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# Central bank independence and the future of the euro

Panicos Demetriades

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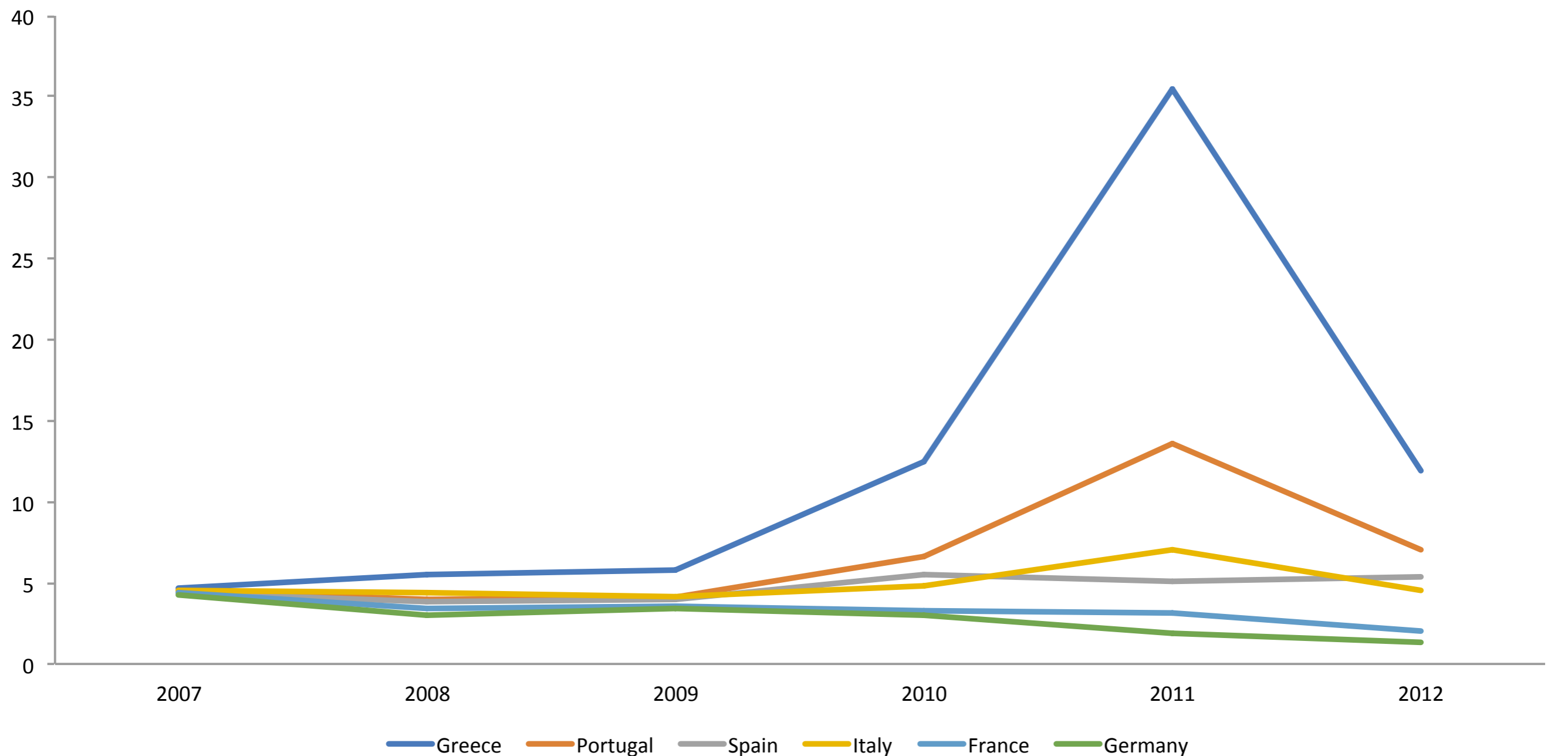
# Background: the euro's design flaws

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- EMU exacerbated the booms and busts that are inherent in a free market economy
- Euphoria from the creation of the euro and lower borrowing costs for the periphery led to over-borrowing and an unsustainable rise in public and private debt
- The automatic stabilisers usually present such as the exchange rate were no longer available, e.g. Greece and Italy had acquired a 'hard' currency that couldn't depreciate
- Government deficits could no longer be monetised: central banks stepped being lenders of last resort to national governments
- There was no automatic bailout clause and no crisis management mechanism

# From euphoria to near breakup

**Selected euro area 10-year government bond yields**



# A famous economist receiving the Nobel Prize



1 (of 14) Paul Krugman receiving his Prize from His Majesty King Carl XVI Gustaf of Sweden at the Stockholm Concert Hall, 10 December 2008. Copyright © The Nobel Foundation 2008

Photo: Hans Mehlin

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# The same economist was predicting the euro's demise

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23 October, 2011 "...its looking more and more as if the euro system is doomed"

10 November, 2011 "This is the way the euro ends...it's hard to see how the euro can survive at all."

17 May 2012 "Apocalypse Fairly Soon..."

10 June 2012 "utter catasrophe may be just around the corner"

29 July 2012 "Will the euro be saved? That remains very much in doubt"

Krugman wasn't alone: many other famous economists and think tanks were pessimistic about the euro, e.g. Willem Buiter, Joseph Stiglitz, George Soros, Capital Economics etc

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# The euro did, however, survive

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- A bailout mechanism (EFSF / ESM) was set up, the troika (IMF, European Commission and ECB) managed the technical aspects of conditionality and Eurogroup became the *de facto* crisis resolution mechanism at the political level, approving bailout funds and economic adjustment programmes
- The Eurosystem provided liquidity to banks under stress, through monetary policy operations or emergency liquidity assistance (ELA)
- The ECB introduced a series of non-standard policies, including OMT, to back up Mario Draghi's 'whatever it takes' pledge. It also adopted QE to avert deflation risk when interest rates reached the ZLB
- Greece, Ireland, Portugal, Spain and Cyprus were bailed out - growth returned in Greece, which finally exited its third programme in August 2018

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# The crisis prompted architecture strengthening

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- Significant steps to create a banking union were made
- The Single Supervisory Mechanism and the Single Resolution Mechanism were created
- A harmonised regulatory and resolution framework for banks was introduced
- However, a European Deposit Insurance Scheme (EDIS) that would complete the banking union, has not as yet been agreed because of German objections

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# Is that enough?

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- Clearly not: a lot more needs to be done to fix the architecture of fiscal policy - the Maastricht criteria are outdated and pro-cyclical
- The fundamental flaws have not been addressed - steps towards political and fiscal integration have not been made.
- Many good reform proposals exist, however political appetite for reforms during normal times is limited
- Germany is reluctant to move forward because it fears the creation of a transfer union
- While the debate has focused on the big reforms needed, an important weakening of the architecture has gone largely unnoticed



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# Collateral damage

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- Central bank independence (CBI) is at the heart of the monetary union
- CBI is widely perceived as the *sine qua non* for safeguarding price stability - the idea is supported by a very large body of research and CBI was adopted by many governments in the 1980s and 1990s
- The Eurosystem has very strong independence safeguards - enshrined in the EU Treaty
- The crisis tested these safeguards, as Eurosystem central banks took on new responsibilities, e.g. bank resolution and supervision
- In practice the safeguards did not work as well as it could be hoped - partly because the Commission did little to uphold CBI

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# CBI in the euro area

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The independence of both the ESCB and the ECB is laid out in Article 130 of the EU Treaty, which states:

“When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks”.

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# Erosion of CBI - examples

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- Three euro area central bank governors, who came under domestic political pressure, resigned before the end of their term: Cyprus (2014), Slovenia (2017), Slovakia (2019)
- Latvia's central bank governor was removed from office in 2018 by a single judge, because of allegations of corruption made by a supervised bank - the removal was found by the ECJ as illegal a year later
- Several other central bank governors found themselves under political pressure domestically after taking actions to deal with failing banks (e.g. Greece, Portugal)

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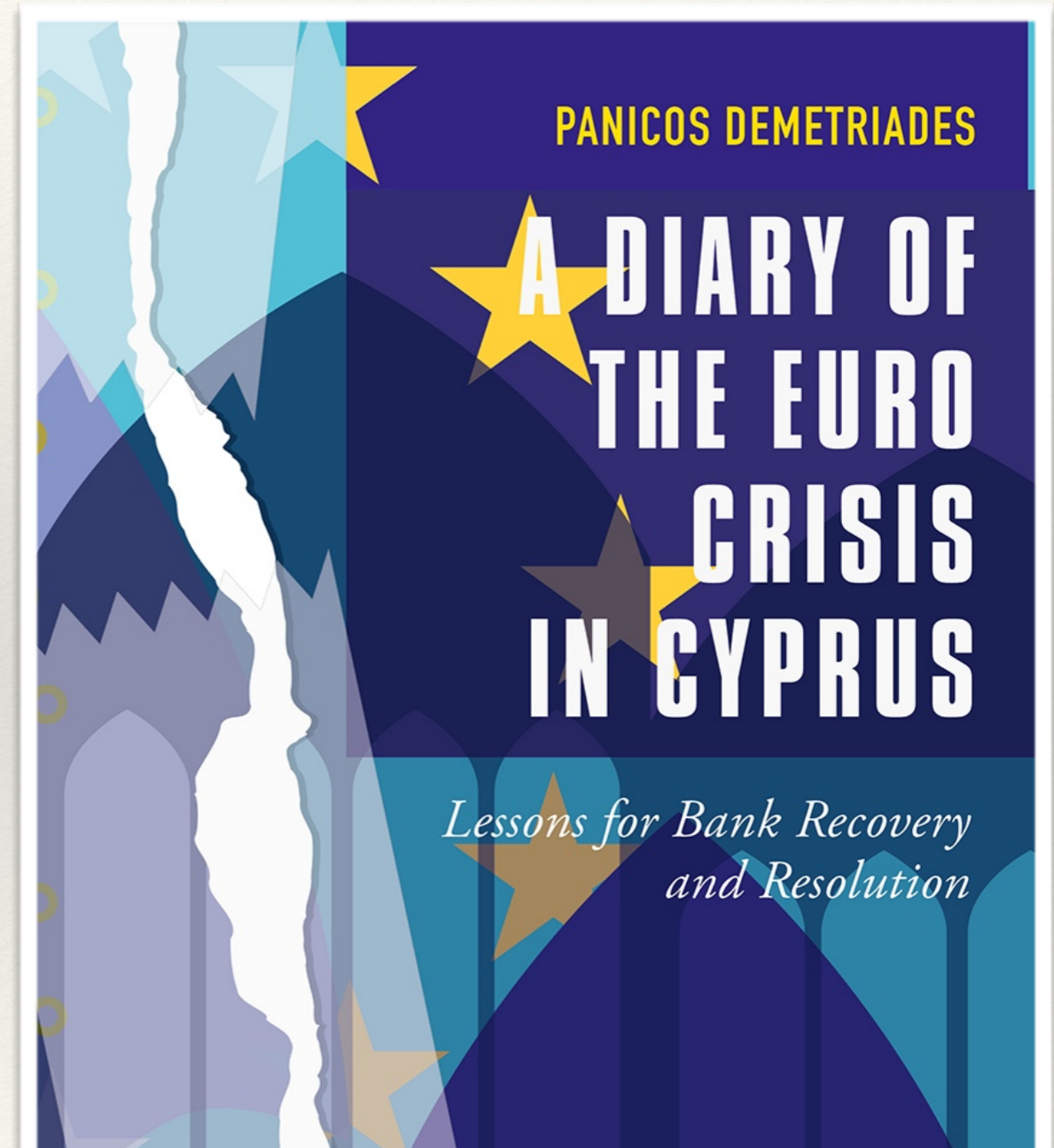
# Was it just an issue of enforcement?

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- Not quite: the independence safeguards are strongest in relation to monetary policy but somewhat vague when it comes to other tasks - by taking on tasks such as supervision and resolution, euro area central banks found themselves in a grey area
- The scope of CBI is limited to members of the Governing Council of the ECB (central bank governors and six member executive board of ECB) - it does not apply to other members of central bank governing bodies
- Governments determined to undermine CBI could do so by capturing central bank boards and by attacking central banks on non-monetary policy tasks e.g. supervision, resolution

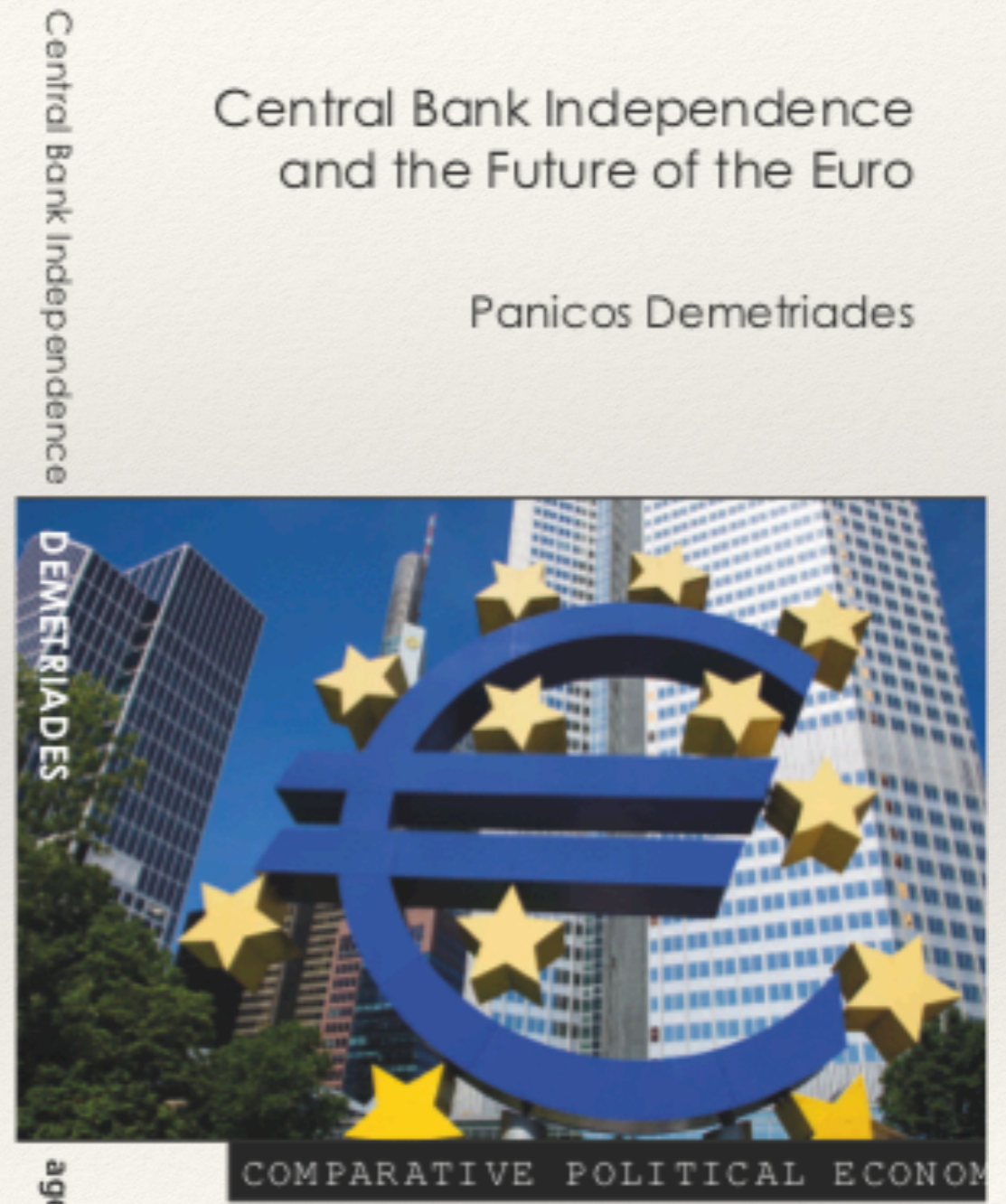
# The erosion of CBI in Cyprus

- As resolution authority, the CBC had to impose losses on shareholders, bondholders and uninsured depositors, who were bailed-in
- As supervisor, the CBC had to screen the new board directors of Bank of Cyprus, including Russian PEPs represented by Cypriot politically connected law firms
- Toxic political fallout from these actions resulted in a change of the CBC law - notwithstanding legal opinion by the ECB - that allowed the government to exert control of the CBC via its board



# CBI erosion is contagious

- The Economist in 2014 described my resignation as a blow to CBI in Europe but went on to say that Cyprus maybe a “special case”
- Events since proved that CBI erosion is contagious - Slovenia followed the lead of Cyprus, Greece attempted a similar attack and the Slovakian governor gave up without a fight, as soon as the government made it clear it wanted to replace him
- Latvia removed its central bank governor from office without due process



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# Does Europe's periphery matter?

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- Yes, because CB governors elsewhere may be changing their behaviour to align themselves more closely with their respective governments
- Banca d'Italia's alignment with Italian government to prevent bail-in being applied to 'retail investors' in failing Italian banks in 2017 is a case in point
  - Although SRB concluded that resolution was not in the public interest, the decision seems to have been influenced by lobbying by Italian government concerned by electoral considerations
  - Changing behaviour is hard to detect but, if widespread, it means that next time there is a crisis, euro system central banks may not do 'whatever it takes to preserve the euro' but whatever it helps to preserve their national governments (e.g. in the book I provide the failure of the coop bank in Cyprus, months after the presidential elections of 2018)
- If Governing Council becomes a cacophony of national interests, monetary policy decisions will be divisive and will generate greater policy uncertainty

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# Another reason the periphery is important

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- When it comes to dirty money, the single financial market is as strong as the weakest link
- Recent money laundering scandals have revealed that the periphery (Cyprus, Estonia, Latvia, Malta) is the entry point of dirty money that can destabilise not only EU but also US
  - Besides reputation damage, money laundering can result in financial instability (e.g. ABLV failure)
  - Modern money laundering may have political objectives to destabilise or erode democracy
- The EU has no pan-European AML body & several EU banks have faced sanctions by the US - should the EU rely on the US to take AML actions?



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# Political money laundering

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- Notwithstanding the creation of SSM, the supervision of Anti-Money Laundering (AML) remains a national responsibility
- In small countries with large banking systems regulators can be inadequately resourced, captured by interest groups or subjected to political pressures e.g.
  - Paul Manafort's trial highlighted how dirty money flowed from Ukraine to Cyprus via a politically connected law firm and eventually to US
  - In 2018, EBA identified serious failings in the supervision of Pilatus Bank by Malta's Financial Intelligence Analysis Unit
- A wave of recent scandals, including ABLV (Latvia) and Danske (Estonia), indicates that money laundering impacts adversely on ECB reputation and financial stability - it may also be linked to electoral meddling

General Trivia

Wilbur Ross earned the nickname, "King of Bankruptcy" for his investments in distressed companies. And this isn't the first time Wilbur Ross has helped to bai...

General Trivia

The St. Pancras station in London is 150 years old. On October 1st, 1868 at 4:20 AM, the first train arrived at the station. Inside the station is the St. Pancras Champagne Bar -- Eur...

# This Giant Beast That is the Global Economy

Season 1, Ep. 1 Money Laundering: A How To Guide



Kal Penn  
Himself - Host



Panicos Demetriades  
Himself

- Wilbur Ross, the current U.S.

Watch this to find out how money laundering connects the global economy

Episode 1, especially Scene 11 explains the details

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# Did Mario Draghi Save the Euro?

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- The actions taken by the ECB during the crisis certainly helped to preserve the euro during Draghi's term
- However, the collateral damage - erosion of CBI - has increased the risk and it may well unravel in the future
- Some actions were perceived as too political and raised legitimacy questions: e.g. ECB participation in the troika, bank resolution actions by national central banks, new supervision responsibilities of ECB
- Moreover, non-standard monetary policy such as QE and negative interest rates were only meant to buy time for governments to take appropriate actions
- Mission creep has raised legitimacy questions and left national central banks vulnerable to domestic politics
- Even now when Europe is plagued by money laundering scandals, few people have connected the dots - erosion of CBI is not unrelated (often CB's are the AML supervisors)

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# Governance weaknesses

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- Paradox: while we have fit and proper criteria for commercial bank boards and senior executives, no such criteria exist for central bank boards
- Often governments can appoint bankers of failed banks to Deputy Governor (if not also Governor) posts
- Non-transparency of the ECB appointment process is a more widespread phenomenon - no such transparency exists in most Eurosystem central banks, for their boards or Governors
- Such weaknesses, unless addressed, can make stakeholder engagement much more challenging - central banks need to get their houses in order before asking for adequate safeguards for their independence (that should also safeguard the independence of board members)

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# Will the euro survive?

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- Safeguarding CBI isn't as easy as it sounds: to protect CBI, the euro system must be able to communicate its actions transparently, effectively and convincingly
- Governance and communication are, therefore, critical to safeguarding CBI and the future of the euro
- My new book makes six recommendations to safeguard the euro, including suggestions to enhance governance and communication, as well as a strengthening of AML supervision
- The book is currently at the printing press and can be pre-ordered from [Agenda Publishing](#) or [Amazon](#)

## Reviews

"Drawing on his extraordinary professional experience, Demetriades discusses the value and curse of central banking. While the author argues in favour of central bank independence, he does not fail to address the challenge to central banks' legitimacy resulting from the latest period of crisis management. This book offers a comprehensive analysis of what might appear an irreconcilable duality in central banking between independence and legitimacy." – **Filippo Taddei**, former Economic and Labour Affairs Spokesperson of the Italian Democratic Party and Economic Advisor to the Italian Prime Minister

"An important and timely contribution to the topic of central bank independence in Europe's monetary union. Based on his experience as an economist and as a former central bank governor, Demetriades presents the academic arguments for independence, the limits of the Euro-system's framework for governance, and the necessary next steps to make sure the mistakes of the financial crisis are not repeated." – **Claire Jones**, Global Economy Reporter, *Financial Times*