ETUC position on the European Central Bank Strategy Review

Adopted at the virtual Executive Committee Meeting of 9-10 December 2020

Introduction

In February 2020, the European Central Bank (ECB) launched its strategy review under the branding “ECB Listens”. Since then, many events took place, all consecutive and consequential to the COVID-19 pandemic. The strategy review is taking place throughout 2020, while the questionnaire related to the review was postponed once, with the deadline being the end of October 2020.

The ETUC provided answers to the questionnaire after consulting the affiliates of its Economic Committee, which was done beginning of October 2020. The document was sent to the ECB. This position paper intends to translate, in a more comprehensive document, the position elaborated by the ETUC in the process, and in coherence with the ETUC positions on the review to the economic governance in the European Union, and more specifically with the expected revision of the fiscal rules framework.

In this paper present the expected role of the ECB on the years to come and how the monetary policies engaged since March 2020 were assessed. However, let us first begin where we are now, in the political and economic debates, and how the ETUC position could represent an exit strategy that could fill the gap between the views expressed. On one hand we have those who argue to cut the massive fiscal and monetary support provided by the European Commission, on the other, we have those who reject calls for the European Central Bank to use its bond-buying powers to tackle climate change, setting up a potential clash with other policymakers[1].

The ETUC disagrees with these positions. A low interest rate policy and active monetary support through quantitative easing programmes and Targeted Long-Term Refinancing Operations (TLTRO), for enabling Member States and businesses to access the necessary spending for just ecological transition, increased investment and quality job creation with strong social standards, could represent a way of exit to the ongoing debates.

Firstly, expansive fiscal policies are needed and even recommended by the recent IMF Fiscal Monitor. Secondly, given the uneven recovery expected in the different Member States - and their difference in public finance management and levels of debts and deficits - a more politicised ECB would be needed, without impairing in any way its independence. One way to bring these two visions closer together would be to put full employment and ecological transition objectives on a par with price stability in the ECB's mandate. In fact, EU treaties mention one primary objective, price stability, and various sub-standards laid down in Article 3 of the Treaty on European Union such as “*aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance. It shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and*

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[1] See the debates in M. Arnold (2020), “Bundesbank chief calls for scaling-back of crisis aid’, Financial Times, 2 September; “Monetary policy in a pandemic emergency”, Keynote speech by Christine Lagarde, President of the ECB, ECB Forum on Central Banking, Frankfurt am Main, 11 November 2020; M. Arnold (2020), “Bundesbank boss sets stage for ECB climate clash over bond-buying”, Financial Times, 19 November; M. Arnold (2020), “Bundesbank boss sets stage for ECB climate clash over bond-buying”, Financial Times, 19 November; R. Khalaf & M. Arnold (2020), “Lagarde puts green policy top of agenda in ECB bond buying”, Financial Times, July.

protection of the rights of the child. It shall promote economic, social and territorial cohesion, and solidarity among Member States".

Therefore, one way then to bring these two visions closer together would be to make full employment and just ecological transition equal to price stability in the ECB's mandate, considering the SDGs general framework.

1. The state of play

The 2008 and 2011 crises had catastrophic consequences for workers. Unemployment surged, inequality increased, wages stagnated or even decreased in real terms, collective bargaining structures have been under considerable attacks, labour protection deteriorated, involuntary part-time and temporary jobs skyrocketed. On the other hand, fiscal consolidation, which was enacted right after an initial support from governments and the European Union, translated into large cuts in public investment and public spending, to such an extent that public net capital stock formation even turned negative for a while at the euro area level. Economic divergences between Member States developed thanks to unwise and ideologically driven internal devaluations, turning the European Union to a net exporter, relying on the rest of the world for future developments, while destroying internal aggregate demand with long-lasting effects. These unwelcomed economic policies were detrimental for workers, to such an extent that the total hours worked in late 2018 in the European Union returned to its 2008 level, with a high level of job precariousness.

The changes of 2015 in the ECB policy were welcome, although insufficient, given the governmental fiscal rules that were imposed. Unfortunately, there were attacks on collective bargaining structures at sectoral and national levels resulting in trade union density decline. In addition, the EU policies implementing internal devaluation policies and the decreases in workers protection systems, prevented price increases Although private investment recovered slowly, the lack of demand (which was repeatedly said to be the main impediment to investment) and the very low levels of public investment had a detrimental effect on productivity and inflation thus hindering a solid and sustainable recovery. The ECB has treated its own legal mandate too narrowly. There is a widespread misperception that the ECB is treaty-bound to the single duty of ensuring price stability. The central bank shares the blame for allowing this error to proliferate, sometimes seeming to believe it itself. Recently, US Federal Reserve chair Jay Powell announced that the Fed's updated policy strategy will no longer worry about "deviations" but only "shortfalls" from full employment so long as inflationary pressures are absent. In other words, it will not tighten monetary policy to prevent "overheating" just because more Americans get jobs than economists thought was possible, at least until 2023. The ECB would be well guided to follow the same principle.

Some lessons have indeed been learned since then. Beside the failure of the ECB to calm down financial markets on sovereigns between the 12 and 18 March 2020, very quickly the ECB responded by launching the PEPP with the suitable flexibility in the distribution of purchase flows over time, across asset classes and among jurisdictions. However, the initial time limit and amount of the PEPP did not allow governments and institutions to develop enough confidence to engage in large enough and/or common fiscal supports. Its increase in size in June 2020 was therefore welcomed, while the statements that the programme could be scaled up, if needed, and prolonged as long as the COVID-19 crisis would impact the economy, incentivised positively governments to agree on a common fiscal support programme in July 2020. Such quick moves are of huge importance for trade unions to prevent an increase in interest rates on sovereigns. Such an increase would have put fiscal sustainability at risk. It would also have caused cuts in fiscal support programmes for workers and public services which proved essential as a social and economic backstop. Therefore, Central banks' unconventional monetary support most likely played an important role in limiting financial instability, which would have added to the direct macroeconomic impact of the pandemic.

2. Public investment and debt sustainability

Massive public support and investment will be needed in the years to come. Counter-cyclical policies can be brought about by the activation of the General Escape Clause of the Stability and Growth Pact and supported by the monetary policy implemented by the ECB. The PEPP proved important to enable Member States to agree on common financial support funds, which should help in the convergence in economic and social development.

Public investment

Investment in physical capital will need to be increased and reoriented toward quality-job-rich, highly productive, and greener activities. The IMF Fiscal Monitor states that the case is stronger for advanced economy and emerging markets which can finance a rise in investment, especially for those countries which can issue reserve currencies. Given the role the ECB now has and the new Next Generation EU instrument, we can consider the European Union, and *a fortiori* the euro area, to be part of this group of countries. Moreover, it is now common knowledge that public investment can also have a more powerful impact than in normal times and that public investment and its crowding-in effects on private investment could have important positive effects. Finally, there were big investment needs before the pandemic and they increased since its onset. Public investment has slowed since the 1990s, reducing the capital-stock-to-GDP and public-to-private-capital ratios in all income groups. Public investment ratios have been falling, especially in the health, housing, and environmental protection sectors, weakening societies' resilience to COVID-19. A major challenge will be to change dramatically the composition of investment toward low-carbon technologies and public investment needs for adaptation to climate change are also large according to the IMF. In addition to its direct effect on jobs, public investment has the potential to boost growth and increase employment through the usual macroeconomic interlinkages.

In the words of Ms Gopinath, IMF Chief economist, fiscal policy plays a very prominent role and she comforts the view that fiscal stimulation was withdrawn too quickly right after the financial crisis. She even recommends not to prematurely withdraw policy support[2]. Indeed, both the IMF and the World Bank are urging richer countries to spend their way out of the pandemic[3].

Indeed, the IMF estimates that, for developed countries, increasing public investment in the current conditions by 1% of gross domestic product was likely to increase GDP by more than 2% after two years, and better, the Fiscal monitor of October 2020 finds that raising public investment by 1% of gross domestic product would raise private investment by more than 10%.

Debt sustainability

The steady stream of fiscal measures and the economic contraction will push the average global general government debt to 126% of GDP in 2020. Compared to 2019, general government debt is projected to increase close to 30% points of GDP in Italy, Japan, and Spain, driven predominantly by large existing debt stocks coupled with the fall in economic activity. It will be more than 20% of GDP in the United States, driven by on-budget fiscal measures.

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[2] *M. Sandbu (2020), "Gita Gopinath: 'Fiscal policy plays an essential role in recovery'", Financial Times, November.*

[3] *C. Giles (2020), "Global economy: the week that austerity was officially buried", Financial Time, October.*

However, according the Ms Gopinath, "*An important lesson that was learnt after the financial crisis is that fiscal policy plays an essential role in recovery. And every increase in debt does not sow the seeds of destruction.*" Many prominent economic stakeholders now share the same view stating that debt sustainability assessment must crucially take into account both the level of growth and prevailing interest rates[4].

Running models, the IMF's Fiscal affairs Director states that lower interest payments would allow the public debt ratios to stabilise and even decline slightly towards the end of the projections, which supports the view that Covid-19 is a one-off jump up in debt and with low interest rates, the debt dynamics stabilise. Consequently, there is no need for budgetary consolidation in countries able to borrow freely from financial markets[5]. "."

The request for the ECB to keep interest low and ensure the right policies enabling Member States to follow a sustainable debt path should therefore be achieved; especially if accompanied with an adequate mandate targeting price stability, full employment and just ecological transition. An increase in interest rates, especially on sovereigns, would have detrimental effects on public debt sustainability while reinforcing distress in economies that would still be experiencing difficulties.

3. Inflation and financial regulation

It has been clear, since the 70s', that a trade-off between employment and inflation existed. If unemployment fell too much and price inflation began to accelerate, Central Banks would raise short term interest rates to keep inflation at a certain level. The basic idea was to keep the bargaining power of labour in check. However, such a relationship seems now to be seriously challenged if not contested. Low inflation could coexist with low unemployment levels, *and vice versa*. Deregulation of global markets in goods, services and capital put an end to this era, which was characterised by a constant and global decrease in the bargaining power of labour, marked by the decreasing labour share in GDP. This lack of inflationary pressure has left modern central banks unconcerned about monetary expansion. Far from fearing inflation, the issue Central Banks are currently facing is how to avoid deflation. Falling prices are a disaster because they put pressure on debtors and create a vicious circle of postponed purchases, leading to falling demand and further deflation.

Inflation

The 2008 crisis showed, especially in the US, but also for example in Spain and Ireland, that financial deregulation and the development of a shadow banking system could hide the structural decrease of aggregate demand and the increased financialisaton of the economy. Unfortunately, the ECB did not have the tools that other Central Banks had in order to counter the crisis. The ECB had to wait for the euro area to be on the edge of deflation to act decisively through assets purchases operations with a policy rate at its effective lower bond. However, European fiscal rules continued to drag down the European economy, and in this respect have to be set in coherence with monetary policy. Politicians campaigned for fiscal consolidation and debt reduction instead of promises of investment and employment. In the agonisingly slow recovery from the 2008 crisis, the problem for the central banks was not overspending but rather the failure of governments to provide adequate fiscal stimulus.

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[4] *See C. Lagarde (2020), "Les Etats européens « doivent être à la hauteur de la gravité du dommage économique »", Les Echos 18 May 2020 ; M. Wolf (2020), "Why the ECB can save the eurozone", Financial Times, April ; [4] R. Harding (2020), "Leave public debt worries for another day", Financial Times, August.*

[5] *See C. Giles (2020), "IMF says austerity is not inevitable to ease pandemic impact on public finances", Financial Times, October.*

High inflation, given the decrease in collective bargaining power of labour to capital, and the decrease in trade union density due to the promotion and expansion of non-standard forms of employment, decreased the capacity of workers to collectively bargain their fair share of productivity increases. If workers were better protected and labour market resilient to economic cycles, higher inflation rates could be considered as beneficiary for investment, growth and therefore to workers. Unfortunately, in the last decades, political demands went in the opposite direction asking for even more deregulation and individualisation of work and acted against workers' interests, preventing inflation to rise.

When assessing the effects of low/high inflation, it is also crucial to assess the definition of inflation. Official inflation has partly been low because it includes only consumer prices and excludes assets values. Including better housing prices in the definition of inflation would reveal quite an opposite picture of the reality. It seems that monetary stimulus through low interest rates and quantitative easing has mostly benefitted financial markets and real estate, causing inflation in asset and housing prices and not in consumer prices. In the future, the ECB should consider including more housing prices directly in its definition of price stability.

One reason why monetary policy has not been able to increase consumer price inflation while asset prices have increased significantly, is the lack of tools. TLTROs are an innovative way to encourage banks to finance the real economy, but probably not enough. The ECB should think of adding other tools to their services. For instance, helicopter money, i.e. direct transfers to households, would have a greater direct impact in the real economy, and therefore consumer prices, than the tools available to central bank at the moment.

This lack of regulatory tool implied an increase in the cost of renting for workers unable to access credit, now spending a large part of their income on housing at the expense of other vital goods and services. In the European Union, although the population as a whole spends an average of 21% of its income on housing, poor households spend 41% of their income on housing (above the 40% threshold which is considered excessive). This is 2.4 times more than non-poor households, which spend on average 17% of their income on housing. Housing costs for poor tenants increased between 2008 and 2018 in almost all the Europe Union countries, with particularly high proportions in Romania (+264.6%), Estonia (+136.9%) and Poland (+108.8%). Looking at 'post-crisis' trends from 2013 to 2018, housing costs for poor tenants rose sharply in Greece (+68.3%). Between 2008 and 2018, the proportion of income spent on housing expenditure fell by -6.2% for the population as a whole, while it stagnated for poor households at +0.2%. Poor households are eight times more likely to be overburdened by housing costs than non-poor households (including both tenants and homeowners).

The search for yield in all fields of social activity strongly impacted housing prices, especially in certain regions, pushing workers to get heavily indebted to find a place to live (due to financial deregulation). Inequality of income and wealth, which is constantly rising and largely documented, complementarily contributed to this process. The 2008 crisis was largely documented and pointed out the role of inequality and financial deregulation as the deep roots of the crisis. It also revealed important paradoxes, pension funds increasingly investing in real estate penalising workers by increasing housing prices, leaving families losing their homes, and workers losing their pensions as consequences of the financial crisis.

Research since the 1970s, based on industrial countries, shows that real house prices are pro-cyclical while labour shares globally, and in Europe in particular, have been on a regular decreasing trend explaining the choice to deregulated financial markets to fill the gap in wage developments.

Financial regulation

An abundance of liquidity was sent to financial markets, before and during the pandemic, with poor consequences on inflation and investment, running doubts on the ability of markets to facilitate the development of the real economy in a sustainable manner. This left financial markets and speculators in a very comfortable situation while workers did not see how these funds translated into growth, investment, employment and wage increases.

IMF research indicates that monetary policy announcements in mid-March led to a significant decline in discount rates (both risk premiums and risk-free rates). This lifted asset valuations perception that monetary policy has supported financial markets and investors, while being unable to revive real activity and reduce unemployment. It could reignite the debate on the implications of monetary policy actions on inequality and on central bank accountability and independence. Despite the recent market recovery, some investors and analysts still fear that a financial crisis could compound the economic damage. It is now urgently needed to rethink the regulation of the non-bank part of the financial system, because it could amplify what could become a full-blown financial crisis. Investment funds and money market funds, as well as other financial intermediaries (shadow banking) have grown enormously and account now for more than 40% of the assets of the financial sector. While activating unconventional monetary policy for allowing Member States to access funding at low interest rates, the purchase of government bonds boosts bank reserves (aiming to stimulate lending); it simultaneously activates a portfolio rebalancing channel. Since government debt is the risk-free instrument that acts as a basis for pricing private instruments, the reduction in sovereign yields increases demand for higher yielding assets and can thus contribute to easing financing conditions for private financial actors and could induce financial instability in returns. Total shadow banking assets more than doubled between 2000 and 2008, and a similar boom was observed between 2009 and 2018. The Basel III reforms attempted to reduce the procyclicality in bank lending, but the rise in the prevalence of shadow banking may turn out to undermine the effectiveness of both capital-based regulation and borrower-based limits. The strong link between shadow banking and insurance corporations and pension funds points to a need to create a framework for testing the interconnectedness of financial institutions at the EU level to assess to what extent the financial system could be under systemic fragility.

4. Just ecological transition and full employment and new monetary tools

The old paradigm that money is neutral in the economy and that there was a clear distinction between monetary and fiscal policy is clearly falling apart. According to this view monetary policy cannot really increase output nor employment, but an increase in Central bank money supply could only produce higher inflation.

Just ecological transition and full employment:

ETUC supports the view that monetary policy can impact the level of employment, investment and output. In this respect, the level of employment and a just transition should be both regarded at the same level of importance as price stability. In 2016, after years of massive asset purchases, the Bank of Japan adopted a new regime known as yield curve control. The Bank committed to ensuring that the effective interest rate for 10-year government debts did not rise above zero. The idea was that if it guaranteed low borrowing costs this would stimulate borrowing and investment. It succeeded in dispelling the spectre of deflation, but growth revived only modestly. We would explain such a failure by the development of shadow banking activities creating financial wealth instead of, employment and investment and economic growth. Earlier this year, at the height of the Covid pandemic, Australia’s central bank began doing something similar. A more suited coordination of credit allocation, at least through the newly created recovery funds, would in this respect be welcomed. Europe is living in an excess private saving period and such saving should not be idle but offset fiscal deficit and public borrowing. Putting up with a smaller interest income is preferable to the alternative of losing a job (certainly for those without savings). Raising current policy rates would not solve the underlying problem of excess saving but rather exacerbate it: spending would be depressed, hurting the incomes from which saving is possible, resulting in higher unemployment and demand would decrease. Re-embedding money and credit in the pursuit of the common good has never been more imperative and should be tailored to green, social and health-friendly objectives. In any case, relying on fiscal stimulus instead of running current account surpluses is not a sacrifice. A well-designed package could improve long-term growth through public investments and raise wages while reducing inequality. It would be affordable at current ultra-low interest rates and would provide much needed safe assets.

New monetary tools

Aside to price stability and full employment, low interest enabled through yield management, should also be supportive of a just transition for workers. Such a strategy would support the real economy, and answer the urgent need to tackle climate change, just transitions and social justice. The ECB has created €2,600 billion new money since 2015 in the context of its pre-pandemic quantitative easing programme. It has announced, though, that when these government and corporate bonds would come to maturity new bonds will be bought in the market, so as to keep the money stock unchanged. This creates a window of opportunity for the ECB to replace the old bonds with new environmental bonds, issued to finance environmental projects by businesses that respect labour rights, social standards and adequate collective bargaining structures. In this respect the new taxonomy of financial assets should be formulated on very clear standards to avoid supporting ecologically detrimental economic activities and socially disrespectful working practices, while allowing Member States to invest in workers' re-skilling for new types of activities in ecologically friendly sectors (again thanks to the PEPP and Next generation EU programmes). As suggested by many, the ECB could, within the PEPP: Target assets and collaterals in line with the Paris Climate Agreement and issued by businesses satisfying strong social standards and working rights, to support the low carbon transition; Make refinancing operations replacing the old bonds come to maturity with environmental bonds issued by business respectful of good social and work practices, and implement a green and social TLTRO; Coordinate and support its market operations for sustainable investment with the European Investment Bank; Develop a new system of financial regulation based upon asset-based capital requirements for green and social investment; and lead by example on climate disclosures and transparency by assessing and regularly communicating to elected officials the alignment of its operations with the Paris Agreement and that of the European banking sector.

Conclusion

While economic and social convergence between Member States resumed shortly before the pandemic, new signals of divergence are appearing. Some warn that this two-speed recovery, in which Europe's fiscally stronger north is rebounding faster than the more heavily indebted south, is set to increase financial market strains. In this respect, the low interest rates resulting from the PEPP programme launched by the ECB is very welcome. Even after an eventual economic recovery, within the ECB's long running asset-purchase schemes, geographical and asset flexibility should continue to be under discussion.

Europe's fundamental problem is not captured by aggregate euro-area inflation rates or, for that matter, the exchange rate with the dollar. The acute problem is the lack of demand and growth, thus also healthy rates of inflation in the weaker parts of the eurozone economy. Without a convergence of growth rates, Europe in its present form will be under constant pressure. The compromise reached in July avoids immediate austerity but does not solve the problem. Creating that convergence in growth is clearly not the primary job of the ECB—it is a matter of much broader economic, social and industrial policy. However, the ECB has an indispensable role as a supporting actor, enabling borrowing and channelling credit to support whatever fiscal and industrial measures are necessary. In this respect ETUC supports the ECB's recent call to the European Union to consider making its new pandemic recovery fund permanent for global aggregate demand concern and convergence issues.

This will require tough and highly political battles about the proper role of the ECB. Moreover, given the timeframe within which it must work, it is inseparable from the need for decarbonisation and a green and just transition.

Therefore, with regards to the developments described above, the ETUC demands:

- Full employment and ecological transition objectives to be on a par with price stability in the ECB's mandate;
- The ECB not to tighten monetary policy just because a decrease in unemployment is in view;
- The ECB to support, through expansionary monetary policies, the increased needs for public investment, through some kind of yield control;
- The ECB to revise its inflation methodology for better including housing prices developments;
- The ECB to consider the possibility of helicopter money;
- The ECB to increase financial regulation as a way to improve monetary transmission mechanisms;
- The ECB to continue to show willingness to intervene including with unconventional monetary tools in a flexible manner to prevent debt crisis in Europe and allow economic and social upward convergence;
- The ECB to reorientate its asset purchase towards bonds issued by companies respecting just ecological transition purposes;
- The ECB to:
  - ✓ target assets and collaterals in line with the Paris Climate Agreement and issued by businesses satisfying strong social standards and working rights, to support the low carbon transition;
  - ✓ Make refinancing operations replacing the old bonds come to maturity with environmental bonds issued by business respectful of good social and work practices, and implement a green and social TLTRO;
  - ✓ Coordinate and support its market operations for sustainable investment with the European Investment Bank; Develop a new system of financial regulation based upon asset-based capital requirements for green and social investment;
  - ✓ And to lead by example on climate disclosures and transparency by assessing and regularly communicating to elected officials the alignment of its operations with the Paris Agreement and that of the European banking sector. We strongly support the role of the ESCB in providing the public with reliable and detailed data that help to better analyse economic activity. This does not only include of macroeconomic data, data on MFIs, but also data on households as the HFCS.