**THE ECB'S QE: THE RULE OF LAW, DEMOCRATIC POLITICS AND INCOMPLETE CONTRACTS**

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I am very glad to be here in Frankfurt so soon after the ECB provided monetary stimulus to euro-area aggregate demand by launching quantitative easing (QE). This will work by purchasing government bonds in proportion to the ECB's 'capital key', ie roughly proportional to each member country's share of area-wide GDP.

I will say something briefly about three topics: whether the ECB was right to launch QE; how the transmission mechanism into nominal demand and so inflation might work, drawing on the Bank of England's experience; and, most important, where on a spectrum of dismayed to applauding we should be about the almost year-long debate around the politics of QE.

I think the ECB was right to launch QE. For some considerable time the euro area has in my view faced a problem of deficient demand, in addition to needing structural reforms of various kinds. Even when, going back a year or so, the central (expected) outlook for inflation was reasonably thought to be positive, there must surely have been a critical probability mass below zero. In my view the public debate --- as well as, perhaps, the Governing Council's own deliberations --- about the course of monetary policy would be materially helped if the ECB's published forecasts for growth and inflation were explicitly probabilistic, bringing out the upside and downside risks to growth and inflation.

Over those twelve months or so, commentators and analysts have argued that buying German and French government bonds wouldn't help the crisis-hit countries of the south. That line of argument betrays a fundamental confusion between, on the one hand, crisis management in and for the so-called 'peripheral' economies and, on the other hand, nominal demand management in the euro area as a whole in order to meet the inflation target (known as monetary policy). If one believed, as I amongst many others did, that there was deficient aggregate demand in the so-called 'core' and, thus, in the currency area as a whole, then more monetary stimulus was warranted. It is in that sense that, although introduced in unusual circumstances, the latest stimulus *is* regular monetary policy in the sense that it is designed to close the gap between aggregate demand and the economy's productive capacity, reducing downward pressures on wage and price formation. Whether or not it is a mistake turns on macroeconomic judgments about the outlook for demand and inflation. At times, too little of the public discussion has been about that.

How will it work? Perhaps at this point it is worth my recalling how I thought about the Bank of England's QE as we prepared for it during the winter of 2008/09.

When the severity of the economic fallout from autumn-2008's financial system implosion began to become apparent, my thinking ran something like as follows. I wanted to get the policy rate down to as close as possible to zero as quickly as possible, while inflation and, more important, expected inflation were still clearly positive. That way we would make the short-run real rate negative. Further, I completely agreed that we should ready to launch QE as soon as possible, by buying gilt-edged securities from investment institutions. Three things are worth emphasizing here.

First, as Mervyn King said at the time, while too much money chasing too few goods creates inflation, we had to be ready to recognize the possibility that there was *in*sufficient money circulating in the economy, which would lead to inflation falling below our 2% target over the medium run and possibly even to deflation. With the implosion of the banking system, we were facing a severe contraction in the supply of bank lending, which over time would destroy broad money. We saw ourselves, therefore, as providing an exogenous injection of money to help offset that endogenous process of monetary contraction.

Second, we did not see the Monetary Policy Committee's stimulus as working through the so-called money multiplier, ie that banks would lend more if they held more central-bank reserves. That the banks would get more reserves was an accounting identify, but not one with economic traction in the circumstances. In fact, we saw a resumption of credit supply as largely dependent on banks recognizing their losses and recapitalizing, on the view that well-capitalised banks lend but poorly capitalized banks, struggling for survival, don't. Sometime later, I described us as operating a Hayekian banking policy and a Keynesian-Friedmanite monetary policy. I observe that the transfer of banking supervision to the ECB seems to having similar effects in the euro area: ie making banks get real. Forbearance when the stakes have been so high for the people of this continent was hard to justify, although no doubt well intentioned.

But if our monetary stimulus didn't initially work through the money-multiplier and the banking system, what was the mechanism?

From the beginning a number of us emphasized the portfolio-balance channel. Namely, by buying gilts from saving institutions such as insurance companies and pension funds, we would take from them an asset that they desired because of its minimal default risk and because its duration aligned with that of their long-term liabilities and, in its place, we would be giving them a monetary asset --- deposits with commercial banks --- that was both risky and of very short duration. That being so, those savings institutions could be expected, first, to charge a premium for letting go of their gilts, driving down the discount rate for all other sterling-denominated assets; and, second, to use the money (bank deposits) to acquire as close a substitute as possible for gilts, high-quality sterling corporate bonds. Such was the demand for corporate paper in the months that followed, that more companies than ever before issued sterling-denominated bonds. This created a twist in the effect on the monetary aggregates. Rather than our injection of money leading to faster (broad) monetary growth than otherwise, broad money shrank partly because firms used the proceeds of bond issuance to repay more expensive bank loans. This was benign deleveraging of the banking system --- not sufficient on its own to cure the banks' problems but helping.

Of course, that wasn't the only channel. Our QE signaled that the Bank of England's policy rate was likely to remain low for a protracted period, pulling down forward rates out to fairly distant horizons.

The point of recalling all of that is twofold.

First and foremost, it is a distinctly *monetary* story of how QE works. In the US, the Federal Reserve has chosen barely to mention the monetary dimension of their actions, preferring to focus on term premia etc. That strikes me as accurate but incomplete, and has risked misleading people about the essential *monetary* nature of these central banking interventions. The thinking I have outlined therefore falls squarely *within* the traditions of the German Bundesbank, which of course were incorporated into the ECB's two-pillar monetary framework.

Second, while the circumstances in which the ECB has launched QE are plainly different --- yields already very low and markets somewhat better arbitraged than back in the spring of 2009 --- that does not mean that QE will have no effect. It is early days, but already yields and the exchange rate are lower, and perhaps we will see a pick-up in bond issuance. Although capital markets play a smaller role in intermediation *relative* to the UK and especially the US, euro-denominated capital markets are big and there are all sorts of investment intermediaries involved.

One possible portfolio-balance channel is that foreign (and perhaps some local) holders of high quality euro-area bonds 'rotate' out of euros and into US Treasuries and other international reserve assets, a 'hydraulic' mechanism that reinforces (or is as at least consistent with) a lower nominal exchange rate. Quite apart from any boost to external demand from temporary effects on the real exchange rate, the lower nominal exchange will tend to put upward pressure on the price level, helping to mitigate the short-run effects of falling oil prices on headline inflation. Whilst typically it would be sensible to look through the effect of cost shocks on headline inflation, as we did in the UK when we accommodated much of the shock that took headline inflation to 5%, in current circumstances the temporary effects of the euro's depreciation might helpfully reduce the probability of deflation becoming embedded in household and business expectations.

This brings me to my third set of remarks, around the political economy or politics of QE.

The ECB has a duty to use monetary instruments to achieve its mandate for maintaining inflation around 2%. It has manifestly not been achieving that recently, including before the downwards cost shock brought about by the fall in oil prices.

It is sometimes argued that central banks should refrain from providing monetary stimulus if that is likely to reduce the pressure on governments (and other actors) to implement structural reforms. That stance is not consistent with the rule of law, with what I understand to be the principles of a *Rechtsstaat*. Central bank policy makers are powerful, independent (nowhere more so, *de jure*, than in the euro area) and, crucially, unelected. They have no right to set their mandate to one side in order to 'game' elected politicians into taking more fundamental actions, however vitally necessary those measures are.

But if they have a duty to stick to their mandate, central bankers --- as trustees for the public interest in price stability --- also have a duty to explain how and to what extent their measures are likely to work, and the risks (on either side). That means explaining that monetary policy works by bringing forward future spending, and cannot conjure up the improvements in permanent incomes necessary to put the economy on a better trajectory. In other words, I believe that first duty --- to explain how QE is likely to work --- entails a corollary duty to explain that in circumstances such as these central banks cannot be, in a phrase, 'the only game in town'[1].

Is there, though, a question about the legitimacy of the instruments deployed by the ECB and by its fellow central banks? Are they intruding into fiscal policy? These are profound questions in monetary economics and in the political economy of central banking.

The best place to start is with a hypothetical baseline, minimal conception of monetary policy. This is that the operation of monetary policy comprises buying and selling domestic Treasury Bills in order to push around current (and expected) risk-free rates by exploiting the non-substitutability of zero-interest bearing central bank money and TBills. There are numerous limitations with that story, but one is decisive right now. With nominal rates at and expected for some time to be very close to the zero lower bound (ZLB), central bank money and Tbills are currently close substitutes. As such, the boundary between monetary policy and fiscal policy becomes unavoidably blurred.

One possible response to this is that even at the ZLB, the central bank can inject reserves by lending secured (repoing) with haircuts to protect it against financial risk. But that leaves the central bank unable to control the size of its balance sheet; the value of repo transactions is demand determined. Thus we saw substantial *shrinkage* in the ECB's balance sheet while nominal demand prospects were softening. Put another way, in normal circumstances the central bank has a choice in how it operates policy: it can either control the (overnight) risk-free rate and let the size of its balance sheet (reserves) be determined endogenously, or it can control its balance sheet size.  Once at the ZLB, the former operational mode is closed if it wants to provide further stimulus. Beyond signaling the expected future path of its nominal policy rate, one option would to hand policy over to the fiscal authority: the central bank goes into hibernation. Another option is central bank balance-sheet policy.

That being so, a central bank faces a choice on the assets side of its balance sheet: whether to create money by buying private sector paper or by buying public sector paper. Either course entails risk. Private sector paper carries default risk. Even the best government paper exposes the central bank to interest rate risk if it sells the paper before it matures, which it can avoid only by maintaining its monetary stimulus longer than warranted, *ex post*, to achieve its inflation target.

In the UK, in recognition of this we sought and obtained up front an indemnity for the government covering any losses from conducting QE. Since any losses would in any case have flowed through to lower seigniorage income, this didn't change the economic substance but was merited on grounds of making the underlying economics clear to the public and the Westminster Parliament.

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[1] For a wider review of similar themes, see Tucker "The Only Game in Town? A New Constitution for Money (and Credit) Policy", Myron Scholes Lecture, Chicago Booth School of Business, 22 May 2014.

At the same time, we sought and obtained a public assurance from the UK government that they would not change their debt-management strategy so as to exploit, and thus undo some of the prospective demand stimulus from, the lower yields resulting from our purchases of gilts. Here in the euro area, where there are 19 counterparty governments, there is a question about how the ECB can address that risk. I hope that will become clear[2].

Rising above those details, the burden of my point is as follows. There is no denying that the monetary/fiscal boundary becomes blurred at the ZLB. But the need for a degree of coordination absolutely does not entail an erosion of monetary independence. The test of that is whether the central bank decides, without interference, the amount and timing of any QE, and whether its monetary policy decisions and actions are motivated solely by its mandate to achieve the inflation target over the medium term. There was no doubt about that in the UK, and I have no doubt about that here.

There is, though, a further complication here in the euro zone: the question of how the financial risks entailed by monetary policy operations should be shared out. While there is lots that could be said about the details, I shall confine myself to two broad points, which as so often pull in different directions. On the one hand, whether or not one subscribes, as I do, to the view that EMU will need a form of fiscal union to be viable in the long run, there is not a fiscal union now and so, arguably, no risk-sharing (over and above that entailed by the LTROs etc) is consistent with the euro area's extant economic constitution. On the other hand, giving a signal cutting across the longer-term trajectory hoped for by the markets risked taking Europe once more to the brink. That is part of the context in which the latest Greek crisis will play out. The sin was not to provide, at the outset, a regime for sovereign default and debt work outs *within* the monetary union, while somehow providing support for people affected by successive government mistakes or mismanagement. Such a regime is still needed.

Two final points flow from all this. One is that the costs of incomplete contracts for delegating authority can be high unless there are clearly understood arrangements for generating timely clarifications. In the UK, thanks to our constitutional structure, it was possible to flesh out the Bank of England's contract a little when we launched QE, although there is more to be done. In the euro area, a lot more fleshing-out is needed, but that will be somewhat harder in a Treaty-based polity. More generally, the unavoidable but often unrecognised *Fiscal Carve Out* for central banking needs refinement and more explicit elaboration[3]. Central bank independence is a set of norms or conventions, underpinned in part by law, about the management of the government's consolidated balance sheet. It entails delegating to an independent agency the discretion, insulated from day-day politics, to change the liability structure and, if private-sector instruments are bought or lent-against, the asset structure of the consolidated balance sheet in pursuit of an objective of medium-term nominal stability. The contract is incomplete if, amongst

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[2] Interestingly, no such commitment was made in the USA and I would judge that the US Treasury did offset some of the economic effects of Federal Reserve QE. Judging from recent debates on this, part of the issue might be rooted in the apparently highly state-contingent nature of US government debt management. See R Greenwood, S G Hanson, J S Rudolph, L H Summers "Government Debt Management at the Zero Lower Bound", Brookings Hutchins Center on Fiscal and Monetary Policy, 2014.

[3] Tucker, Myron Scholes lecture 2014, *op cit*.

other things, it does not cover the central bank's degrees of freedom to change the liability and/or asset structure.

My other concluding reflection is about the nature of the public debate on QE over the past year or more. I confess to being a little schizophrenic about this. On the one hand, I think there have been lots of confusions. For example, while I can see that in the real world it was prudent for the ECB to await the Advocate General's Opinion on the Outright Monetary Transactions (OMT) policy, in truth that policy is quite different from QE as an instrument of nominal demand management for the *euro area as a whole*. In a similar vein, it has seemed at times that the Governing Council was badly handicapped by the fact it did not publish minutes, leading to debate via the newspapers and with participants at times unseen.

On the other hand, debate and deliberation are part of the very essence of democracy. Precisely because the contract was incomplete, the people of the euro area were entitled --- and I mean morally entitled --- to debate the pros and cons of the various instruments contemplated or explored by their unelected central bankers. And they were entitled to learn about differences of view. If that is correct, there was of course a special burden on policy makers to explain the disputed issues as clearly as possible. That is hard when the stakes are so high and the issues complicated. For example, it has not been easy to disentangle the meta-debate about whether QE is legitimate from the operational debate about whether, given uncertainty about the economic outlook and about the transmission mechanism, it is worth doing. I have given my views on that for what they are worth.

Much more important for now, however, we must hope for steadfastness in execution. Further, we must hope that governments of the euro area serve the long-term interests of the people by grasping the imperative of real-economy reforms. Monetary stimulus can help smooth the transition, and might keep deflationary tail risks at bay, but it cannot be the only game in town.