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BLACKBOX ECB

**THE POWER AND IMPOTENCE
OF THE EUROPEAN CENTRAL BANK**

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INTRODUCTION

Central banks resemble modern churches. They reside in grand buildings and they radiate an aura of authority, power, mystery and importance. Central banks are regarded as “guardians of stability and money”, and “provide society with liquidity”. Their mission seems unquestionably good and useful, because everyone wants a stable currency and fears the monster called inflation.

In economically calm times the general public is hardly even aware that central banks exist. They operate in the background. However, the financial and euro crisis moved the central banks of the industrialized nations into the focus of attention. The European Central Bank (ECB) was a central element of crisis management strategies and sat at the same table as the politicians. It is often said that the ECB managed the crisis of financial markets virtually on its own.

Nonetheless, its anti-crisis measures have also made the ECB a focus of criticism. Economists are warning that the ECB is ruining the euro and the euro area. In Germany, the ECB policy was denounced before the Federal Con-

stitutional Court. From the left too there is criticism of the ECB’s policies: “Following a capitalist logic, the policy of the Troika¹ – imposed in particular by the ECB – of structural adjustment programs has had disastrous effects on the lives of millions of people.”²

How does all this fit together? The first part of this publication uses readily accessible terms to explain what central banks normally do and how they “maintain” the value of money. The second part focuses on the special characteristics of the ECB and its policy in the crisis. First, we look at the ECB as a *central bank* and then at its *European* aspects. It should become clear from the discussion that central banks are never impartial and that there is a lot more to criticise about the ECB than the fact that it is a part of the Troika.³

1 The ‘Troika’ consists of the EU Commission, the International Monetary Fund (IMF) and the ECB. In euro states such as Greece, Italy, Ireland and Portugal it supervises the fulfillment of the austerity measures and reforms that governments committed themselves to in exchange for emergency loans. **2** See: Blockupy call to May Day action days and to the blockade of the ECB, January 2014. **3** The following text is based on a lecture held for the Rosa Luxemburg Stiftung that can be accessed here (in German): www.rosalux.de/news/40051/-98707ec29b.html.

PART 1: THE CREATOR OF THE EURO – WHAT DOES THE ECB DO?

According to legislation, the task of a central bank is to ensure price stability. In the case of the ECB, this translates into maintaining the inflation rate at “below but close to 2%”. Before we ask how the ECB attempts to achieve this, we need to answer the following questions: Which problems does the central bank face? And in which kind of environment does it operate?

1.1 What central banks aim to steer

Private companies are the main actors on the market. Their goal is to make a profit, in other words a surplus in the form of money. In a simple example, a company invests 1,000 EUR in machinery, equipment, and workers, and produces, sells and earns 1,100 EUR. Then the whole process starts over. This company competes with many other similar companies, and its two main ways of selling more products are price and quality. A company that offers lower priced, higher quality products should sell more than its competitors.

To increase or maintain competitiveness, companies continuously need to increase their productivity. All companies do this and this means they constantly force each other to produce better products at cheaper prices. Furthermore, they also force each other into permanent growth, because only companies that expand gain the additional means needed to beat the competition.

Companies need money to re-invest and increase productivity. But they cannot wait to sell their goods, generate and accumulate the necessary funds and invest when they have finally made enough money. This would take

too long. Companies therefore organise their liquidity by taking on loans, in other words they borrow money.¹

Loans are offered by commercial banks. Commercial banks collect money from society through people’s bank accounts. But whenever a commercial bank awards a loan, it does not simply give out the cash it has collected. In reality, the banking sector can award loans worth much more than the money it actually has.

Theoretically at least, commercial banks can award an infinite number of loans. This is fine as long as there is no doubt about the bank’s solvency. If doubt does arise, then this can cause a run on the bank: the customers go to the bank and demand their money back. This

The central bank is backed by the state’s power and currency monopoly. This means that the central bank is ultimately limitlessly solvent.

causes the bank to go bankrupt and customers’ deposits at the bank are worth nothing. They vanish. This can lead to a chain reaction (such as during the 2008 bankruptcy of Lehman Brothers), the bankruptcy of further banks, mass bankruptcies and to general insolvency.

This is why the state supervises banking. It regulates bank lending and tries to limit it:

- First, through *rules* that bind the maximum amount banks can lend to certain figures – such as a bank’s equity or deposits (the money customers deposit in the bank);
- Second, by establishing a *central bank*. A central bank can create real money (central bank liquidity), for example by printing euros. The central bank is backed by the

power and the currency monopoly of the state. This means that the central bank is ultimately limitlessly solvent (at least as long as euros are accepted as a currency). You cannot go broke if you can print money.² Commercial banks then award loans based on the central bank's liquidity.

The central bank supplies commercial banks with real money and uses this as a means to fulfil its mission, namely to steer commercial bank lending. This enables the central bank to steer a society's liquidity.

1.2 Money supply through credit

Commercial banks receive their liquidity from central banks. What does this mean? Basically this is the well-known fact that central banks can "print" money. A central bank is the only institution in capitalism that neither needs to earn money nor to rely on money which others have earned (like the state does through taxes). It can "create" money out of thin air. The crucial question here is: How does this work? Do central bankers jet over the country

Money creation and printing

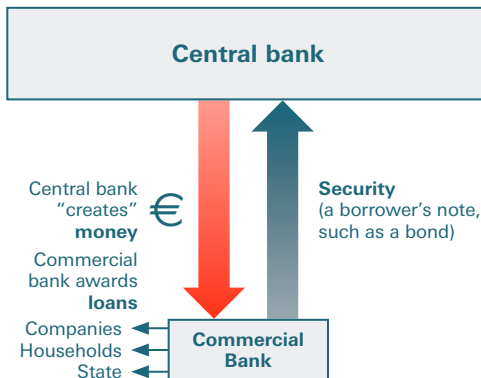
Whenever a central bank lends money to commercial banks it literally creates money out of thin air. More specifically, it transfers the created amount of "central bank liquidity" onto a commercial bank's account at the central bank. On request, the central bank must actually pay this sum to the commercial bank, that is, the commercial bank can ask the central bank to provide the agreed amount in printed banknotes. Then, and only then, does the central bank actually print bank notes.

When commercial banks award loans, they too create liquidity. They grant a customer a credit and promise to award the customer a certain amount of money.³ However, this is not the same as when the central bank creates liquidity. Both central and commercial banks lend money, create demands towards themselves and thus

create liquidity. But "money creation" by commercial banks is only as sound as the financial situation of the bank in question. When a commercial bank needs money, it must either borrow or earn this money. If this is not possible then the commercial bank goes bankrupt and the money it has created is worthless. The central bank, however, cannot go bankrupt. It does not have to earn money nor does it have to borrow money. In the case of the ECB, it can "create" euros. Money creation by commercial banks rests on the success of private capitalist enterprise; money creation by the central bank relies on a currency monopoly. Basically this means that commercial banks only create credit money, whereas the central bank creates actual money and thereby the medium on which the loans of commercial banks are based.

dishing out freshly printed banknotes? Of course not. The “supply of money” is organised differently today: instead of supplying euros, the ECB lends them. Every single euro that sees the light of day is born in the form of credit. Basically, this works in the way shown in chart 1.

Chart 1: How money is born (I)



A commercial bank (for example Commerzbank) provides the ECB with collateral (for example a debt certificate or a bond) worth 1,000 EUR, usually for a specified period (such as one month). In return for this collateral, the ECB lends the commercial bank 1,000 EUR. These euros are new money, real “central bank liquidity”, which have been freshly created by the ECB. Commerzbank can now use these fresh euros to grant loans to private households, businesses or the state.⁴

This is the wonder of central bank money creation, and there are several striking aspects to it:

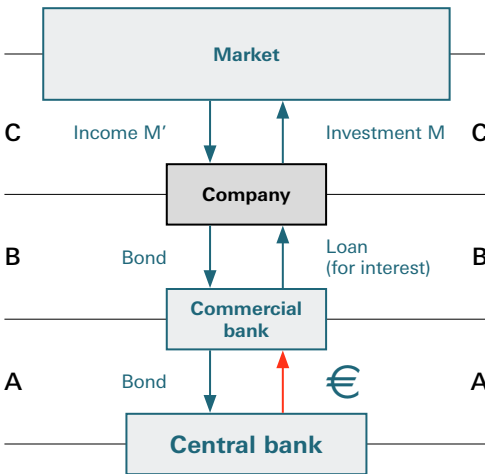
- The ECB accepts a **bond** (see glossary), for example a security, for freshly printed euros. What exactly is a security? It is a certificate of debt, that is, a *promise* by the issuer of the certificate (which can be a government, a business or a bank) to *repay* the borrowed

sum at a certain point in the *future*, including a set amount of interest. Whether the sum will actually be repaid, though, is uncertain.

- For the *commercial bank* a certificate of debt becomes part of its financial capital. It treats a *promise* to pay as if the *payment had already been made*. What does this mean? If the bank holds a certificate of debt for 1,000 EUR with an annual interest rate of 10 per cent that is due in one year, the certificate represents the right of the bank to receive 1,100 EUR (1,000 EUR plus 100 EUR interest) within one year. However, on the bank’s books this promise appears as capital, even though it is still unclear whether the debt will actually be serviced. In this sense, the bank anticipates a positive outcome of the deal (it lends 1,000 EUR and assumes it will receive 1,100 EUR); in other words, it speculates.⁵

- The *central bank* covers such speculation by commercial banks. The central bank accepts the collateral and gives the commercial bank real money in exchange. In this way, it replaces a simple *promise* to pay with real money and anticipates that the commercial bank will be successful with its speculation (in other words, it assumes the loan will actually be repaid).

Let’s take a step back. Where did the Commerzbank get its certificate of debt from? The certificate of debt was created when the bank awarded a loan, for example, to the company Daimler (see chart 2, B). Daimler gives a certificate of debt to Commerzbank, in other words the promise to pay back the entire sum including a certain amount of interest. With the borrowed money, Daimler then buys labour and machinery, manufactures cars and sells them (see chart 2, C). If Daimler is successful and the company makes a profit, it can repay the loan to the commercial bank including the agreed interest. In this case the commercial bank would also have made money.

Chart 2: How money is born (II)

From the perspective of the central bank, successful business means that the new euros it printed (see chart 2, A) are basically “covered for” by Daimler’s increased business (see chart 2, C). The central bank’s speculation was successful: increased economic activity underpins the increased volume of money.

Several significant conclusions result from this, and they show exactly what the ECB is “worried about” when it “supplies” society with liquidity:

- Every euro that is born is based on a loan, more precisely on a twofold loan. It is born *as a loan* (when the central bank lends a commercial bank 1,000 EUR) and is *based on a loan* (when the commercial bank lends out 1,000 EUR, receives a certificate of debt and deposits it as collateral at the central bank). Why is this significant? It is significant, because loans are always expected to be repaid and repayment only leads to successful valorisation of capital when the money that was borrowed plus interest is repaid.
- Whether Daimler will be able to service its certificate of debt (repay its debt) is unclear

at the beginning. However, the euros that the central bank creates are immediately available. This means that the commercial bank as much as the central bank (through its money supply) speculates on Daimler’s success. Every euro that the ECB creates from the outset is created with the *anticipation* of a profit.

- When the ECB “prints” euros, it (along with the commercial banks) actually finances economic growth which has yet to take place. Each newly created euro thus represents not only an anticipation, but an *entitlement* to successful business and profit, or, as Marx put it: the entitlement for M to become M’. Ultimately, a currency’s stability depends on the success of these loan-financed deals (in this case, that Daimler makes a large enough profit).

Money from the ECB always implies the necessity of growth because when the central bank “supplies” society with money, it also makes numerous demands – demands that society ensure capital is valorised. Importantly, only economic growth can valorise this greater volume of capital.⁶

1.3 The goals of the central bank: supply of liquidity and inflation control

Through its supply of liquidity, the central bank attempts to regulate and therefore limit lending by commercial banks. At the same time, it provides the banking system with a form of ‘crisis insurance’ because commercial banks know they will always be backed by the powerful central bank. This produces confidence in the banks and ultimately enables them to lend. Commercial banks can draw as much credit as the central bank allows (whether they actually use the total amount available is a different question).

Through its provision of liquidity, the central bank basically follows one goal: to ensure the availability of money for profitable capitalist

businesses at all times. To fulfil this goal, it can theoretically “create” unlimited amounts of money, but only for profitable business. So at least goes the ideal. The central bank aims to achieve this by creating each new euro from the outset as credit money, that is, as money with an entitlement to a fixed amount of interest. The German central bank, the Bundesbank, puts it like this: “Having to pay interest is a financial incentive to borrow only when it seems economically justified. For a company, this means that it has to deal productively with the money it borrows so that it achieves an income that at least covers for the agreed interest.”⁷

Primarily, the central bank measures the success of its policies against the rate of inflation. This is because the ECB’s primary objective is “to maintain price stability” (Article 127, paragraph 1 of the European Treaty). According to the ECB, an

inflation rate of just under 2 per cent is considered as “price stability”. Inflation should therefore never be higher than this.⁸

But what is inflation? Inflation is an increase in the general level of prices. This is the same as saying that companies overall are increasing their prices. This is why the inflation rate is also known as the rate of price increases. Increased prices mean that money devalues, in other words, money’s buying power decreases. For example, instead of being able to buy twelve eggs for two euros you can now only buy ten.

Often it is said that a rising or high inflation rate is due to the existence of “too much” money in society. Higher demand is said to enable companies to sell their goods for higher prices. After all, the money is out there. That inflation is directly related to money supply is a basic assumption in so-called quantity theory, an assumption that also affects many people’s understanding of economics. Put simply,

many people believe that a lot of money in the system leads to high inflation. However, this theory is wrong. The decisive questions are: When is there “too much” money? And how should we measure this “too much”? As mentioned above, when the central bank creates new money it enables commercial banks to lend more. If the commercial banks actually do this,⁹ then the liquidity of society increases. More “money” (in the form of loans) is available, which means society can consume or invest more.

To a certain degree at least, it is important whether this increased liquidity finances an expansion of capitalist business. Continuing with our example: if Daimler borrows money that it then invests and eventually produces

Many people believe that a lot of money in the system leads to high inflation. However, this theory is wrong.

and sells a product, it can service its loan. This means that the money the central bank created is covered for by increased business activity. More money has led to more valorisation. In this case there is no danger of inflation. However, if Daimler’s plans for expansion fail, then the loan does not finance additional valorisation. In this case, liquidity has increased but there is no growth in economic activity. This can lead to a higher risk of inflation, or in other words the devaluation of money.

So how can there suddenly be “too much” money? The central bank and commercial banks “create” additional liquidity. A persistently high or rising rate of inflation is a sign that growing parts of this additional liquidity are no longer flowing into expanded production capacity, but are merely making it possible to increase prices. Yet, at the moment the money was created and credits were awarded it was unclear whether this additional liquidity would actually end up financing expanded

production capacities. This only becomes apparent afterwards, once the loan has already been awarded and money created.

Clearly, what is meant by “too much” money is not a question of creating the “right” amount of liquidity, but a question of the loan’s “performance”, that is, whether it finances increased business activity. This in turn depends on the course of capitalist accumulation. The central bank, however, upholds the position that to steer inflation it only need create (or actually permit commercial banks to create) the “right amount” of liquidity.

1.4 The key interest rate

Key interest rates are an essential aspect of the central bank’s monetary policy (see Glossary). Basically, they represent the interest rates central banks charge when lending commercial banks money in exchange for collateral (see chart 1). Ideally, key interest rates are used to control borrowing and inflation as follows: when inflation becomes too high the central bank *raises* the key interest rate. Higher interest rates make it more expensive for commercial banks to borrow central bank liquidity (see chart 2, A). Commercial banks pass this higher cost to government, companies and households by increasing interest rates on loans (see chart 2, B). Subsequently, customers tend to take on less or no loans. This reduces the liquidity of society or ensures that it increases at a lower rate, which then leads to lower levels of consumption and investment (see chart 2, C). This again is precisely what leads inflation to decrease and economic growth to slow. However, if inflation is low and the economy is weak, the central bank can *decrease* the key interest rate. In this case, it becomes cheaper for commercial banks to lend money from the central bank (see chart 2, A). This means they also offer loans at cheaper interest rates to borrowers, not willingly, but because of competition (see chart 2, B). Governments, companies and households then

take up more loans and society’s liquidity increases. This also increases the level of consumption and investment (economic activity), and everything seems well with the economy (see chart 2, C).

This at least is the *ideal* model of loan and inflation control through the key interest rate. Yet it remains an ideal, because the central bank is faced with numerous problems and because the economy is far more complicated than sketched out here. Even the ECB admits that “The exact effects of monetary policy” on the whole of the economy and the price level “are hard to predict”.¹⁰ Generally speaking, a central bank faces two problems: although it can create money and thus try to create an incentive for loans, it has no influence on whether these loans will lead to increased economic activity or merely inflate the amount of central bank liquidity. Second, the central bank can indeed raise (or lower) the key interest rate, but whether this results in commercial banks awarding fewer (or more) loans is not in the central bank’s power. This depends on many factors, and the euro crisis showed how powerless the ECB can actually be.

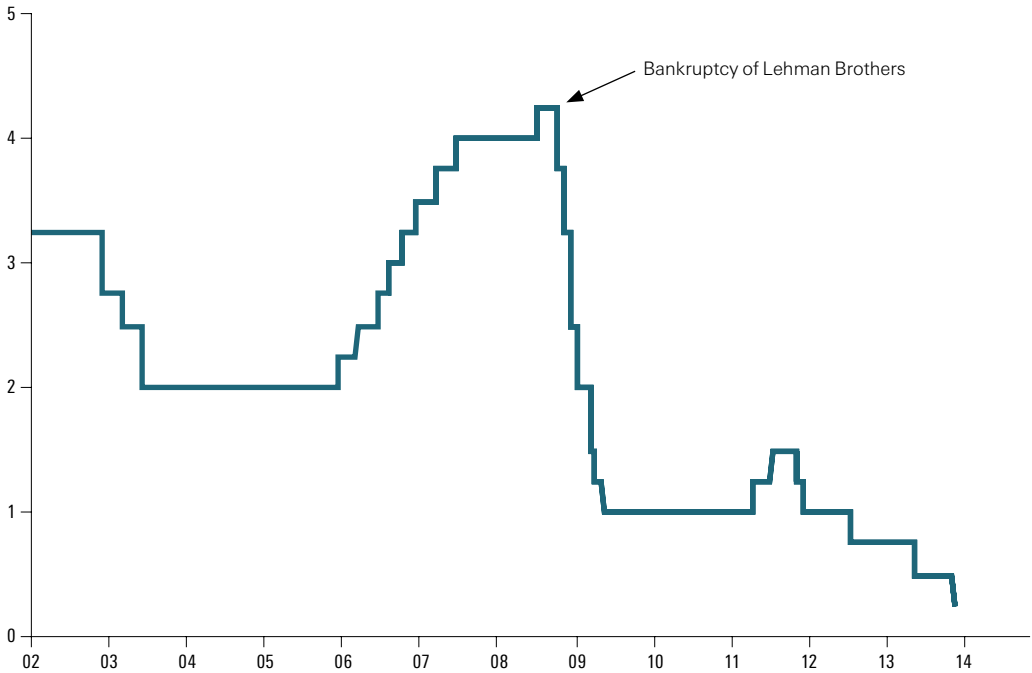
1.5 The ECB during the crisis

During the euro crisis, the economy was weak and the inflation rate was low in most euro countries. The ECB therefore resorted to some pretty drastic measures. It lowered the key interest rate to nearly 0 per cent to make loans cheaper and thus generate more liquidity (see chart 3). And it did even more to “open the money gates”:

- The ECB resorted to so-called full allotment, that is, it lent commercial banks any amount they asked for (during regular refinancing operations the central bank usually only allots specific, previously determined sums);
- The ECB lowered the eligibility criteria on collateral accepted for refinancing, and accepted riskier collateral of inferior quality from commercial banks in exchange for

Chart 3: The key interest rate

Interest for main refinancing operations (1 week) in per cent



euros. This enabled banks to borrow more money from the ECB.

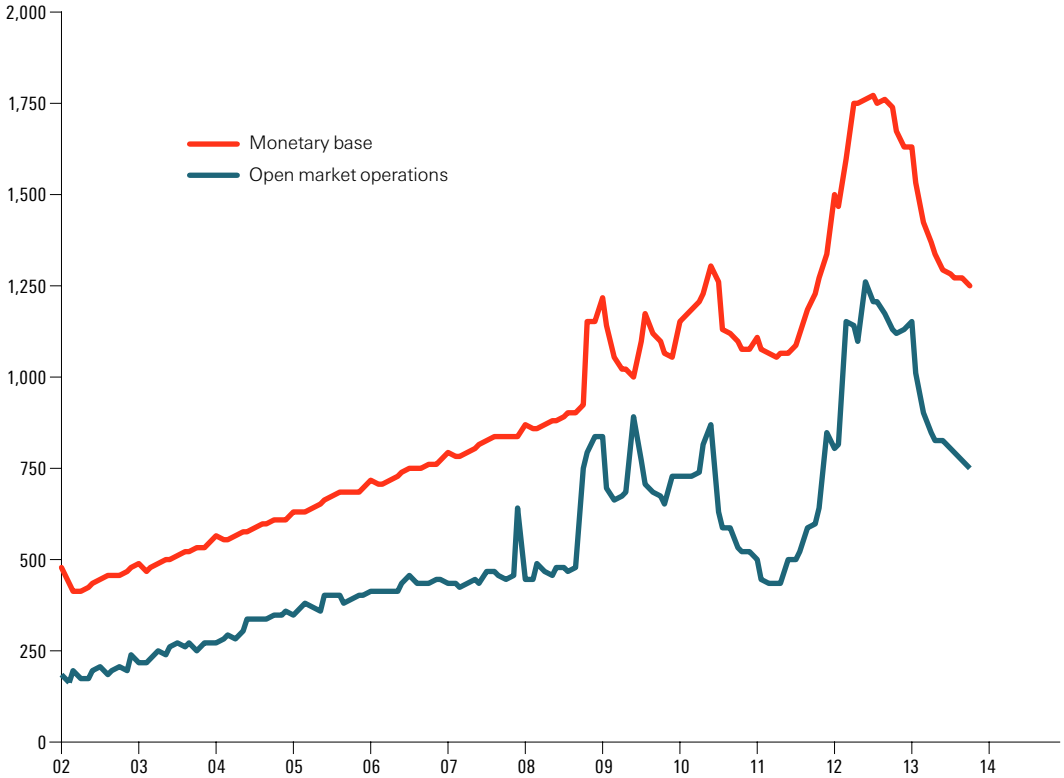
- Furthermore, the ECB allotted euro area banks two mega loans (the so-called LTRO) worth a total of one trillion euros at an interest rate of just under 1 per cent. The loans under this scheme were due within three years, a relatively long term for a central bank loan.

- Finally, the ECB even bought debt certificates from banks, in other words, it not only lent the banks the money; it actually gave it to them permanently.

The ECB used all of these measures to pump a lot of money into the banking sector. This became evident at the so-called monetary base.

Chart 4: The ECB “pumps money into the markets”

Figures in billions of euros



On the one hand, this strategy was successful because the flow of cash maintained the liquidity of banks and prevented their bankruptcy. On the other hand, the ECB's measures were unable to kick-start the economy. Although commercial banks could have lent more to their customers, they did not do so. Instead, they saved much of the money from the ECB and later even gave back a large portion of this money (this is clear from the contraction of the monetary basis from the middle of 2012 onwards, see chart 4). Why did the banks not allot more loans? The reason is certainly not a mystery.

The economy in the euro area was stuttering, economic performance was slowing and unemployment was rising. This implied that businesses that were still doing well did not need loans to further expand. On the contrary, such businesses generally had too much money and did not know what to do with it. At the same time, there were also many other companies that were in trouble, but the banks did not want to lend money to them. Moreover, the crisis had led many private household and state debts to increase greatly; this meant they either did not want any more money or were no longer considered creditworthy.

ECB interest rate cuts therefore only had a very limited effect. Without capital valorisation even the cheapest loan is useless. This shows the actual impotence of a central bank. Yes, it can reduce the cost of loans. But each new euro still remains an entitlement to capital valorisation and can therefore only be used for this purpose. Without valorisation no money is borrowed, no matter how low the interest rate.

Central bankers are also aware of this fact. They therefore went beyond a simple interest rate policy and formulated demands directed at the whole of society. The ECB called for the conditions for economic growth to be improved, but it was actually referring to the conditions for capital valorisation. The bank argued that investments needed to become profitable again, and that this would only be possible if the costs for businesses and in particular unit labour costs were to go down. A consultant working for Mario Draghi, the head of the ECB, stated that the euro area needed “Competitiveness as a leitmotif”.¹¹ States were to become “slimmer”, more competitive, and cut down on unproductive costs such as social spending. Draghi then announced that “The European social model is a thing of the past”.¹²

In short, society as a whole was to become more profitable and thereby ensure that the “money supply” from the central bank provided the desired results¹³ – high investment returns, capital valorisation and growth. With its demands for “flexible labour markets” the ECB aimed to ensure that wage levels were “adapted” and that companies created growth pre-financed through the ECB’s money supply. This boils down to a simple

equation: by printing money the central bank creates the conditions for growth and then makes wage earners responsible for ensuring that this growth actually occurs.

But it is not only capitalist economic laws that limit the power of the ECB; politics also plays a role. This leads us to a specific characteristic

The central bank creates the conditions for growth and then makes wage earners responsible for ensuring that this growth actually occurs.

of the ECB, and one which sets it apart from other central banks. The ECB is responsible for monetary policy within a specific structure: the euro area. This structure is characterised by a fundamental contradiction. It was the dispute over the “rescue” of the euro by the ECB that was exemplary for this inherent contradiction.

1 For the reasons why companies depend on the availability of loans see: Von wegen Casino. Populäre Irrtümer über Banken, Börse und Kredit, Rosa-Luxemburg-Stiftung (ed), Luxemburg argumente No. 5, 2, Berlin 2013, p. 6 f. and Heinrich, Michael: Kritik der politischen Ökonomie. Eine Einführung, Stuttgart 2004, p. 165. **2** Explained in more detail in: Troost, Axel/Hersel, Philipp: Was passiert, wenn die EZB Verluste macht? See: www2.alternative-wirtschaftspolitik.de/uploads/m3413.pdf. **3** For an explanation of how this works see: Von wegen Casino, p. 40 and Heinrich: Kritik, pp. 158. **4** The bank can offer loans in a multiple of the euros it receives from the central bank. It thereby generates and creates more liquidity than the 1,000 EUR it actually borrows. See: Von wegen Casino, p. 40. **5** “Speculation” here only means that the bank anticipates that in the future it will receive its money. **6** This though does not imply that interest that commercial and central banks demand is behind the growth imperative in capitalism. This imperative is rooted in the competition between companies. See: Von wegen Casino, p. 13. **7** German Bundesbank: Schülerbuch Geld und Geldpolitik, Frankfurt, 2012, p. 78. **8** In the following the question is how central banks aim to prevent high inflation rates. The case of too low inflation – or deflation – is not discussed here. **9** Whether it does this depends on various factors – the strength of the capitalist business cycle, the world market, etc. **10** See: www.ecb.europa.eu/ecb/educational/facts/monopol/html/mp_007.de.html. **11** Frankfurter Allgemeine Zeitung, 12.08.2013. **12** Wall Street Journal, 24.02.2012. **13** It should be emphasised that it is not the central bank that forces companies to valorise capital. Capital valorisation is a principle inherent to capitalism. Within this logic of valorisation the form of money supply aggravates the imperative of capital valorisation.

PART 2: THE ECB AS THE SAVIOUR OF THE EURO

In 2012, the ECB saved the euro, or so this story goes. Supposedly, the bank ended the crisis of confidence in financial markets. But what does this mean? The crisis in the euro area consisted of a simple fact: in 2010, some euro countries lost the “trust” of financial investors. “Losing trust” meant that financial investors no longer believed in the creditworthiness of Greece, then of Ireland and Portugal. Financial investors eventually lost all faith that these countries would be able to repay their loans and no longer believed that bonds from these countries were a profitable and safe investment. They demanded that the governments of these countries pay ever higher interest rates for loans, up to the point of threatening them with bankruptcy.¹

The liquidity of Greece, Ireland and Portugal was ultimately saved through loans from other euro area countries. A permanent fund (the eurozone bailout fund) was established, tasked with lending money to euro countries in financial distress. As a result, the situation on the financial markets calmed down at least until 2012 when the big losses in Spain’s banking system became apparent.

At that point, the euro crisis flared up again and it affected the entire country. Financial investors began demanding higher risk premiums for loans to the Spanish government and Spain had to pay higher and higher interest rates for

fresh money. In the eyes of financial investors this made Spain even less creditworthy, which again led the interest rate to rise. The situation turned into a vicious circle and was exacerbated by state austerity programs, which deepened the recession in Southern Europe and further fed the doubts of financial investors.

By now the euro bailout fund (ESM) had been established, and in a worst case scenario Madrid could have borrowed money from it. However, the funds belonging to the ESM would then have been largely exhausted and it would have been unable to support another country like Italy with a sovereign debt of around 2,000 billion euros. The “markets” therefore also lost confidence in Italy, and interest rates on Italian government bonds rose. A bankruptcy of Italy, the breakup of the euro area and thus a massive devaluation of the finance capital invested in euro government bonds loomed.

This is when the ECB intervened. At an investor’s conference on July 26, 2012 Mario Draghi, the head of the ECB, recited the magic words: “Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.” The consequence was that interest rates fell, and in this regard the euro crisis was over (see chart 5) without the ECB ever actually having bought government bonds.

The calm that characterised the financial markets was not surprising. Draghi had made a great promise to investors: in a worst-case scenario the ECB would buy bonds from euro area member states in crisis.

Chart 5: ECB ends speculation

Interest rates for ten year Spanish government bonds as a percentage



The calm that then characterised the financial markets was unsurprising. Draghi had made a great promise to investors: in a worst-case scenario the ECB would buy bonds from euro area member states in crisis. Investors were now free to buy bonds and thereby lend Rome and Madrid money at no risk.

At the beginning of September 2012, the ECB officially presented its sovereign bond buying program called OMT. This program enabled the ECB to replace the lost confidence in the creditworthiness of governments. The ECB's purchase guarantee was absolutely credible, as the ECB can create money at its own discretion, which means it has unlimited liquidity.²

2.1 Criticism from Germany and resistance within the euro area

Even before the crisis had calmed down, criticism began to appear, in particular in Germany. A good example of this was the statement made by the general secretary of the conservative German CSU party Alexander Dobrindt. In an interview with the newspaper *Bild am Sonntag* Dobrindt called the ECB's proposal "highly dangerous". He continued by arguing that Draghi was using the ECB "as a paddle wheel [...] to shift money from stable northern Europe into the loss-making South". Draghi was said to be turning the ECB into an "inflation bank".³

The case before Germany's Federal Constitutional Court

Germany's criticism of the OMT bond-buying program resulted in a case before the Federal Constitutional Court. Plaintiffs included the conservative CSU politician Peter Gauweiler. The Bundesbank also appeared as a "witness" against the ECB. Basically the Bundesbank argued that through its purchasing guarantee, the ECB had cut interest rates for crisis countries and therefore saved them additional costs. This amounted to a form of **monetary financing** (see glossary) and as such was not covered by the ECB's mandate.

But the ECB argued that its goal was not to save individual countries from additional interest payments and to finance them in this way. Instead, the bank stated that it was attempting to ensure the effectiveness of its monetary policy (see chapter 1.2 and 1.3). To fight the crisis, the ECB had lowered the key interest rate for the euro area. Still, in Southern Europe in particular interest rates had failed to go down. Why? Because an irrational fear that the euro area could break up still dominated the markets; this fear was driving up interest rates. However, through its guarantee, the ECB had eased these fears. Now

that the "markets" proper functioning had been restored, ECB cuts to the key interest rate would again be effective.

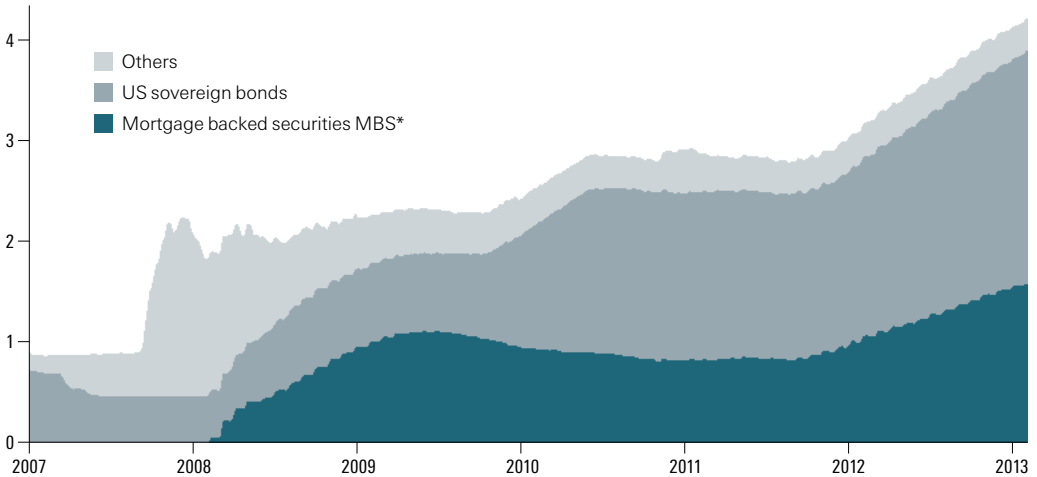
ECB critics responded by alleging that although interest rates for southern European countries were very high, these rates were an effect of the unsound budget policies implemented in crisis countries. Therefore these high interest rates were actually quite positive. They were the markets' way of putting pressure on countries to cut costs and become competitive again. The Bundesbank argued that buying bonds "on a large scale supports the financing of state budgets" and thereby helps avoid the "disciplining effects" of financial markets.⁴ Germany's Federal Constitutional Court was supposed to answer an unanswerable question: Were the interest rate increases in southern Europe in 2012 justified due to unsound financial policies and therefore rational (the Bundesbank's position)? Or were the rising rates owed to an unjustified fear that the euro area could break apart and were therefore irrational (the ECB's position)? In February 2013 the Federal Constitutional Court passed the case on to the European Court.⁵

The case before the Federal Constitutional Court and the criticism of the bond-buying program are illustrative of a fundamental contradiction within the euro area and also demonstrate the consequences of this contradiction for the ECB. To fully understand this contradiction, it is helpful to look at the strategies other central banks (such as the Fed or the Bank of Japan) have used to deal with the crisis. Unlike the ECB, these banks bought large quantities of bonds from their

respective countries and became their government's largest creditors.⁶ Every month, until the middle of 2014, the Fed bought US sovereign bonds worth 35 billion USD (see chart 6). Its goal: to create demand for US sovereign bonds and bring down interest rates. This would lead loans to become cheaper for everybody – for US companies, banks, private households and the state. The bond buying program was good for everybody.

Chart 6: Balance of the US Federal Reserve

Assets in billion dollars



* MBS are bonds secured by mortgages.

However, the ECB is in a catch-22 situation. With its OMT bond-buying program it hoped to support the states in Southern Europe. The interest rates in countries in this part of Europe were very high, whilst in Germany they were very low. As a consequence, the ECB planned to buy mainly Italian and Spanish sovereign bonds in an effort to reduce interest rates in these countries. But from the point of view of German critics this was an unjustified preferential treatment of individual euro area countries. In other words: not all euro area countries would have profited equally from OMT, the main beneficiaries would have been in Southern Europe.

This complaint reveals the fundamental contradiction within the euro area: the umbrella of a single currency unifies otherwise *competing* nation states. With his criticism that the ECB “was shifting money from stable northern Europe to the loss-making south”, CSU general secretary Dobrindt, as a representative of a creditor country, was actually com-

plaining that German money and German credit was being used to support debtor nations. Whereas in the US, the central bank’s bond-buying is embedded within the overall national interest to lower interest rates, in the euro area such a program leads to a heated debate on the question of who should bear the costs of the crisis. German critics of the ECB thereby argue that the winners (the core euro nations) should not be financing the losers (the peripheral euro nations).

Yet such a position undermines the single currency. Capitalist competition will always produce winners and losers, in other words creditors and debtors. Precisely for this reason, some kind of clearing mechanism is required to ensure that even those who lose out can permanently maintain a certain level of liquidity.⁷ Because financial transfers between euro area member countries are basically non-existent, the ECB must take on this role. By guaranteeing the liquidity of debtor nations, it stops them from going bankrupt

and ultimately prevents the euro area from breaking up. In this sense the ECB pursues the general interest of maintaining the single currency from which some countries profit and others lose. However, as a breakup would also damage the economy of the winner nations, the ECB protects German success from the very narrow German interest of not wanting to pay for the crisis in other countries.

Eventually, even the German government was convinced by this argument. It accepted the implementation of the bond-buying program, albeit under certain conditions:

1. A euro area member country can only expect help from the ECB if it signs the stringent stability pact and the even more stringent *fiscal compact*. Accordingly, countries must commit themselves to austerity programs and reforms to increase “competitiveness”.
2. As a pre-condition for support from the ECB, a country must sign an agreement with the euro rescue fund (ESM). In exchange for ESM money, countries commit to further austerity measures.

The ECB only grants support if a country agrees to impoverish a large part of its population - both before and whilst receiving funds - implement social spending and salary cuts and of course only if Germany agrees.

3. To receive ESM support, a country must be faced by a severe crisis that also endangers the stability of the euro area as a whole. Accordingly, ESM and ECB support primarily protects the creditor/winner nations from the consequences of the crisis in debtor nations.

4. The fact that an agreement with the ESM is a pre-condition for ECB support means the German government has a de facto right of veto, because whether a country receives an ESM program and therefore access to ECB liquidity is also decided by the German parliament.

In brief: the ECB only grants support if a country agrees to impoverish a large part of its population – both before and whilst receiving funds – implement social spending and salary cuts and of course only if Germany agrees. This gives the contradiction in the euro area, namely that economic competitors share a single currency, but do not support each other, a particular form: loser states receive support, but only by subordinating themselves to the diktat of the winner nations. Support from the ECB therefore remains precarious and a politically contested field.

2.2 Special features of the ECB

With its loans to the banking sector and its bond-buying program, the ECB took on a role which is an implicit part of what all central banks do: acting as the lender of last resort. What does this mean?

Crises are inherent to capitalism. Companies can go broke, markets can be lost, and the economy can shrink. Banks nonetheless

speculate on growth and therefore provide their customers with loans. If this growth does not materialise, these loans might not be repaid. This in turn damages the creditors as they have to write off these loans and suffer losses. In

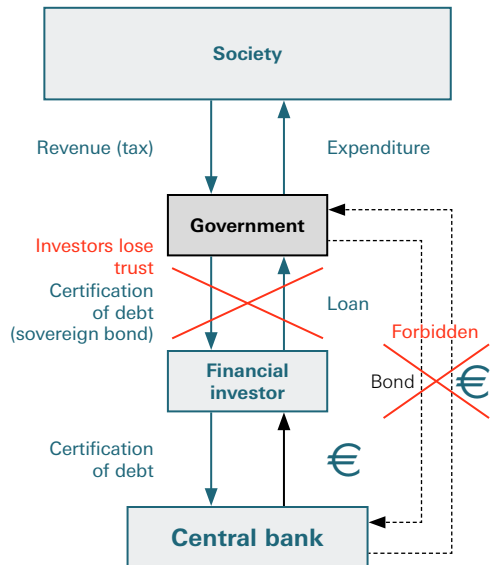
the banking sector, this can lead to a chain reaction ending in the meltdown of an entire financial system. To prevent this, the state intervenes with a central bank. The central bank awards loans when nobody else wants to. Or said differently: if for economic reasons no loans are being awarded, then the central bank provides “political” loans. In this way, the central bank prevents a meltdown. All market participants can rest assured that in the worst case scenario the central bank will step in as creditor and prevent mass bankruptcies. The

central bank has this power because its goal is not to make profit and because it can autonomously “create” money.⁸ The central bank becomes the “lender of last resort” for commercial banks, but implicitly also for governments, for example when the central bank buys sovereign bonds in a situation where the state can no longer attract money from financial investors.⁹ “It is unthinkable that a central bank would push its home country into bankruptcy by not buying this country’s sovereign bonds.”¹⁰ During a crisis, if a central bank lends money to a government and therefore creates money, this simply means that the state makes use of the fact that the currency (the euro, dollar, etc.) is the money of the state in question. The currency is therefore under its control and the state can “produce” this money. The currency is under its sovereignty. A state can also employ this sovereignty and permit its central bank to buy sovereign bonds. This then reduces the amount of interest a state must pay for its debts.

However, the ECB is barred from this form of “monetary financing”, or rather, can only selectively resort to it. According to its statutes, the ECB is in principle not allowed to help governments. The reason behind this is the way the euro area is constituted. The ECB does not stand for a single state, but for a group of competing nations that separately calculate their economic success. Each country has its individual gross domestic product, its own budget and there are basically no financial transfers between states. Each country takes care of its own economy.¹¹ When the ECB was founded, the German government in particular insisted on barring the ECB from helping individual countries. Instead, the ECB was simply to ensure the stability of the currency in the euro area *as a whole*.¹² This led the ECB to be awarded a corresponding mandate and it was granted a high degree of autonomy in relations with member state governments. As a consequence, the ECB can only help euro

area countries to a very limited degree¹³ and therefore only partially fulfil its function as “lender of last resort”. This means that states in crisis cannot get loans from financial investors, nor can they autonomously “create” money (see chart 7). In short: the central bank is not under their control, it is not “their” central bank and the euro is not “their” currency. This is very unlike the situation in the US, where the Federal Reserve creates the amount of money it deems necessary to maintain the functions of the system as a whole.¹⁴

Chart 7: Cut off from credit



This is why it is sometimes said that although the euro is the currency of the euro area’s member states, when these states indebt themselves they do so in terms of a foreign currency. Although the euro is used by euro area member states, these states do not control the euro. Taking on debt in a foreign currency is normally the fate of countries with weak currencies such as Argentina. Argentina took on debt in US dollars in the 1990s. When the country was no longer able to service its

debt, it was driven into bankruptcy. As the Fed holds the privilege to print dollars, Argentina's central bank could not print money during the Argentinian crisis.

During crises, the governments of euro area member states cannot necessarily rely on the ECB. Whether the ECB can and does help, ultimately depends on the bank and the limits of its mandate.

This leaves states in crisis with only one option if they are to maintain solvency: drastic austerity measures that further deepen the crisis. The special position of the ECB therefore creates a situation where the costs of the crisis are borne mainly by the states in crisis. It also means the euro area is a precarious system.

2.3 The ECB turns to politics: the case of Italy

The announcement of the OMT bond-buying program also had immediate positive effects for Italy: interest rates went down. The spread between Italian and German sovereign bonds shrunk from 5.12 per cent at the beginning of July 2012 to 1.94 per cent in February 2014.¹⁵ This happened without the ECB having to buy a single Italian sovereign bond. Should Italy be grateful to the ECB? To judge this we need to go back in time, because the story begins about a year earlier. In August 2011, the Italian government, led by Prime Minister Silvio Berlusconi, received a letter from the ECB. The letter was signed by Jean Claude Trichet, outgoing president of the ECB, and Mario Draghi, the incoming president. The text of the letter was kept secret at first, but the press made the main points public and it was published later.¹⁶ The central bank presidents stipulated the conditions under which the ECB would intervene in support of the government. The ECB demanded cuts to public expenditure and a flexible labour market. The ECB demanded

that the Italian government implement these measures first to build confidence and ensure all stakeholders that Italy's budget was fundamentally sound and the government credit-worthy. In exchange, the ECB would support Italy to avoid a default should the need arise.

The special position of the ECB therefore creates a situation where the costs of the crisis are borne mainly by the states in crisis.

Only a few months later, in November 2011, the Italian President, Giorgio Napolitano, received Silvio Berlusconi's resignation. He had been politically unable to fulfil the ECB's demands. The president then designated Mario Monti as prime minister; Monti was an economist and former European commissioner (from 1995 to 2004) who was held in high esteem by the ECB. On 16 November, 2011, Mario Monti was officially sworn in as prime minister at the head of a *technocratic*, in other words, a non-elected government. He selected himself for the post of minister of economy and finance.

By 4 December, 2011, and in compliance with the ECB's demands, Monti's government had presented a package of austerity measures. The measures proposed by the government included tax increases, pension reforms, a public spending review, welfare and social expenditure cuts and a reduction in public sector wages. Twenty days later, parliament approved these measures. Shortly afterwards, a government proposal led Article 81 of the Italian constitution to be changed to strictly limit future budget deficits.

In retrospect, can we say that the ECB appreciated the course taken by the Italian government? The answer is SMP: Securities Markets Programme, a forerunner of OMT. As part of the SMP framework, the ECB bought a limited amount of euro area sovereign bonds as well as stock from private debtors to support

bond and stock prices. Between 2011 and 2012, the ECB bought Italian bonds worth a nominal value of 102 billion EUR.¹⁷ This was around half the total amount of bonds and stocks bought by the ECB as part of the SMP framework. Eventually, the ECB owned 6 per cent of all Italian sovereign bonds. This was a costly investment for the ECB, but also a profitable one. After all, the ECB is not a charity. In 2012, the ECB gained 2.3 billion EUR (2011: 2.0 billion EUR) in net income from interest. The collateral bought under SMP alone produced a net income of 1.1 billion EUR (2011: 1.0 billion EUR).¹⁸

The Monti government lasted from 16 November, 2011 until 28 April, 2013. The new government under Enrico Letta (28 April, 2013 to 14 February, 2014) continued to implement the austerity measures. There was no public debate concerning the austerity measures or the docility with which the Italian government succumbed to the ECB's demands. The government's economic and financial policies were extremely unpopular in Italy, but were supported by nearly all of the political parties in parliament. Trade union opposition has been weak and reduced to formal channels. The whole process was never discussed in detail, neither in the media nor in academia. Unlike in Greece, there were no strong protests, demonstrations or strikes. Furthermore, we should not forget that these austerity measures strongly curtailed economic growth in Italy.

Much like Greece, Italy was forced to implement austerity measures. However, imple-

mentation in Italy was swift and quiet. There were no transparent negotiations between Italy and the ECB; no political conflict and no choice. The SMP bond-buying program was a refined tool of political influence – much more elegant than was implemented in Greece – but with the same message: eat or be eaten.

1 On the reasons why states depend on loans see: Kaufmann, Stephan/Stützle, Ingo: *Ist die ganze Welt bald pleite? Staatsverschuldung: Was sie ist und wie sie funktioniert*, Rosa-Luxemburg-Stiftung (ed), luxemburg argumente No. 1, 5., Berlin 2013. **2** To calm down the financial markets, in 2010 the ECB developed a "small" bond buying program, the so-called SMP. Through this program the ECB bought Greek, Portuguese, Irish, Spanish and Italian bonds for more than 200 billion euros. Nonetheless, SMP could not calm the financial markets, because the ECB from the outset made it clear that this bond buying program was temporary and its volume limited. SMP was therefore not an unlimited ECB guarantee and was therefore ineffective. **3** Bild am Sonntag, 26.08.2012. **4** Quote from Wirtschaftswoche, 11.06.2013. **5** On the decision of the German Constitutional Court and criticism of this decision see the bibliography. **6** See: www.berliner-zeitung.de/wirtschaft/kredit-wennstaaten-sich-selbst-anpumpen,10808230,27533556.html. **7** The IMF has this function on the global level. **8** This too has its limits. Though the central bank can print money and support banks and companies to prevent them from going bankrupt, it cannot do this limitlessly. If "political" credit grows without the economic situation improving, then this eventually undermines trust in the central bank's main weapon: the currency. **9** For bond buying to have an effect it is not important whether the central bank buys bonds directly from a government or bonds that already exist on the financial markets. **10** See: Natixis Flash Economics, 04.08.2011, at: <http://cib.natixis.com/flushdoc.aspx?id=59465/>. **11** The successes, for example, of French companies and the French economy are not superposable with the successes of German companies or the German economy. **12** See: Sablowski, Thomas/Schneider, Etienne: *Verarmung* made in Frankfurt, Rosa-Luxemburg-Stiftung (ed), Standpunkte 6/2013, p. 2. **13** "Whether or not such a safety net [of the ECB] exists is a political question. And it is mostly decided in Berlin." (Holger Schmieding, Berenberg Bank, in: *Eurozone deflation scare*, 12.03.2014). **14** The US central bank does not only buy sovereign bonds directly from government. It prefers to buy large quantities of bonds from financial investors and this basically has the same effect. **15** See: www.mtsmarkets.com. **16** See: www.corriere.it/economia/11_settembre_29/trichet_draghi_inglese_304a5f1e-ea59-11e0-ae06-4da866778017.shtml. **17** See: http://www.ecb.europa.eu/press/pr/date/2013/html/pr130221_1.en.html. **18** See: <http://www.ecb.europa.eu/press/pr/date/2013/html/pr130221.en.html>. ECB profits are distributed to the euro nations. Deutsche Bundesbank receives the largest share, in other words the German minister of finance.

CONCLUSION: THE FUNCTION OF CENTRAL BANKS AND THE ECB IN PARTICULAR

Central banks work like a hinge between the state and the financial sector. The state guarantees the principle validity of the national currency (in Germany, for example, through §14 of the Bundesbank Act). Commercial banks use this currency. They grant loans in euros; accept collateral for these loans and speculate on earning income from interest. In turn, the central bank accepts this collateral, creates euros and enables commercial banks to expand their credit business.

The goal of credit allotment – that is, the allotment of created euros – is to increase the valorisation of capital. Every created euro is an *anticipated* successful valorisation as well as an *entitlement* to a successful valorisation. This is why the ECB pressures governments to reform their economies to enable high returns on investments. Put differently: the ECB acts as the euro area's ideal aggregate capitalist/banker/investor. The central bank is therefore not neutral, and its supply of liquidity is subject to the demands of capital valorisation. For this reason, a "left-wing" central bank exists as little as "left-wing" money.¹ Nonetheless, there can be very large differences between central bank policies. For example, does the central bank demand rapid or slow debt reduction? Does it act against high interest rates on the financial markets to reduce pressure on debtors? Or does it treat these high interest rates as a lever to apply pressure on states to reduce their debt? Central bankers

have a certain degree of margin, which could be used politically – at least if the corresponding relations of power were in place.

Within the euro area, the ECB is the only powerful institution that actually watches over the stability and growth of monetary union *as a whole*. Individual euro countries only attend to their own interests. They also depend on the stability of the euro area, but only as a pre-condition for *national* success, and they pursue this success in competition with other euro countries.

It is therefore hardly surprising that during the crisis the position of the ECB and, for example, that of the German government collided, as was the case with the OMT bond-buying program. At first, the German government did not want to provide money to the states in crisis; nonetheless, the ECB insisted on financial support in the name of the broader interest of conserving monetary union. This contradiction is expressed within the whole process. The states in crisis receive loans and the prospect of aid from the ECB. In exchange they implement austerity measures, cut wages, and become more "competitive". Yet, this means they impoverish large parts of the population. However, the view that impoverishment is a necessary means of maintaining the stability of the euro is a position shared by both the German government and the ECB.

¹ See: Sablowski/Schneider: *Verarmung*, p. 6.

GLOSSARY

ECB/ESCB: Monetary policy in the euro area is managed through the European System of Central Banks (ESCB). In Frankfurt, the ECB fixes the key interest rate and manages credit supply. In contrast, the central banks of individual euro countries mostly focus on implementing the ECB's directives. They lend money to national commercial banks at the conditions set by the ECB. To avoid overcomplicating matters, the European System of Central Banks and the ECB are treated as the same entity in this brochure.

Key interest rate: The key interest rate is the rate at which commercial banks borrow money from the central bank for a determined period. In exchange, commercial banks provide collateral – bonds – and deposit them at the central bank. This is known as refinancing.

Monetary financing: The financing of state expenditure through the central bank. The central bank creates money, lends govern-

ments this money and receives a sovereign bond in exchange. Nonetheless, the ECB is barred from directly buying up sovereign bonds. Governments need to borrow money on financial markets. In principle though, the ECB has the option to buy sovereign bonds on the financial markets.

Bond: A bond is a securitised asset, a claim to a payment. This can be a share, a participation right in a profit (dividend) or a certificate of debt that represents an awarded loan and therefore an entitlement to the repayment of the awarded sum plus interest. Bonds are therefore finance capital – a sum of money that produces a profit (dividend, interest). Their “value” (the price determined on the stock exchange every day) depends to a high degree on the profits expected in the future – and therefore on the (expected) purchasing power of the institutions that provide them. Because bonds are based on expected, future cash flows, their value is “speculative”.

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Central banks can “print money” and are supposed to “combat inflation”. But how do they achieve this? Who profits from their policies? And how much power do they really possess? What is behind the debate over the European Central Bank (ECB)? And why is the ECB allowed to save banks but not countries?