

# A FUTURE OF FAIR AND DEMOCRATIC EUROPEAN CENTRAL BANKING

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The Eurozone as structured in 2019 may well not withstand its next serious challenge. From here to 2049, fundamental reforms to how the financial sector, public finances, and central banking work will all have to be made. Among the possible futures, ambitious monetary reform could put money creation at the service of society's most pressing social and environmental needs.

It is of course conceivable that the Eurozone continues with business as usual, with an incomplete structure made up of a persistently weak political arm and a monetary arm that does what it can within a narrow and counter-productive framework. But is it really credible for this structure to face up to the great challenges of the next 30 years: the fight against poverty, inequality, and climate change? A complete breakdown of the Eurozone would only trigger competition between states and undermine their capacity for coordinated action. Yet nor will allowing the Eurozone to remain as is, unsteady and incomplete, resolve existing competition between member countries, with its damaging effects on wages and government budgets. As the current situation shows, when challenged, so far the Eurozone has come up short.

Between an unsatisfactory present and the grim prospect of collapse, an alternative, a different future, must then be imagined. Any alternative demands a large-scale monetary reform and would necessarily involve treaty change. The objective of monetary reform should be to meet society's most pressing needs, as defined by democratic choices and any emergencies that may arise. These priorities should never go unmet because of a 'lack of money'. Whether it is a question of social spending or environmental investment, this rule which is based around society's needs should take precedence. The tricky bit

is clearly how to do this while maintaining financial stability, which is why monetary reform also entails reforming the banking sector and retaining an orthodox monetary policy for the private sector.

## **A FLAWED STATUS QUO**

Today, money creation is left to the financial sector, within a general framework laid down by the European Central Bank (ECB). The ECB uses interest rates to set the price of money, thus influencing the total amount of loans granted by private banks. These loans are how money enters the economy. However, nothing is done to influence how money created by private banks is used. Instead, the ECB has just one ultimate aim: to limit inflation in the Eurozone. This goal is set out in its mandate and is why the central bank is only concerned with the overall quantity of money.

Under the logic of its design, the ECB could achieve its mandated objective successfully using measures with disastrous social and environmental consequences, for inflation is ultimately all that matters for it. Zooming out from that particular institution, the wider economic and financial structures of the Eurozone are in bad shape. Financialisation and increased debt levels in the European economy have driven chronic instability, competition between states, a regulatory race to the bottom, and a constant need to cut social transfers.

In this context, any prospect for reform of the Eurozone appears blocked. Keynesian options are determinedly opposed by the adherents of ordoliberalism and the interests of exporters from countries where these ideas prevail. These actors defend a fragile status quo that in turn is often imposed on their suppliers in the south and east of Europe. The effort to ensure competitiveness vis-à-vis the rest of the world creates high surpluses in exporting countries, which destabilise the currency union and the global economy. The result is chronically weak, low-quality growth, which generates inequality and lacks the means to address urgent ecological and social issues. In addition to these defects, the export-led strategy has been further weakened by the rise of China and increased protectionism.

The Eurozone will inevitably face another existential crisis in the medium term. When this crisis arrives, neoclassical economics-inspired solutions should be off the table. The economic consensus is likely to fracture in the 2020s; it is already happening. Teams within the International Monetary Fund (IMF) and the World Bank have criticised the dominant economic paradigm harshly, as shown in the work of Olivier Blanchard and Paul Romer. With this break coming, proposing radical changes to the Eurozone offers the European political class the opportunity to counter the Eurosceptics by responding to current economic, ecological, and social emergencies.

Between now and 2049, a genuine reform of the European monetary system, one way or another, will happen.

## **A SOCIAL AND ENVIRONMENTAL MANDATE**

To correct the current system's flaws, monetary reform should be based on three pillars: defining priority objectives (for which money should never 'lack'); 'signposting' money creation towards these objectives; and financial regulation to ensure stability. These three pillars are complementary. The central bank's objectives should correspond to the interests of society and be determined democratically. For these objectives, the ECB should assume, as part of its 'contract', the responsibility for achieving them. For the rest of the economy, the ECB and financial regulators should ensure that the provision of loans to sectors outside of these priorities remains compatible with financial stability. If there is to be massive investment in priority domains, the ECB should also have the right to restrict access to credit elsewhere to ensure said stability. However, without it endangering society's key objectives, the private sector should retain its ability to adjust.

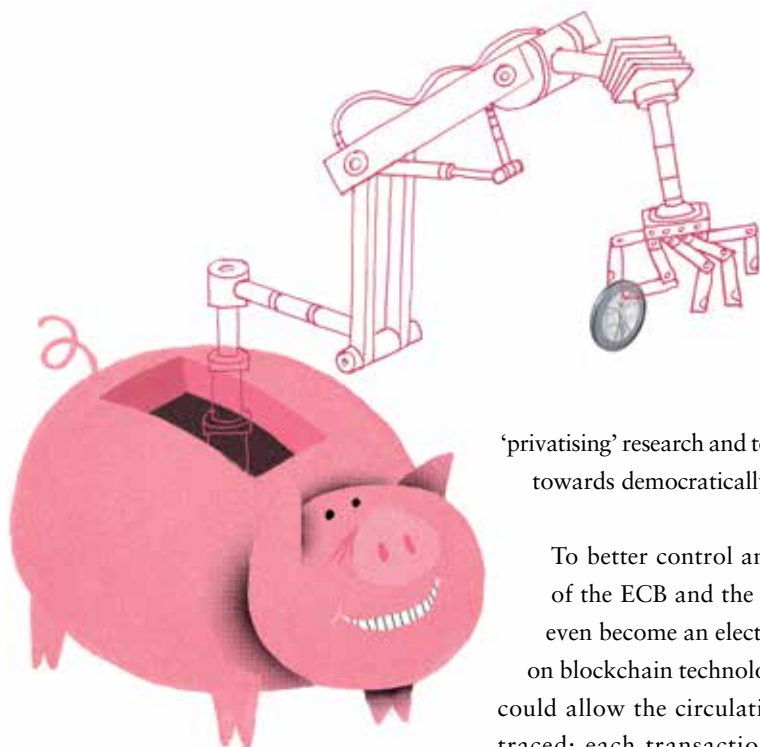
The overarching principles of this new policy should be constitutionalised in renewed European treaties, as is currently the case for monetary policy. Looking to the future, three equally important principles should

be committed to these treaties: overcoming poverty by satisfying basic needs (food, health, housing, etc.); reducing inequality, including income inequality and geographical inequality; and the fight against global warming. These three principles should come before all others when defining European economic policy, and they should bind all the institutions involved in its implementation. The European Commission would propose multiannual objectives for taking action in accordance with these principles and based on current needs. They would be debated, deliberated on, and adopted in the European Parliament before the Commission and the ECB would sign a contract committing the bank to them.

## **FROM MARKET FAILURE TO PUBLIC INVESTMENT**

With the democratic groundwork in place, the ECB's task would be to provide the means to fulfil the policy objectives. It could do so in various ways.

The first would be direct financing. In cases where the private sector cannot be depended upon to achieve a given objective, the public authorities step in. To be precise, there should be two aspects to direct central bank intervention. For pan-European projects, the ECB provides financing to the European Investment Bank (EIB), which operates under a new remit, expanded compared to that



‘privatising’ research and to reorient its findings towards democratically defined needs.

To better control and target the action of the ECB and the EIB, the euro could even become an electronic currency built on blockchain technology. This technology could allow the circulation of money to be traced; each transaction identifiable in a data chain confirmed by economic agents. Seeing where money actually goes, and the technological possibility of modifying that path, could help guarantee that money created actually goes towards the objectives and projects it was democratically decided to fund. Tax avoidance and tax evasion strategies would be far easier to follow and prevent. Nonetheless, electronic euros should not mean the complete replacement of paper money, which is vital for the symbolic acceptance of money’s value. However, use of cash should be limited to low-value transactions.

## GETTING THROUGH TO THE REAL ECONOMY

For projects with a national or regional focus, the EIB would act through intermediary ‘special purpose’ national public banks, which could support environmental projects, housing provision or social programmes, for example.

of 2019. The EIB then makes investments, monitored by the Parliament and the ECB, in European public enterprises or research centres active on the ground.

The private sector only invests where it can expect a return and in its own interest, so today, in 2019, the ecological transition chronically lacks investment. Investment in the future is largely left to digital giants from the United States and their Chinese competitors. However, these investments are not made in the public interest. A new monetary system should correct this bias: rather than developing artificial intelligence to sell more products, its potential should be harnessed for waste management or the heating and cooling of buildings, for example. Thanks to the work of Mariana Mazzucato, it has been demonstrated that private sector innovation is almost always based on the fruits of public research.<sup>1</sup> It is vital to stop

<sup>1</sup> Mariana Mazzucato (2013). *The Entrepreneurial State: Debunking Public vs. Private Sector Myths*. Anthem Press: London.

These banks oversee the parts of national budgets that address the EU's objectives. For structural investment, such as developing new clean industries or research centres, the funding is long term and interest free, or with an interest rate that reflects the project's profitability. Partnerships with the private sector are explored, agreed upon, and monitored on a case-by-case basis.

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To best serve local economic prosperity, the euro could sometimes exist alongside local electronic currencies, which would make it possible to target priority regions. The ECB could decide to issue funds in a local currency for a specific region at a fixed rate of one euro per unit. This currency would only be convertible to euros for the purchase of goods and services unavailable in the area it circulates. Thus, where possible money stays within the targeted region, stimulating local production.

For social expenditure such as employment schemes or anti-poverty initiatives supported as part of meeting European objectives, national governments would be able to seek financing from financial markets through

loans guaranteed by the ECB. When necessary, the central bank buys back these securities as per the current method of quantitative easing.<sup>2</sup>

Following the rule that a lack of money should not prevent the realisation of democratically determined objectives, a state unable to finance its social expenditure is advanced funds by the ECB. For all other expenses, states issue unsecured loans that can be restructured. No further deficit objectives are set:

investors now estimate and fully assume the risks involved in the securities they buy.

It is worth noting that as direct aid from the EIB to firms outside the priority sectors would no longer be permitted, its budget would be relieved from the burden of supporting businesses. The EIB thus gains significant room for manoeuvre and reduces its need for external financing. A structure of this type would certainly require a transition period and some form of a public debt relief window before its implementation. For example, this might involve cancellation of a debt bought by the ECB in the course of its quantitative easing programme or as part of ESM or EFSF

<sup>2</sup> Quantitative easing is an unconventional but, since the 2008 financial crisis, common monetary policy whereby the central bank buys private or public debt directly on financial markets to lower the cost of money and thus, in theory, revive inflation.

loans.<sup>3</sup> This type of debt jubilee has historical precedents. It is the classic model of the IMF and also that assumed by the Allies in 1953 to allow economic recovery in Germany.

## A NEW MONETARY POLICY

The ECB would have different rates, or targeted financing policies. Thus it offers preferential rates to retail banks that then provide a specified proportion of their loans to priority sectors. These preferential rates are tailored to support development in specific regions or sectors. For example, a very low rate can be offered for loans for retrofitting buildings, and a further premium rate agreed to target a region lagging behind on this objective. This approach is inspired by Keynesian theory that holds that the ECB should generate supply and demand for money.

This system still allows private money creation, but strongly gears it towards the realisation of set objectives. In effect, this system improves upon and refines the ECB's Targeted Longer-Term Refinancing Operations, a programme for small and medium-sized enterprises launched in 2014.<sup>4</sup>

The ECB would also directly buy back loans issued on the market by firms to finance

projects fulfilling objectives defined by the Parliament. These securities are then certified and monitored by the ECB to ensure that they are in line with set objectives. As this debt has an implicit ECB guarantee and can therefore be bought back by the markets, it is more secure and cheaper. Indeed, the ECB is now prohibited from buying back unsecured debt, as was the case in the Eurozone from 2015 to 2018. In this way, firms that so wish can finance projects in the public interest at a lower cost. Quantitative easing thus gains an environmental and social focus.

## RE-INTRODUCING RISK

As we have seen, the money created by the ECB and commercial banks would now be directed towards priority sectors. However, it is vital that growth in these sectors does not drive excessive inflation, and that financial sector instability does not trigger a complete destabilisation of the economy, which would make meeting objectives impossible.

To achieve this result, the ECB would still use its traditional lever: 'refinancing rates' or the rates at which private banks borrow from the central bank. These standard, non-preferential rates are offered for financing non-priority sectors. Through these rates, the central bank

<sup>3</sup> The European Stability Mechanism is a Eurozone bailout fund established in 2012. It incorporates the operations of the European Financial Stability Facility, a special-purpose bailout fund created in 2010 to support Ireland and Portugal, and later Greece.

<sup>4</sup> TLTRO offers banks long-term loans with very advantageous conditions. To benefit from this programme, banks have to show that they are providing small businesses with a minimum quantity of loans set by the central bank.

maintains financial stability in the broad sense, though subject to the higher objectives defined above. Whereas today's ECB statutes establish a rigid inflation objective, allowing the ECB to evaluate the optimal level of inflation for the economy would be more appropriate.<sup>5</sup>

Beyond central banking, defining an overarching macroprudential and regulatory policy is crucial. The starting point for this reform is a genuine and complete separation of investment and retail banking.

Investment banks would have access to the stock and bond markets, and offer savings products linked to these markets. They pay a single financial tax across the entire Union, which goes to state budgets. Those taking risks would cover any losses. There are no state bailouts for investment banks, nor would securities be bought back by the ECB, apart from the targeted lending defined above. These activities are strictly regulated to reduce the leverage effect and thus investment banks' capacity to create money autonomously.<sup>6</sup>

Retail banking would receive deposits from savers, and use them to make loans to the economy. Their capacity to create money is checked in various ways: standard monetary

policy and solvency ratios are now calculated using a unified model defined by the ECB. Bailing out this type of bank is still justifiable – retail banking finances the economy – but the possibility of penalising directors and requiring creditors and shareholders to shoulder costs ('bail-in') is open too.

These measures could be implemented without major changes to treaties, as was the case for the banking union.<sup>7</sup> During the next financial crisis, the inevitable failure of this incomplete banking union, the financial bubble, and the current fragility of major European banks could be the perfect storm that opens the path to the construction of this new financial architecture.

## INDEPENDENT BUT ACCOUNTABLE

The ECB would remain independent, but its task would change. Its mission is no longer just financial stability, but above all to enable observance of the objectives democratically determined in the framework of European treaties. The Parliament, through the preparatory work of the Commission, sets precise objectives to be respected during the term of legislature (growth in certain sectors, targets for financial poverty, health outcomes,

<sup>5</sup> This is what is happening in 2019. For a long time, the ECB was happy with very weak inflation even at the cost of growth, whereas today it seems prepared to accept slightly higher inflation.

<sup>6</sup> The leverage effect means the ability to generate increased profits through taking on debt. If a company takes on a debt of 100 hoping to earn 150, it is using a leverage effect of 50 per cent.

<sup>7</sup> Banking union refers to the integration of banking regulations and procedures for insolvency within the EU. In 2019, banking union remains an incomplete process.

and regional development). If these objectives are missed, the ECB has to correct its policies. In case of repeated and constant failure, a procedure to remove the ECB's governing board can be activated. This procedure is sufficiently restricted to make it an exceptional occurrence and it is only applicable in cases where the objectives have not been met. Independence without responsibility poses a threat to the fulfilment of objectives.

Nevertheless, the ECB remains free to act as it sees fit within this framework. The ECB sets interest rates, be they preferential or not, and the appropriate level of 'socially useful' debt purchases. It can refuse advances to the EIB if it believes that the investment bank does not need these funds, but this refusal always needs to be justified. In all areas of its activity, the ECB needs to get results.

## TRANSITION TO 2049

How could this type of reform be achieved by 2049? Business as usual is untenable and inevitably new treaties will be necessary. The reform described requires that EU rules be changed in three respects: to define the key principles of European economic policy; to set the new role for the ECB; and to profoundly reform how states raise and manage their finances. Since the debt crisis, the idea of treaty change has enjoyed broad acceptance on the Left and among many environmentalists. Some

in the centre, particularly those concerned with ecological questions, could be tempted to join the movement. While the proposed structure maintains a significant private sector and removes many moral hazards created through implicit subsidies, it does represent a break from purely neoliberal approaches. A programme of this type might just be enough to persuade those who have given up on Europe, believing it to be ineffective or overly centred on elites. Politically, to make sure that states are well represented, the Council could be replaced by a second chamber of the Parliament modelled on the German Bundesrat, which would vote by 'country'.

The 2030s could be the decade when these new institutions are put in place. They would permit common challenges to be confronted progressively and based on a pan-European vision, which would be in turn reinforced by the positive effects of a much-needed change in direction.



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