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Changing the mandate of the ECB is not the solution to Europe's problems

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The widespread dissatisfaction with the economic management of the crisis in the euro area over the past few years has prompted calls for change in numerous directions. Included in the debate are questions whether the currency is the underlying problem and whether the mandate of the European Central Bank should be extended as a possible remedy.

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It is certainly true that a massive policy failure has been witnessed in the euro area over the past few years. Following the global financial crisis and recession of 2008-2009, growth was restored elsewhere in the developed world. By contrast, the euro area suffered another recession in 2011-2012 the end of which has not yet been confirmed because evidence of a sustained improvement in economic activity is lacking.

This was a policy-induced recession, the outcome of a collective failure of the governments and institutions responsible for the euro area. Unemployment recorded historic highs in the euro area as a whole and has reached depression-era dimensions in several member states. The carnage has left an adverse imprint on the long-term prospects of the economy. Extremely high youth unemployment has impaired human capital. A dearth in investment has kept physical capital levels depressed. Real income per person has declined in much of the euro area, and prospects of a strong recovery remain elusive.

The euro has failed. Rather than complete the Union, the common currency has contributed to its disintegration. But what exactly has failed in the construction of the euro area? While the massive policy failure is in plain sight, identification of the underlying problem is more complex. Care is needed to identify the proper remedies and changes needed for restoring growth, prosperity and stability. Symptoms and contributing factors must be distinguished from underlying causes. The role of different policies, governed by different decision makers and institutions must be delineated. The role of the broader economic and political governance of the euro area must be examined.

The underlying cause of the failure of the euro area is neither the currency *per se*, nor the monetary policy of the ECB. Focusing on the currency of the euro area *vis-à-vis* other currencies is too narrow a perspective of what ails the euro area. While it may be true that the euro has been stronger than would have been desirable over the past few years, this is not the cause but rather a symptom of the problem.

Focusing on the ECB to provide solutions to the underlying problem seems misplaced. The accumulated experience in modern central banking over the 20th century is properly reflected in the mandate of the ECB, as enshrined in the Treaty. The primary objective of a central bank should be price stability. Subject to that, the central bank can and should contribute to broader economic goals. However, this is best achieved when the central bank is not overburdened with additional objectives that dilute the primacy of price stability. Overburdening the central bank hinders rather than improve its contribution to economic prosperity over time.

To be sure, this is not to absolve the ECB from its share of responsibility in the collective policy failure. An issue that requires attention at present stems from the overly tight monetary policy pursued by the ECB over the past two years. With policy rates at exceptionally low levels in much of the industrialized world, unconventional aspects of monetary policy have become important factors of policy accommodation. The size of the balance sheet of a central bank is a key proxy (though not the only one). Changes in the relative size of the balance sheets of major central banks, for example the Federal Reserve and the ECB are indicative of the relative change in the stance of monetary policy when policy rates are very close to zero. Over the past two years, the ECB has contracted its balance sheet from over 3 trillion euro at the end of June 2012 to merely 2 trillion euro at present. In contrast, over the same period, the Federal Reserve expanded its balance sheet by over 50%, from under 3 trillion dollars to about 4.5 trillion dollars.

As a result of pursuing overly tight monetary policy, the ECB has failed to maintain inflation in line with its price stability objective, has contributed to the unwelcome strength of the euro vis-à-vis other currencies and has added to the difficulty of adjusting private and public sector balance sheets, especially in some member states where deflation is experienced. It is within the power and responsibility of the ECB to adopt policies that appropriately expand its balance sheet to achieve its primary mandate. Direct purchases of one trillion euro of euro area assets over the next several months would be one example of how the ECB could contribute to an improvement in the euro area in line with its price stability mandate.

The larger cause of the troubles of Europe does not involve the ECB

The problem lies with the governments of the euro area. Overall, the ECB deserves praise for limiting the damage caused by actions and decisions of the government since the start of the crisis. The euro has tightly bound together the fates of member states. The interconnectedness raised the stakes for economic cooperation among the member states. Unfortunately, the crisis has revealed that governments of some member states exploit the flawed design of the euro area for their own benefit to the detriment of the common good for the euro area as a whole. During the crisis, decisions have been taken to protect interests in some member states and to shift losses to other member states. The euro area suffers from a misalignment of political incentives. Solutions require greater cooperation among the states. Solutions require political leadership very different from what has been observed. Solutions are not easy but hopefully are not out of reach.