# EMU: From Denial to Crisis (and Back?)[1]

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## 1. Introduction

In October 1998, three months before the European Central Bank opened for business, CEPR inaugurated its *Monitoring the ECB* series. The first paper in the new series (by David Begg, Paul De Grauwe, Francesco Giavazzi, Harald Uhlig and Charles Wyplosz) was entitled: "The ECB: Safe at Any Speed?". It started observing that *"Given the energy devoted for over a decade to planning how EMU will work, it is amazing how much is yet unresolved."*

The paper identified five areas of concern: (i) The relationship between the ECB and the National Central Banks (NCBs): the presumption that NCBs would act simply as agents of the ECB was thought to be incompatible with the fact that financial regulation would remain a national responsibility; (ii) The objectives of the ECB were considered to be ambiguous: *"While both the letter of the treaties and the rhetoric of policymakers proclaim a clear ordering of priorities – price stability above all, other economic objectives if and when scope remains – the simple fact is that no central bank has ever behaved this way";* iii) The bank's monetary policy strategy also looked ambiguous: *"The bank has yet to choose whether to adopt a money stock target or an inflation target*". This was seen as an obstacle to the transparency necessary for accountability; (iv) The link between the single monetary policy and national fiscal policies was seen as fraught with difficulties: *"The appropriate monetary policy depends a great deal on the fiscal policies in the Euro 11 (the original number of member countries)"*; (v) Finally the paper also expressed concern over the ability of the ECB to deal with a financial crisis: *"A central bank is much more than the embodiment of a monetary policy rule. Like any central bank, the ECB will necessarily have scope for discretionary actions, especially in a crisis, for provision of liquidity and for involvement in regulatory decisions about supervision of banks, including their possible closure. It remains unclear how the ECB will act as a lender-of-last-resort. Can a banking crisis, say in Spain, be quarantined within Spain, or will it have systemic dimensions? And in the latter case, what action by the ECB is appropriate?"* These were questions that seemed valid but that were then summarily dismissed: *"The ECB currently believes that adequate procedures are in place both for financial regulation at national level and to safeguard the payments system of the Euro area in the event of a crisis. We remain unconvinced on either count."* [2]

The point of this recollection is not self-congratulation. Many others have expressed similar misgivings. The point is that the monetary union started with serious flaws, that these flaws had been carefully diagnosed and yet no attempts were made to deal with them. As an original experiment, it would have been extraordinary that its

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[1] Prepared for CEPR's 30th Anniversary Conference. London, November 21-22, 2013.

[2] Similar concerns had been expressed a few years earlier in a forward looking paper by David Folkerts-Landau and Peter M. Garber, "The European Central Bank: A Bank or a Monetary Policy Rule". NBER working paper No. 4016, March 1992. See also *The Making of Monetary Union* by D. Begg, P.A. Chiappori, F. Giavazzi, C. Mayer, D. Neven, L. Spaventa, X. Vives and C. Wyplosz, published in 1991.

design be perfect from the start.[3] The fact that these flaws came together to generate the euro area crisis is an indictment of the denial that has characterized the first decade of the monetary union. The costs of this denial have been enormous, whether they are measured in lost incomes, in millions of workers laid-off, in bankruptcies, or even in dangerous political under-currents.

This paper revisits three main flaws. The lack of planning to deal with threats to financial stability in EMU, the lack of transparency of the ECB and the poor articulation between monetary policy and national fiscal policies. As we take up these issues, we ask two questions: (i) What did we miss? Were there issues that eventually became important and we didn't get? For instance we warned that the ECB might be ill-prepared to face a financial crisis, but our examples (admittedly in 1998) were backward looking pointing to the South-East Asian crisis as an example; (ii) What progress has been made in the areas that we had indicated as yet incomplete? Is this progress satisfactory?

## 2. EMU and financial stability

In the decade preceding the start of EMU, CEPR researchers worried about the ability of the ECB to deliver financial stability. Three concerns had been raised:

- in the event of a sudden increase in the demand for liquidity, the ECB might be unable to provide such liquidity rapidly enough;

- EMU might not be able to deal effectively with the insolvency of a large financial institution -- either closing it down or using tax-payers' money to recapitalize it – so that such a default might reverberate throughout the euro area;

- the new euro-wide payment system run by the ECB (TARGET), may not take off and that transactions might use private and more fragile payment systems.

The ECB has dealt surprisingly well with the first and last of these concerns. The issue of how to face a bank insolvency has been put aside for over a decade: now it has emerged as the most relevant issue in the euro area, under the name "banking union".

<u>TARGET</u>

We worried that payments might not migrate towards the new system set up by the ECB – first TARGET, later TARGET 2. We expected that private payments system would be able to offer more attractive conditions thanks to the implicit assumption that governments would step in to protect payments in case of an accident. The result – this is what concerned us – would be a fragile payment system.

In the event only one alternative private payment system developed, EURO 1, the payment system owned by the European Banking Association. The difference between the two is that TARGET is a real-time gross settlement system in which

[3] Other monetary unions, in Africa and the Caribbean, differ in several respects from the European one. The closest precedent, perhaps, is the adoption of the dollar in the highly decentralized USA in 1790 and of the Federal Reserve System more than a century later. Several lessons from this experiment have been ignored, more below.

each transaction is settled conclusively in real time. EURO 1, instead, cumulates transactions during the day and nets them only at a certain point in time: around 4:30 pm through TARGET transfers. Defaults can thus spread through the system in EURO 1, while they are limited to individual transactions in TARGET.

In 2012 the share of TARGET2 in terms of value of all euro-denominated payments processed in the euro area was 91.6%. In terms of volume it was 59%, indicating that EURO 1 tends to settle smaller individual payments. Our concerns were thus largely exaggerated.

## The provision of liquidity

We worried that limiting the ECB to lend only if adequate collateral was posted, might curb its ability to provide liquidity. This did not happen, on the contrary. When the crisis started, in the Summer of 2007, the ECB intervened faster than the Fed in providing liquidity because at that time the Fed only accepted a narrow range of collateral. The ECB instead maintained an extensive list of Tier 1 collateral. This was not smart anticipation, however, simply the fact that the ECB took on board all types of collateral previously accepted by the NCBs. In the event, when this large list turned out to be too narrow for the task, it was expanded. Successive revisions in the definition of "acceptable collateral" meant that, as the need for liquidity increased, the type of assets that could be posted at the ECB was widened to the point that even bank loans (or pools of loans) became acceptable collateral. Thus collateral has never been a limitation to the provision of liquidity.

Differently from the Fed, however, the ECB never engaged in outright purchases of the assets sitting in the balance sheets of banks. It provided liquidity under the assumption that the banks were solvent, i.e. that their problem was momentary illiquidity: the possibility that the "true" value of those illiquid assets made the bank insolvent was always ruled out. By doing so the ECB, differently from the Fed, protected its balance sheet, but refused to face the reality of European banks. This ended up postponing the problem, which over time grew only worse. One reason for the ECB behavior is that, in order to distinguish (or try to distinguish) between illiquidity and insolvency, a central bank needs to be involved in banking supervision. The ECB, differently from the Fed is not. Why and how the debate over giving the ECB supervisory powers evolved, is the topic of the next section.

## Banking supervision and the ability to distinguish between illiquidity and insolvency

As early as 1991, in *The Making of Monetary Union* (see footnote 2), CEPR researchers had noted that in the preparations that would eventually lead to a monetary union, banking supervision had received only scant attention: *"Overseeing the smooth operation of the payments system is one of the functions that the ECB will be required to perform. This will presumably involve supervisory functions, but this is not developed in the statutes."* In the event the Treaty Protocol on the statute of the ESCB and of the ECB (articles 25.1 and 25.2) left the door open for the possibility that the ECB might have a role in the prudential supervision of banks and other financial institutions (with the surprising exclusion of insurance companies) and in guaranteeing the stability of the financial system.

The ECB at the start didn't think that a single supervisor, even less one coinciding with the ECB, might be necessary: "*The euro area has a central bank which does not carry out banking supervision. This would be normal, because in many countries*

*banking supervision is not a task of the central bank. What is unique is that the areas of jurisdiction of monetary policy and of banking supervision do not coincide … There is no expectation, at least to my mind, that the division of responsibility in the euro area between the central bank and the banking supervisory functions should be abandoned. Although the Treaty has a provision that permits the assignment of supervisory tasks to the ECB, I personally do not rely on the assumption that this clause will be activated. What I perceive as absolutely necessary, however, is that co-operation among banking supervisors, which is largely voluntary, will allow a sort of euro area collective supervisor to emerge that can act as effectively as if there were a single supervisor " [4].*

As already noted, we remained skeptical that co-operation might be sufficient, arguing in favor of a single supervisor. "*Coordination by committee encounters the problems traditionally associated with collective decision-taking: excessive bargaining, high communication costs and lobbying from pressure groups of national authorities. Deadlock may result. A central agency is required that has appropriate incentives to collect information on the activities of banks."* We argued however for keeping separate the regulatory functions associated with illiquid and insolvent banks: "*The ECB should be concerned with authorizing banks and addressing illiquidity by providing lender-of-last-resort facilities; a separate regulatory agency should be concerned with insolvency, that is with closure of banks and the provision of deposit insurance. Separation limits the risk that authorizing institutions may be reluctant to admit their failures and close down banks"*.

Throughout the first ten years of EMU national jealousies have prevented any serious step towards centralization. Banking supervision has remained a prerogative of national regulators. We had neither a common banking supervisor, nor common rules to evaluate a bank's exposure to risk and the adequacy of its capital buffer. *"We would need a serious banking crisis to move ahead"*, wrote Otmar Issing. A crisis eventually did happen and what looked impossible – the assignment of supervisory authority to the ECB – came about in a couple of years, although only for the 124 largest Euro area banks. This is a step in the right direction, but only a step – for instance the list of banks to be supervised by the ECB does not include many German saving banks, yet it was one of them that first blew up in the Summer of 2007.

However, although we correctly identified the problem, we only scratched its surface. The issues that have come to the forefront, as the ECB prepares to take over responsibility for supervising the major euro area banks, were largely overlooked in our analysis. They are examined next.

Current burning issues in the steps towards a banking union

- How should supervisors determine the appropriate amount of a bank's equity? Since many Euro area banks hold large quantities of domestic sovereign bonds, the answer depends, importantly, on the way such bonds are treated. The first step in the ECB review of the strength of Euro area banks (to start in 2014) will be an analysis of the quality of the assets held by each bank (Asset Quality Review). As banks do not have to hold capital to back their sovereign debt holdings under Basel III, the ECB is unlikely to address the issue of sovereign bonds in the AQR, i.e. it will treat them as safe assets. Some banks, however, may need to raise additional capital already as this point, as the ECB is likely to

[4] Tommaso Padoa Schioppa, "EMU and Banking Supervision", lecture delivered at the London School of Economics on 24 February 1999, available at: http://www.ecb.europa.eu/press/key/date/1999/html/sp990224.en.html

impose an 8% risk-weighted capital requirement, which may exceed the current buffer for some banks.

- The next step will be stress tests, that is simulations of the effect on a bank's balance sheet of an extreme event, such a financial crisis. In the past (for instance in the stress tests run by EBA in 2011) sovereign bonds were considered risk-free under any circumstance, including a financial crisis: this is no longer credible. Stress tests will measure the effect on a bank's balance sheet of a change in external conditions, for instance the effect of a fall in sovereign bond prices during a crisis. To run such a test one starts from the assumption that under current conditions the bank is viable – if it were not this would have come up in the AQR preceding the stress test and the supervisor would have already acted -- and then stress those conditions, for instance simulating the effects of a financial crisis. The bank should have enough capital to absorb the ensuing loss, or enough capital weighted by the probability the ECB assigns to such a fall in bond prices. The estimated loss will depend on the way a bank is holding sovereign bonds. If they are held in the "Trading book" the bank will have to absorb the entire estimated loss; if instead they are held in "Banking book", i.e. the bank intends to hold them to maturity, it would suffer a loss only in the case of a failure to reimburse them and the estimated loss could thus be smaller.

- The capital requirement in "stressed" conditions is likely to be lower than 8% (maybe 5 or 6%) and banks may be allowed some time to raise the additional capital they might need to satisfy this requirement. Still, in those countries where banks hold large amounts of sovereign bonds, this would mean that banks would need to raise very significant amounts of additional capital, and this may not be easy. One way to make the problem easier consists in establishing that, when a bank's capital buffer has run out, creditors – all the way down to, but excluding, guaranteed deposits – are "bailed-in". This is the current position of the ECB. But when should such bail-ins happen? Assume a bank is found to have too little capital under stress test conditions. Should the amount of additional capital needed be reduced by an ex-ante bail in of creditors? This was the view of the EU Commission, which however overlooked the consequence of an ex-ante bail in, namely a run on the bank by senior and junior non-guaranteed creditors. The ECB position – announcing that bail-ins are possible, but activating them if and only when needed, seems the correct solution. Another solution is to require that banks issue contingent convertible bonds (or Coco's), capital commitments that can be activated on demand.

- Admati and Hellwig (2013) ask why should banks not be unable to raise equity when non-financial corporations regularly do it and propose a sharp increase in required bank equity. But banks are different from non-financial corporations. What makes them different are the loans that sit on their balance sheets, which pose an asymmetric information problem that a non-financial corporation does not face, at least not to the same extent. But Admati and Hellwig are right in saying that the difficulty in raising equity should not justify softer capital standards. Which raises the issue of "national backstops".

- The availability of a "backstop" – that is a way to keep a bank alive in case of a bad shock – is critical to run serious stress tests. One of the problems faced by the stress tests run by the EBA in 2011 was the absence of backstops, which resulted in EBA's decision to assume that the value of sovereign bonds would not fall in stress test situations – otherwise the stress tests could have induced a run on some banks. This is the reason the ECB insists on backstops. While Coco's could help, unlimited backstops could only be provided by the government's

commitment to step in and take over the bank. But, as we shall discuss in Section 3, national backstops, if used, would raise the level of the public debt risking a vicious circle. Given the high level of public debt in several member countries, some form of collective backstop is thus needed before the stress tests are undertaken. At the time of writing, policymakers aim to entrust the ESM with this task. But the ESM may well be too small to the task (its total funding is € 500 billion).[5] This means that the only collective institution able to backstop banks is the ECB itself, which would thrust it into fiscal policy territory. This aspect is also picked up in Section 3.

- Banks can reach a situation where they have adequate capital in two ways: by raising enough equity or by trimming their balance sheets. The second solution implies lower lending and is thus more costly for the economy. It is however easier for the bank, and this is why many Euro area banks have gone down this road.[6] In the US, on the contrary, stress tests have indicated the amount of capital each bank needed to raise, thus avoiding deleveraging through a downsizing of the assets. It is important that this is also the criterion used in the stress tests the ECB is about to run. The risk is that deleveraging happens before, in anticipation of the stress tests. This is happening in some countries and is an issue the ECB should address.

The wrong sequence

The decision to postpone for over a decade the choice of who should be responsible for banking supervision had a serious consequence. It induced the euro area to address the financial crisis in the wrong sequence. This is one of the reasons why the recession is lasting so much longer in the euro area than in the US. The US government first cleaned up the banks, through the TARP (Troubled Asset Relieve Program) and then, once the credit channel was repaired, used macroeconomic policies. These policies worked – or at least worked better than in Europe – because the credit channel was functioning again. In Europe, where banks are much more central than in the US in the financing of firms, monetary policy (right or wrong) was made ineffective by a non-functioning credit channel. Although little can be done at this stage to correct the sequence, we should at least avoid making the problem more serious. What we wrote at the end of the previous paragraph -- on how to address the risk of deleveraging -- is a way to avoid it.

Financial stability in post-crisis central banking

A common view before the crisis was that central banks had a single objective: price stability. As Jean-Claude Trichet used to say: "The best contribution of monetary policy to financial stability is price stability." In *Safe at Any Speed* we did not accept that. Central banks, we argued, must take financial stability into account.

This view is now accepted by most central bankers. To quote Charlie Bean, the deputy Governor of the Bank of England: *“It is now pretty clear that price stability is not a sufficient condition for financial stability. Indeed, the empirical results presented in this paper suggest that the reduction in volatility associated with the Great Moderation contributed to excessively optimistic assessments of risk, the*

[5] Just in the case of Italy, for instance, the IMF Financial Counsellor, José Viñals, considers that “the estimated gross losses on corporate exposures could amount to 125 billion euros and that would exceed the existing provisions by about 53 billion euros.” http://www.imf.org/external/np/tr/2013/tr100913.htm

[6] See also Lorenzo Bini Smaghi, “What to do with the Eurozone banking system”, *Financial Times*, November 5, 2013

*compression of risk premia and the expansion in leverage. That does not imply that central banks should retreat from the pursuit of price stability, and macroeconomic stability more generally. But it does suggest that policy makers need both to be aware that long periods of benign conditions may foster excessive private sector risk-taking and be ready to take necessary action when that happens"*[7]. But if the central bank has two objectives *"One really wants another instrument that acts more directly on the source of the problem. That is what "macro prudential policy" is supposed to achieve."* (*ibid*) We agree, but is this enough? Can a central bank do away with its lender-of-last-resort function? We don't think the issue can be swept under the rug saying that macro-prudential is enough, except if macro-prudential includes a LOLR function. A central bank cannot avoid the issue because insolvency and illiquidity cannot easily be distinguished.

The ECB is moving haltingly to accept its role as lender of last resort, which most major central banks now acknowledge freely. The reason is that such interventions are inherently risky. It does not have to be the case, though, as shown when the Swiss National Bank intervened a lender of last resort to save UBS. The well-crafted salvage operation cost taxpayers nothing – in fact the Swiss National Bank is making a profit out of its intervention, as the Fed has done in similar circumstances. Yet, risk can never be eliminated. The ECB's reluctance to being involved in a bailout is explained by the fact that this could result in a fiscal transfer: imposing costs on taxpayers of Country A because a bank in Country B has failed. This position is understandable if the bank failure in A is the result of poor supervision by Country A's supervisor. This is why we need a banking union.

When the ECB is the supervisor, it bears responsibility for a bank failure. To intervene as lender of last resort, however, it must trust the Resolution Authority that will determine whether and which taxpayers will be made to bear the burden. Indeed, it is the relevant Resolution Authority that will set the conditions under which a failing bank is recapitalized with public money. In other words, a bank resolution determines the risks taken on behalf of the taxpayers by the institution that provides resources. In the particular context of EMU, where there are no European taxpayers, only national ones, the ECB needs to be fully reassured that bank resolution will minimize the risk of a residual cost to taxpayers and that eventual losses will be borne by national taxpayers – since taxes cannot be imposed by a "foreign" entity. Either the Single Resolution Authority can be depended upon to tilt the risks toward the bank stakeholders, or resolution will remain in national hands where capture by national champions is the rule, in effect undermining the authority of the single supervisor.

Summing up

In developed countries, large and sudden debt buildups are typically triggered by a financial crisis through cash injections into ailing financial institutions and fiscal policy actions required to cushion the ensuing recession. Banking and financial stability can be seen, therefore, as an extension of fiscal discipline. Given the specific danger of debt build-up in the monetary union, properly regulating and supervising banks and financial institutions is even more important than elsewhere. This need was not recognized by policymakers until the crisis made it plain. Some progress has been achieved but many thorny issues remain untreated, still swept under the rug.

[7] See Bean et al (2010).

## 3. Interplay Between the ECB and Member Governments

Coordination: the old debate come true

In our 1998 paper, we were not convinced that the Stability and Growth Pact would deliver fiscal discipline.[8] We used the theory of policy coordination to think about the macroeconomic relationship between one central bank and *n* governments and we concluded that this would lead governments to be excessively lax and the ECB to be excessively tight. Many governments indeed relaxed their fiscal stance after joining the Eurozone, but for a different reason, and monetary policy has not been unduly tight except, maybe, occasionally. Fiscal profligacy arose in various countries for two different reasons that were mentioned in some early works but not fully exploited. First, came the temptation by some governments to hide behind the monetary union to be profligate, guessing that the no-bailout clause would be relinquished if needed.[9] Second, Euro area membership provided an aura of credibility that would ensure low or inexistent risk premia on national public bonds. As noted by Dornbusch et al. (1998), this would imply a rapid decline in interest costs and an incentive to adopt larger primary deficits. One or both of these factors came to play in many countries and the Stability and Growth Pact failed to impose the fiscal discipline that was necessary to uphold the monetary union, avoiding undue pressure on the ECB: "*The Pact is considered by European central bankers as a key element of stability, and indeed aims to shield the ECB from pressure to finance deficits. […] The Pact helps to ensure discipline in normal times [but] at the onset of a crisis it may turn into a stumbling block. […] An unintended implication is that in a crisis the whole burden of getting things back to track will rest on the shoulders of the ECB."* ("Safe at Any Speed", pp.42-43).

The lack of fiscal discipline and the implications for the ECB are further examined below. Here we raise the issue to note that the relationship between the ECB and member governments has remained unsatisfactory. The ECB has frequently expressed frustration with governments that were not fiscally disciplined and with financial markets that did not price public debts accordingly. Its warnings went ignored. To its credit, the ECB did not proceed to punish governments with high interest rates, as we feared.[10] While the Eurogroup assumed increasing responsibility to coordinate fiscal policies, it did not really seek to apply peer pressure on stray members and never developed the instruments to examine the overall fiscal policy stance of the monetary union. The European Commission tried to use the Stability and Growth Pact to constrain deficits but its legalistic approach failed in the face of occasional slowdowns or "special circumstances".

The absence of a fiscal authority at Eurozone level is a well-recognized inherent characteristic of EMU, in fact the reason why this experiment is both an innovation and a threat, as argued by Feldstein (1997). The political constraint is that there is no chance that national authorities (governments and parliaments) will give up sovereignty in fiscal policy matters.Furthermore, the disparity of sizes and ideological imprints from history always implied that coordination among governments would be challenging, adversely impacting coordination with the ECB. During the sovereign

[8] The argument was laid out in Eichengreen and Wyplosz (1998).

[9] The underlying common pool externality is developed in von Hagen and Harden (1995).

[10] Policy coordination inside EMU was discussed in MECB 3 authored by A. Alesina, O. Blanchard, J. Galì, F. Giavazzi and H. Uhlig.

debt crisis, when speed and effectiveness became of the essence, the void was filled by the re-emergence of the German-French leadership, which soon turned into a German leadership.[11] This extreme form of coordination is not just politically explosive and an aggravation of the famed democratic deficit, it is also inefficient. In many respects, the crisis could have been mitigated and shortened had proper decisions been made. Examples of politically-induced procrastination include the rejection of a Greek debt reduction that was finally enacted as the Private Sector Involvement (PSI) – which however failed to reduce the debt – or the long-lasting refusal to move to a single bank supervisor and a single resolution mechanism. Examples of misguided policies include the imposition of austerity policies on countries in depression, failure to make clear the distinction between austerity implemented by cutting spending or by raising taxes, and opposition to the ECB's role as lender in last resort.

Unfortunately, there is no easy solution. Democratic legitimacy lies with national governments and parliaments, which are constitutionally required to uphold national interests. Even though the collective good may justify compromises in the name of national interest, in crisis situations national interests may diverge too far for enlightened coordination. The European Commission is ultimately a reflection of this political situation. The creation of a European Presidency and of a permanent Chair of the Eurogroup merely added new bureaucratic layers designed to obfuscate political deadlocks.

The single monetary authority itself had to forge its own identity out of equally disparate inherited traditions. The mantra that the Eurosystem makes decision by consensus sometimes cannot conceal deep differences of opinion within the Executive Board (until its latest renewal in 2011-12) and within the Governing Council. This was anticipated in our 1998 paper as we wrote that *"problems are created when the central Executive Committee is weak in relation to the chairmen of its constituent banks. […] How quickly the ECB achieves effective centralization may be one of the keys to its eventual success."* (p.4-5). Recently this centralization appears to have been accelerated, but much remains to be done.

We suggested that lessons be learned from the difficult early years of the Fed. Nowadays, no President of a regional Federal Reserve Bank, who sits on the policy-making bodies, even hails from the region, except by pure coincidence. They represent their respective regions in the sense that they report on local economic conditions, but they are unencumbered by local interests. Within the ECB Governing Council, instead, the views of the national governors are invariably shaped by national interests and prejudices.[12] The solution is to reduce the power of national governors, which can be easily done by reducing the frequency of Governing Council meetings, currently scheduled twice a month. A more audacious solution would be to move to the US model as recently suggested by Burda (2013).

## Fiscal discipline

The need for fiscal discipline was clearly identified by the Delors Committee. The adopted solution, unfortunately, has clearly failed. As noted above, lower interest rates and the belief (correct, as it turned out) that over-indebted governments would

[11] Here we admit that we wrote that "Germany is no longer likely to play the role of enforcer of fiscal restraint".

[12] This national bias is reinforced by the appointment process of the Executive Board members by the European Council, which has been clouded by political maneuvering around national pressure. We return to the problems this raises in Section 4.

be bailed out have provided irresistible temptations. Not all governments have been fiscally undisciplined, however, which shows that domestic institutions can be effective if well designed. A key conclusion of Hallerberg et al. (2009) is that, to be effective, institutions for fiscal discipline must be well adapted to political institutions. Two major conclusions follow. First, the one-size-fits-all Stability and Growth Pact is unlikely to be effective in all member countries. Second, any Euro area-wide arrangement must be compatible with EU political institutions.

This is where another lesson can be borrowed from the early US experience. Upon independence, the federal government was small and weak relative to the pre-existing states, not unlike the European Commission today. In his famed effort to build up a federal Treasury, Alexander Hamilton offered to assume the state public debts that had grown large – by the standards of the late 18th century. This seminal bailout encouraged many more bailouts and the growth of the federal Treasury. Fiscal indiscipline at state level flourished until the 1840s when Congress created a precedent by refusing one more bailout. US states responded by adopting various forms of balanced budget rules.[13] The precedent still applies today and fiscal discipline is firmly established at the state level. Wyplosz (2013) argues that this model is relevant to the Euro area, in contrast to the Stability and Growth Pact, which is inspired by Germany's own arrangements based on a powerful federal government.

Another lesson can be learned from the Euro area crisis. Ireland and Spain had a good record of fiscal discipline before the crisis and, yet, they were drawn into it. The reason is that both countries had to bail out their banking systems. In the absence of a domestic central bank, the lender of last resort function had to be assumed by the government through massive borrowing, including indirectly from ECB through the Emergency Liquidity Assistance (ELA) program. The implication is that either the ECB has to fully assume the role of lender of last resort, including the risk of suffering losses, or other governments must be ready to bail out a government that faces a banking crisis.

As mentioned above, since most major debt buildups are triggered by a financial crisis, banking and financial stability can be seen as an extension of fiscal discipline. Given the specific danger of debt build-up in the monetary union, properly regulating and supervising banks and financial institutions is even more important than elsewhere. How to do that was discussed above in section 2.

### Policy dominance

The Euro area provides a stark example of policy dominance. On paper, the ECB's independence status is as hard as can be. It is enshrined in no uncertain words in an international treaty that is very unlikely to ever be modified in this respect. Yet, a highly reticent ECB was pushed into contributing to the Greek bailout. Since then, it has joined the Troika, which goes way beyond its mission. It has provided banks with massive amounts of liquidity because it had no choice but to act as lender of last resort. It has been led to buy large amounts of public debts and to backstop the prices of debts from crisis countries through its OMT program. Monetary dominance ends when a central bank is somehow led to finance deficits and/or buy public debts.

[13] With one exception, Vermont. For an overview of this evolution, see Henning and Kessler (2012).

Given the circumstances, these actions of the ECB were justified. Indeed, other major central banks (e.g., the Federal Reserve and the Bank of England) have carried out similar actions, often earlier, on a larger scale and without the safeguards that the ECB has sometimes obtained, e.g. the OMT program's conditionality.

All central banks now wonder about the policy dominance issue. As explained in Leeper (1991), no formal independence status can protect a central bank from financing the government one way or another, if refraining from doing so can have dramatic consequences – for example a break-up of the monetary union in our context.

When discussing this issue in our 1998 paper, we made a number of suggestions that, we think, remain valid today:

- it is essential that the ECB achieves and retains a high degree of support from the broad public. The polarizing nature of the sovereign debt crisis, broadly separating the North and the South, represents a major challenge for the ECB. The massive expansion of the ECB's balance sheet has implied the acquisition of large quantities of collateral. Even though it was already large before of the crisis, the list of eligible collaterals has been expanded. This has meant a deterioration of the quality of the central bank's assets. The ECB applies haircuts on risky collaterals; even so, it takes risk, including on officially riskless public bonds. Any loss would have to be distributed among its shareholders, the national central banks. Ultimately these potential losses will be borne by the taxpayers. Enlisting the support of taxpayers, a key necessity for upholding the central bank' ability to resist pressure from governments, is no easy task. The countries not in crisis fear that they may have to bear the burden of ECB losses. The countries in crisis see the ECB as a hawkish member of the Troika that has imposed highly unpopular policies;

- we argued that the ECB needs to be as transparent as possible. The better its policy is understood, the less controversial it will be. We shall discuss transparency in the next section;

- we called for the adoption of a policy rule. A clear rule not only allows for more transparency, it also takes the edge off criticism when taking controversial actions. We suggested adopting the flexible inflation targeting strategy that many other central banks have pursued with evident success. We still believe that this is a desirable step. But the flexible inflation targeting strategy is designed for normal times. During the crisis, inflation-targeting central banks have had to adapt for two main reasons. As they reached the zero lower bound of their policy interest rates, the Taylor rule, which underlies inflation targeting, became unusable. In addition, financial stability came to the fore of policy objectives, somehow undermining the primacy of the inflation objective. A rule that is occasionally suspended somewhat loses its power of conviction and, yet, this was the right thing to do. The ECB, and several other central banks as well, now need to redefine their monetary policy strategy. As suggested in Blinder and Kohn (2013) this will require adopting the flexible inflation targeting strategy but making it explicitly conditional on the occurrence of major shocks, mostly financial shocks. While markets and observers can understand conditionality, the task of explaining the strategy to the broader public will be hard sale. Recently, the ECB has started to provide its own version of forward guidance, a step that may herald a more open approach to communication. Section 4 develops this issue.

Like several other central banks, the ECB is now about to be involved in banking supervision and is bound to be given some bank resolution authority. These activities do not belong to monetary policy proper. They involve decisions that have redistributive effects and are therefore normally in the realm of governments, which have the required democratic legitimacy. In many countries, these functions have been transferred, partly at least, to the central bank because the government agencies in charge of bank supervision and/or resolution have failed during the crisis. An additional reason to do so in the Euro area, as noted above, is that bank stability carries important externalities that are not properly internalized when supervision and resolution is carried out at the national level. By accepting these tasks, central banks take risks, which can reduce their effective independence if they come under pressure from politicians. As argued previously, monetary dominance ends when a central bank faces the choice between bowing to pressure and risking producing a major crisis, as well illustrated in the case of Lehman Brothers. Here again, it is vital that the ECB be seen as impartial to national and special interests, not as an agent of particular governments.

The ECB has already announced its intention to establish a Chinese wall between its monetary policy functions and its banking supervision branch. The new Supervisory Board (SB) will be a committee whose chair will have a non-renewable term of five years. The first Chair will be Ms. Danièle Nouy who is not a member of the Governing Council. A vice-chair will be chosen from among the members of the ECB's Executive Board. These two will be accompanied by four ECB representatives, and one representative of the national competent authority of each participating country. Will such a large group be able to deliberate effectively? Will this setup be enough to guarantee separation between the two functions, monetary policy and banking supervision? To resist national pressures the SB will need to evolve rapidly towards a committee where the chair and the 5 ECB representatives make the important decisions. But this will bring the two functions dangerously close to one another.

## 4. ECB Transparency

### Changing theory and practice

Central bank transparency is one issue that has undergone profound changes over the last twenty years, both in theory and practice. Using the Barro-Gordon model with rational expectations, Cukierman and Metzler (1986) showed that central banks must maintain a veil of secrecy for monetary policy to be effective. This conclusion was based on the "only unanticipated money matters" assumption of the then-workhorse macroeconomic model, and on the assumption that central banks are better informed than the private sector. This theory provided support for the highly ambiguous, often purposely secretive behavior of most central banks at the time. Blinder (1998) challenged this orthodoxy. As formally established by Woodford (2005), central bank transparency is desirable when monetary policy affects the economy through interest rates of a longer maturity than the policy rate. In this case, providing information about future policy rates allows the central bank to shape the longer-term interest rates and therefore gives more power to policy actions. This effect is reinforced when the central bank has an information advantage over the private sector, but this assumption is not needed to establish the usefulness of transparency. A number of

central banks, following the lead of the Reserve Bank of New Zealand, of the Norges Bank and of the Riksbank, have moved to become increasingly more transparent.

Until now, the ECB has strenuously resisted providing information on future interest rates, except in the days immediately preceding a change, a practice that it calls "market preparation". This practice, however, has nothing to do with the kind of information needed to shape longer-term market expectations. The ECB has recently changed its approach, adopting "forward guidance". Forward guidance is a way of providing information about the level of future policy rates which, however, is less transparent then publishing a path for interest rates (as done e.g. by the Riksbank) and clearly explaining why that path needs to be changed if new information becomes available.

The ECB approach to communication

The issue of transparency was raised critically by CEPR researchers. In the 2008 *Monitoring the ECB* report by Gerats et al., we recalled the Blinder-Woodford arguments in favor of a high degree of transparency. We further argued that the process of decision making itself is a source of opaqueness since the press conference invariably states that the decision has been reached by consensus. This makes it impossible for interested observers to detect whether the decision has been "obvious" and therefore that future policies will be a mere continuation of the current policy stance, or whether the Council has been split, which could herald shifting majorities. Finally, the report observed that, in a democracy, central bank independence must be constantly defended. The only way of protecting independence is by acquiring and maintaining wide popular support, which calls for better communication, and not just towards financial markets.

The implications of these observations run deep. First, our report asked that decisions be made by formal vote. This is a requirement of the European treaty, which the ECB has presented as unnecessary given the existing consensus. This argument is surprising given that the Governing Council includes 6 + $n$ members, $n$ being the number of member countries. With $n$ starting at 11 and soon to become 18, the Council is a large body where the probability of achieving (near) unanimity is extremely small. Consensus, therefore, is likely to allow a majority, possibly a narrow one, to silence a minority. Second, the report asked that the results of votes be made public, maybe without mentioning the names of Council members if it is believed that doing so could be exploited for nationalistic reasons. Third, the report called for the rapid publication of minutes, possibly unattributed for the same reason, so that observers can understand the arguments that led to each decision.

Until recently, the ECB has denied that such transparency was needed. Jean-Claude Trichet has famously asserted that *"We are a team: We have the ECB, and we have the system itself with the 12 national central banks, and communication at a national level in the various languages that make up Europe are also, of course, very important. […] And again, one of the things the team tends to be proud of is that with 18 members of the Governing Council, and again 12 different cultures, the degree of unity, the degree of, I would say, a single voice through 18 persons has been reasonably successful."* [14]

The ECB has also long refused publishing minutes, claiming to be highly transparent:

[14] Interview with Jean-Claude Trichet, Federal Reserve Bank of Minneapolis, 2004
http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3304

*"My colleagues and I are convinced that our present real time detailed communication is, in our case which is unique, superior to mentioning individual votes which could wrongly suggest in the eyes of some that the Governing Council is a place where we are confronting national interests which is not the case and should never be the case. […] The "single voice" principle in monetary policy was introduced from the very beginning and has been efficiently applied in my judgement."*[15]

The crisis has shown the shortcomings of this approach. The ECB contribution to the bailout of Greece has triggered strong opposition within the Governing Council, too strong to be hidden, especially as the leading opponent was the Governor of the Bundesbank. Further nonstandard policies, especially the SMP and OMT programs, have met with criticism from the next Governor of the Bundesbank and a few colleagues. Although the ECB has not explicitly mentioned it, it seems that some form of voting, explicit or not, has taken place. The "team spirit" has evaporated, assuming that it ever existed.

The votes of individual Governing Council members in divisive decisions are often eventually revealed, as exemplified by some of the cases discussed above. It would have been better if those votes, instead of being leaked to the press, had been acknowledged in a transparent way through the publication of minutes.

There is now hope that the ECB will move on this issue. Several Executive Board members have expressed the view that minutes could be published. The issue of explicit and formal voting, and of publishing voting records, however, remains clouded in secrecy.

Communication and strategy

We have so far discussed the "how" of the ECB communication strategy, but the "what" is intimately linked to the "how". Communicating intentions and doubts is difficult when the monetary policy strategy is not spelled out precisely. Very transparent central banks like the Norges Bank or the Riksbank accept that, at least in normal times, their strategies can be interpreted as minimizing a quadratic loss function that measures deviations of expected inflation from target and of unemployment from its natural rate. They even provide information on the weights that they attach on these deviations. In this case, communication amounts to publishing forecasts and explaining how these forecasts map into current and future interest rates.

The ECB strategy is far less clear-cut. In our 1998 report, we expressed concern about the two elements of the announced strategy. First, the lexicographic ordering of objectives – price stability above all, the rest if possible – is not just vague, it is unrealistic. It is vague because price stability is not a precise concept and because "the rest" remains to be detailed. The ECB has given its definition of price stability (close to but below 2% inflation) but has always refused to provide information about "the rest".[16] The absolute priority given to price stability is not realistic because no central bank can ignore the state of the economy (GDP growth, unemployment), not to mention financial stability as explained in Section 2. In fact, there is convincing evidence that the ECB has behaved like other central banks, broadly following a

[15] Jean Claude Trichet "Communication, Transparency and the ECB's Monetary Policy", BIS Review 5/2005, p. 3.

[16] Other central banks typically provide an inflation target and a margin of flexibility around the target. Svensson (2003) has argued that the ECB's definition hurts transparency.

Taylor rule. This means that the ECB does not do what it says it intends to do and that it does not say what it is trying to achieve. Communicating such an approach is mission impossible.

Second, the ECB has adopted its well-known two-pillar strategy. It analyzes the overall economic situation (inflation and the rest) and monitors the evolution of monetary trends. The second pillar, inherited from the Bundesbank, is a vestige of the times when the German central bank had developed a strategy based on the quantity theory of money. As we noted in our 1998 report, the Bundesbank had long abandoned this approach *de facto* but insisted that it remains faithful to the quantity theory. The reason is that the quantity theory assumes a constant velocity of money while this velocity has been varying, following both a trend and cyclical fluctuations around the trend. Indeed, most central banks have abandoned the monetary pillar. Insisting that the second pillar is useful for "cross checking" the information obtained under the first pillar unnecessarily clouds the analysis that lies behind policy decisions. It also makes the communication of the analysis confusing.

There is no indication that the ECB is ready to jettison either the presentation of its strategy or the second pillar. The statement by the President after each policymaking meeting of the Governing Council continues the ritual of explaining decisions on the basis of the primary price stability objective and of referring to the two pillars. Recently, the President has been much more open during the Q&A session that follows the formal presentation of the decision of the day. Keen ECB observers have long learned to read in between the lines of this ritual but that does not make for transparency. It could even preclude hard-nosed debates within the Governing Council if the discussion is effectively structured along the lines of a strategy that is ill conceived.[17]

<u>Appointments to the Executive Board</u>

Finally, transparency also concerns the appointment of members of the ECB Executive Board. Even though it does not make policy decisions, the Board is arguably shaping them, so its composition is crucial. As befits the "federal" nature of the ECB, these appointments are made by the European Council, and are not, therefore, a responsibility of the ECB itself. Unfortunately, the process has been clouded by political maneuvering so that it has been anything but transparent.[18]

To start with, four of the six positions have been informally attributed to the largest countries, although Spain recently lost its seat. The implicit logic, that larger countries must have a larger say, directly contradicts the nature of the ECB, an institution that serves the whole Euro area, not its individual members, certainly not because they are large. It also contradicts the brief of Executive Committee members who should never see themselves as representing their own countries. We noted that one weakness of the Euro area is the excessive weight of national central bank governors; the *de facto* large-country seats arrangement worsens the problem.

For such important positions, one would expect a wide search for the best talents, for functions discussed below. In fact, the European Council announces its decision

[17] The increase of the policy rate in June 2008, when the crisis was already building up, remains a mystery unless one accepts the primacy of a price stability objective defined not in terms of an inflation forecast but of current-month inflation only.

[18] See e.g. "Selection of the central bank Council is a fait accompli", by F. Giavazzi and C. Wyplosz, *Financial Times*, February 10, 2006.

without appropriate consultations.[19] The nominee must then be approved by the European Parliament, on which more below. For the large countries, the choice is left to each respective government; the other countries do not wish to interfere. For the two remaining small-country seats, some countries put up candidates but the choice usually reflects horse trading for other important European positions.

The question of defining what talent is needed is not innocuous either. The Executive Board members are not just making monetary policy decisions. They have multiple responsibilities, both policy-making and management. This has several undesirable implications. EB members use a significant amount of their time to exercise their management responsibilities. It also dilutes the job description: do we need monetary policy experts or good managers? As a result, the scope for political meddling is widened. This feature sets the ECB apart from most other important central banks where the policy-making committee brings together highly specialized and competent monetary experts. Executive Board members – except for the President and the Vice-President – should have a single responsibility, that of formulating and communicating monetary policy. This would make it harder for politicians not to appoint the best monetary experts.

The vetting of nominees by the European Parliament is also troublesome. For a while, the European Parliament was merely endorsing the Council decisions. The latest appointment led to a negative vote by the Parliament because it violated "gender balance", defined as at least one female on the EB. The Council simply ignored the Parliament's negative vote and went ahead with the appointment of its preferred (male) candidate. Besides leaning against the wind of increasing female participation at the highest levels of power, this episode further increased the democratic deficit of the EU.

Summing up

The ECB stands apart from other major central banks for its lack of transparency, bucking a trend that has led to profound changes, including at the once-secretive Federal Reserve. The ECB flatly denies that this is the case. Some progress is happening. The Q&A session which follows the monthly policy meetings has become much more open and informative. The publication of minutes of Governing Council meetings could be coming soon. Other sources of opaqueness discussed above, however, are not on the ECB agenda. This is not just contributing to the EU democratic deficit. It also reduces the effectiveness of monetary policy. Furthermore, it perpetuates a strategy that was seen from the outset as outdated. Worse, maybe, is that it weakens the central bank at a time when its independence is being challenged.

## 5. Concluding remarks

We referred abundantly to the first issue in CEPR's Monitoring the ECB series because it was published before the launch of the euro and because it aimed at offering an exhaustive assessment of the experiment about to start. The series eventually included 6 issues and two updates before its somewhat untimely end in

[19] A treaty requirement is that the ECB and the European Commission be consulted, but this is a formality designed to weed out egregious cases of incompetence.

2008 (see the Appendix). Each issue covered topics that mattered importantly at the time, often already touched upon in the first issue. Taken together, this series and many other contributions by CEPR researchers show that the Euro area crisis did not come as a surprise, at least to the academic community. To be sure, the precise way events unfolded was not foreseen, but the key weaknesses that provoked the crisis had been identified long beforehand.

Another aspect of these contributions is the increasing interactions between central banking and academic research. As in many other areas, causality is nearly impossible to pinpoint. Central banks have innovated a lot over the last two decades or so with inflation targeting, improved communication strategies, new and unorthodox instruments, etc. These innovations were made by central banks on their own, but they relied in many ways on academic contributions and, in turn, they generated much new research. It is not just ideas that move back and forth between the two worlds of central banking and academia, people too travel. Research departments at central banks, at the BIS and at the IMF are increasingly producing works that are published in the best academic journals, not to mention central bank reviews with academic content, in particular the International Journal of Central Banking. Most governors and top officials of major central banks are now card-carrying economists with either a PhD, or distinguished academic work, often both, and several of them have long been associated with CEPR. The road is also traveled in the opposite direction, bringing valuable experience into the classroom.

The Eurosystem has, for some time, been rather slow in following this trend. This may explain that the warnings issued in the Monitoring the ECB series have long fallen on what seemed like deaf ears. The Eurosystem is now catching up, both at the ECB and in NCBs. Already, we are reassured to observe that the ECB is changing. Such innovations as the Outright Market Transactions (OMT) program, which single handedly calmed down markets after three years of intense anxiety, reducing risk premia without so far spending a single euro, are in line with academic research. The ECB has asked to being given the role of single supervisor, and partially obtained this responsibility, as long suggested by many CEPR researchers. The same will happen when the minutes of Governing Council meetings are published, as is currently under discussion.

We believe that much has to be gained when academics learn from central bankers and when central bankers learn from academics, sometimes through migration. We feel privileged to have witnessed a clear evolution in that direction, including at the ECB.

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APPENDIX: THE MONITORING THE ECB SERIES (1998-2008)

The series was launched by CEPR under the aegis of the late Luigi Spaventa. The list of reports, available at http://www.cepr.org/active/publications/books_reports/booklist.php?list_type=MEC, is as follows.

1. "The ECB: Safe at Any Speed?" (1998) MECB No. 1
   Authors: David Begg, Paul de Grauwe, Francesco Giavazzi, Harald Uhlig, Charles Wyplosz.

   1.1. MECB Update (1999)
   Authors: David Begg, Paul de Grauwe, Francesco Giavazzi, Harald Uhlig,Charles Wyplosz.

2. "One Money, Many Countries", Monitoring the European Central Bank No. 2
   Authors: Carlo Favero, Xavier Freixas, Torsten Persson, Torsten, Charles Wyplosz.

3. "Defining a Macroeconomic Framework for the Euro Area" (2001) MECB No. 3
   Authors: Alberto Alesina, Olivier Blanchard, Jordi Galí, Jordi, Francesco Giavazzi, Harald Uhlig.

   3.1. MECB Update (2001)
   Authors: Alberto Alesina, Olivier Blanchard, Jordi Galí, Jordi, Francesco Giavazzi, Harald Uhlig.

4. "Surviving the Slowdown" (2002) MECB No. 4
   Authors: David Begg, Fabio Canova, Paul de Grauwe, Antonio Fatás, Phillip Lane.

5. "The Monetary Policy Strategy of the ECB Reconsidered" (2004) MECB No. 5
   Authors: Jordi Galí, Stefan Gerlach, Julio Rotemberg, Harald Uhlig, Michael Woodford.

6. "Transparency and Governance "(2008) MECB No. 6
   Authors: Petra Geraats, Francesco Giavazzi, Charles Wyplosz.