ECB or national central banks could be transferred to this institution.

The mission of the European Credit Council would be twofold: on the one hand, to provide expertise to the Parliament and present divergent points of view (not just those of experts) so that the Parliament can make proposals on credit policy; on the other, to publish reports validated by each institution that reflect the common objectives of their policies.

The Council would therefore have no decision-making role, and the ECB would not answer to it, but always to Parliament. It would not replace a parliamentary committee, and would not be responsible for monitoring the ECB and other institutions. Its institutional value would lie in the fact that it would provide Parliament with independent studies that would enable it to strengthen its control over the ECB and the EIB.

Ultimately, the ECB would derive, and indeed guarantee, the legitimacy of its decisions from the reflexivity and consultation facilitated by this Council. In terms of democratic practice, an important consequence would be the reversal of the burden of proof regarding price stability and the priority accorded to it. Concretely, if the Credit Council formulates measures by indicating that they support the general objectives of the EU (secondary objective of the ECB), it would be up to the ECB to respond by clarifying the possible impacts on price stability (primary objective).

This Council would not call the ECB's independence into question, but it would give the European Parliament a greater role, strengthening its legitimacy and expertise. Indeed, this framework would provide the Parliament with economic expertise, enabling it to engage in a structured dialogue on the objectives of monetary policy, the means of achieving them and, above all, the consequences of ECB policy on the Union's other policies. The Credit Council could act on its own initiative or at the request of the European Parliament, and produce studies and institutional reflections on the effects of the EU's current monetary and financial policies (or "credit policies") and their possible coordination. To ensure that ECB policy is in line with its objectives, it is essential to strengthen the authority of the European Parliament.

Conclusion

While rate differentiation policies are compatible with maintaining the ECB's independence and price stability mandate, they will require greater coordination with regard to other aspects of credit policy, as well as a change in central bank accountability and communication with the public. Strengthening the balance of power between the European Parliament and the ECB - and other independent authorities operating in the credit field - is not limited to the issue of a greener monetary policy. It is necessary to adapt the democratic framework to the growing importance of the effects of central banks in the economy.

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