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ECONOMIC AND MONETARY AFFAIRS

Changing of the Guards

NOTE

Abstract

On 31 October 2011, after eight years in office, Mr Jean-Claude Trichet's term as President of the ECB will come to an end. The aim of this note is to evaluate the presidency of the Mr Trichet and to discuss the challenges that his successor will face.

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DISCLAIMER

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EXECUTIVE SUMMARY

- In assessing Mr Trichet's tenure it is important to judge both the performance of the ECB and the effect of his tenure on the institution's legitimacy. The ECB's legitimacy affects the future effectiveness of the institution as well as the standing of other EU governance institutions.

- The ECB performed well in targeting price stability prior to August 2007 and Mr Trichet did a thorough job of explaining the reasons behind the ECB's policy decisions. His notorious opacity about the decision-making process, however, has probably damaged the ECB's input legitimacy.

- The Governing Council of the ECB's response to the liquidity crisis was at least as good as that of other central banks, but the ECB appears to have been somewhat unprepared for its role of lender of last resort and market maker of last resort. Mr Trichet's expertise and interest is clearly in the area of monetary policy, not in the area of financial markets. It is a design flaw of most central banks that the same person is in charge of both monetary policy and financial stability matters when each of these activities requires its own expertise and is a full time job.

- The ECB's opacity about collateral policies is potentially much more damaging than the lack of transparency in monetary policy. In deciding what securities to accept as collateral and how to value and haircut them the Eurosystem is redistributing income and wealth.

- In its attempt to maintain financial stability the ECB and Eurosystem have had to walk a fine line between providing just enough liquidity to keep potentially solvent institutions afloat and subsidising the financial sector. Occasionally Mr Trichet has strayed into the latter territory.

- Unfortunately, Mr Trichet's policy of allowing the markets to properly price sovereign debt was not a success. That ECB policymakers did not speak out about the state of Greek finances or impose an additional haircut on Greek sovereign debt must have suggested to the market that there were two possibilities. Either the ECB had superior information that suggested Greece was unlikely to be insolvent or it knew that euro area policy makers (or the ECB itself) would bail out Greece – or at least its bondholders and other creditors – if Greece were to become insolvent.

- The Securities Market Programme has made the ECB's continued insistence on secrecy particularly damaging. One does not have to be a conspiracy theorist to imagine that it is possible that the euro area taxpayers are being called upon to subsidise German and French banks after their own governments and government agencies failed to exercise proper regulation and supervision.

- The incoming president Mario Draghi faces a difficult task. If he too intends to scorn accountability, then he must come up with an output performance that is as about as good as that of Mr Trichet. On the other hand if he wishes to be more accountable than his predecessor, then he must either somehow square this desire with the design flaws of the ECB or facilitate institutional change, some of which would require a change in the Treaty.

1. INTRODUCTION: CHANGING OF THE GUARD

On 31 October 2011, after eight years in office, Mr Jean-Claude Trichet's term as President of the ECB will come to an end. The aim of this note is to evaluate the presidency of Mr Trichet and to discuss the challenges that his successor will face.

An obvious way to assess Mr Trichet's tenure is to ask the question: how did the performance of the ECB (and also that of the Eurosystem) while he was in office affect the economies of the euro area and the EU during his term in office? However, it is also important to ask how the ECB's standing as an institution – that is, its legitimacy – was affected by the Trichet presidency. The ECB is in its infancy and Mr Trichet will have been president for well over half of its existence. Did the practices instituted or perpetuated by him increase or decrease its legitimacy? The legitimacy accumulated or lost during Mr Trichet's term in office will affect the future effectiveness of the ECB in the pursuit of its objectives. The legitimacy of the ECB matters also because a lack of legitimacy of one key EU governance institution weakens the legitimacy of all other institutions of governance in the EU, including the European Commission, the European Court of Justice and the European Parliament.

Legitimacy has two components: output legitimacy and input legitimacy. The ECB can attain output legitimacy if it achieves success in the pursuit of its assigned objectives of price stability and financial stability and if it does not undertake tasks that it has not been assigned, even if it can do these tasks well. Apart from its roots in the Treaty, the ECB's input legitimacy depends on the degree to which it is accountable. As the ECB's extraordinary degree of independence means that it is difficult to punish its policymakers for bad behaviour, the ECB's accountability depends on the degree to which the public can observe or is provided with the relevant information about its actions and decision-making processes and on how good a job the ECB does at explaining and justifying its actions.

I will argue that in terms of output – the effect on the economy – Mr Trichet's presidency has been relatively successful and this must be due in some part to his obvious intellect and energy. Up until August 2007 inflation was low and stable and the ECB's response to the financial crisis has been at least as good as that of other central banks. Aside from its direct benefit, this has increased the output legitimacy of the ECB. However, Mr Trichet's notorious opacity (something his predecessor Wim Duisenberg shared) has done little to enhance this institution's accountability and input legitimacy. In his defence, it may be that Mr Trichet's lack of transparency has not been entirely due to disdain but to some extent may rather have resulted from being handed a poorly designed institution.

The incoming president Mario Draghi faces a difficult task. If he too intends to scorn accountability, then he must come up with an output performance that is as about as good as that of Mr Trichet – and this would be no mean feat. If he fails, something that could happen due to shear bad luck, this could threaten the institution's legitimacy and possibly even its survival. On the other hand if he wishes to be more accountable than his predecessor, then he must either somehow square this desire with the design flaws of the ECB or facilitate institutional change, some of which would require a change in the Treaty.

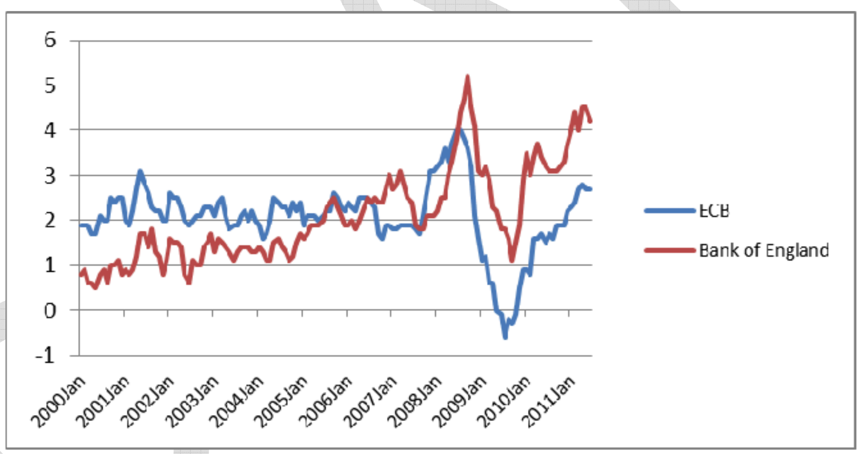
2. PRESIDENT TRICHET AS AN INFLATION TARGETER BEFORE THE CRISIS

In evaluating the performance of the ECB and Eurosystem under the Trichet presidency, it is useful to split Mr Trichet's term in office into two parts. Up until the onset of the liquidity crisis in August 2007, conditions were benign and the primary task of the ECB was to provide low and stable inflation. Since August 2007, the primary focus of the ECB has been to contain the liquidity crisis and the financial crisis into which it evolved and, within its powers as a central bank, to mitigate the credit, banking sector insolvency and sovereign debt crises. In this section I consider how the ECB did prior to August 2007 under the tenure of Jean-Claude Trichet. I consider the inflation-targeting performance of the central bank and the degree to which the new institution was seen as accountable.

2.1. Did the Trichet Presidency Result in Low and Stable Inflation?

How good a job has the ECB done in targeting inflation? An obvious and simple way to judge this in this relatively calm period is to consider how near observed inflation has been to the ECB's target inflation of below but close to two percent in the medium term.[1] Figure 1 below depicts monthly annual percentage changes in the euro area inflation rate under both the Duisenberg and Trichet presidencies.

Figure 1. Inflation rate (HICP), Annual Percentage Changes



Sources: ECB, UK Office of National Statistics

Given the long and variable lags between the implementation of monetary policy and when the policy is fully transmitted to inflation, the data in the chart begin in January 2000. Mr Trichet took office in November 2003 and cannot be entirely responsible for inflation prior to about November 2005. However, as seen in the chart, the inflation targeting performance was remarkably similar for both Mr Trichet's presidency and his predecessor's.

As seen in Figure 1, up until the beginning of the liquidity crisis in August 2007, the ECB did a good job of producing stable, if slightly above target, inflation. Average inflation was 2.2 percent with a standard deviation of 0.3. In comparison, the Bank of England produced significantly lower, but much more volatile inflation, with an average of 1.6 percent and a standard deviation of 0.6.

[1] Or, less than two percent prior to May 2003.

In addition to the ECB performing well in providing price stability prior to August 2007, Mr Trichet did a thorough job of informing the press, policy makers and the public about the reasons behind the ECB's policy decisions. Each monthly rate decision was accompanied by a detailed explanation for the actions and a press conference. During Mr Trichet's time in office members of the Executive Board gave a total of 9.2 speeches per month, with Mr Trichet accounting for 3.4 – over a third.[2]

2.2. Did the Trichet Presidency Enhance the Legitimacy of the Central Bank in Monetary Policy Making?

The ECB was set up in a way that would allow individual members of the Governing Council to be held accountable. Article 10 of Protocol 4 of the consolidated version of the treaty makes it clear that decisions are to be the result of a vote. Indeed, the description of exactly how the voting is to work is extraordinarily detailed, with 834 words devoted to the topic. During Mr Trichet's tenure in office the procedure was simple: decisions were to be made by a vote and '[e]ach member of the Governing Council [was to] have one vote'.

The ECB is not unusual in that its decisions are supposed to be made by majority vote. The Bank of Japan, Sweden's Riksbank, the Bank of England and the US Federal Reserve are all expected to operate in this fashion. The way that the ECB and these other central banks disclose their deliberations and votes is shown in Table 2, below.

Table 2: Procedural Transparency

Country	Policy Statement	Minutes
ECB	Decision	none
Japan	Decision and vote	Unattributed discussion, named dissenters' arguments
Sweden	Decision and dissenters	Attributed discussion
United Kingdom	Decision	Unattributed discussion and vote
United States	Decision and vote	Unattributed discussion

As can be seen in Table 2, Japan, Sweden, the United Kingdom and the United States all publish the votes of their monetary policy committee. Japan, Sweden and the United States do it right away; the United Kingdom waits two weeks to publish the vote with the minutes. Moreover, these four countries all publish the minutes of their discussion. Japan publishes the dissenters' arguments and the discussion in the Swedish central bank's minutes is attributed. The ECB alone among these five countries does not publish a vote or minutes.[3]

[2] This includes speeches, interviews and the Quarterly Dialogue.

[3] The ECB is not alone in not publishing a vote or minutes. Australia provides only its policy statement after the meeting and the consensus view in its minutes two weeks later; Canada and Norway provide only their policy statements. The monetary policy committees in these central banks however, do not vote, and are expected to reach a decision by consensus.

Given the lack of information provided by the ECB, it was natural that the press should be curious about how its decisions were reached and this has been a popular question at the post-meeting press conferences. On 12 April 2003, Mr Trichet assured the press that there was a consensus. On 12 February 2004 he announced there was 'a very, very large consensus'. On at least eight further occasions prior to August 2007 he claimed the Governing Council was unanimous. When he announced on 3 August 2006 that a decision was 'overwhelmingly supported', a member of the press eagerly asked if that meant there were dissenters. Trichet clarified, that '[b]y "overwhelming majority" I meant a fully-fledged consensus. There were no other views on today's decision.' On May 2006 he insisted that not only was the decision unanimous, but that the Council had thought as one: 'At today's meeting we were unanimous in our attitude, decision and overall analysis… .' Throughout the period the press repeatedly asked if any other decision than the one taken had been considered, only to have Trichet refuse to be engaged. On 5 February 2004 he insisted his answers were a 'demonstration of total transparency'.

When questioned about the ECB's lack of transparency in its conduct of monetary policy Mr Trichet's stock response has been to view transparency as being equivalent to explaining one's decisions *ex post* and to extoll the virtue of the ECB in this regard. The following response at the 3 June 2004 press conference is typical:

> 'First of all, as regards the transparency of the central banks, I have to mention again what I have already said quite a lot of times: first, that we are – to my knowledge – the first central bank in the world that has introduced a real-time display of the diagnosis of the Governing Council, of the monetary policy body. We were the first ones. We started the thing. We started the concept. We are still the only ones, to my knowledge, who publish a thorough diagnosis of the Governing Council in real time. And you will have this diagnosis – I have just read it and it will be published. Others publish short communiqués, not four or five pages of diagnosis. We probably remain the only ones among comparable central banks to have a press conference in order to be as clear as possible and as transparent as possible. For a number of reasons we consider that it is not opportune, as you know, to display the individual position of members of the Governing Council. I will not go on stressing the fact that we are very, very transparent.'

The press have not been the only ones to receive this answer. European Parliament ECON committee members were similarly brushed off at the 14 September 2005 (page 12) and 20 February 2006 (pages 14-15) Quarterly Dialogues with the ECB.

Professional economists, even ones that become central bankers, are not especially known for thinking alike and abhorring confrontation. So, how is it that – according to Mr Trichet – year after year the members of the Governing Council arrived at exactly the same conclusion at the end of every meeting? Eventually the answer became clear: there was no dissent because *votes were never taken*. This was made explicit in the 10 January 2008 press conference when Mr Trichet said, 'As you know, we do not vote and have never voted in the past.' Apparently, some small subset of the Governing Council decides, prior to the meeting, what the decision will be and this is then presented to the entire Governing Council as a *fait accompli*. This arrangement also explains how the Governing Council is able to produce the lengthy post-policy meeting statement that Mr Trichet views as the ECB's major contribution to transparency. With the decision made *before* the meeting, there is ample time to prepare it.

That this extraordinary decision-making mechanism has gone on for so long with no formal explanation beggars belief. It also leaves open a number of questions. Exactly who gets to make the decision? And, why is it that no Governing Council member has ever insisted upon his or her legal right to a vote? That one can ask these questions about an institution that is supposed to be one of the world's two most important central banks is not good for the legitimacy of such an institution. Moreover, while admittedly the arrangement functioned reasonably well in terms of economic performance under the leadership of Mr Trichet, what would happen if some future president were a little less like the current one and a little more like, say, Davíð Oddsson?

Why have both Mr Trichet and his predecessor been willing to be party to such a lack of accountability? And why have the European Parliament and its Committee on Economic and Monetary Affairs put up with this? Part of the reason may be that the structure of the ECB has meant that its Governing Council would never be able to function efficiently in a manner similar to those models of transparency the Bank of England and the Swedish Riksbank. Even prior to Slovakia's entry into the euro area in 2009 the Governing Council had 21 members: a ludicrous size for a decision-making body. It now has 23.

With 21 members, if each had gotten a ten-minute opening statement, the rate-setting meeting would have gone on for three and a half hours before any actual debate began. The optimal size for a monetary policy committee is probably about seven: just enough for reasonable collection of different types of expertise and not too big for serious discussion. With no formal way of reducing the size of the decision-making body, Mr Trichet and some of his colleagues may have opted for making monetary policy informally.

How monetary policy is made is not the only thing that the ECB has always been guarded about. At the 13 January 2005 post-policy-meeting press conference a reporter asked, 'You said the bulk of your currency reserves are dollars? How much is that?' Lucas Papademos, the Governing Council member accompanying Mr Trichet responded, 'The composition of our foreign reserves we do not disclose.'

As of 2006, 23 countries demonstrate their commitment to transparency by disclosing the currency composition of their foreign reserves. Of the world's top 25 holders of foreign exchange reserves, seven disclose their composition. Of those who do not, all but four at least adhere to the Special Data Dissemination Standard set up following the Mexican Crisis of 1994-1995 and, as part of that, disclose the amount of reserves denominated in SDR currencies in aggregate at least once per year. The four who refuse to adhere are China, Libya, Algeria and that bastion of secrecy, the ECB.[4]

[4] See Truman, Edwin and Anna Wong, 'The Case for an International Reserve Diversification Standard,' Institute for International Economics Working Paper, May 2006.

3. THE TRICHET PRESIDENCY AND FINANCIAL STABILITY

In this section I consider how well the ECB did in handling the liquidity and solvency crises and the sovereign debt crisis. I consider the effect on the ECB's legitimacy.

3.1. How did the Trichet Presidency Handle the Liquidity and Solvency Crises?

By early August 2007 the market for asset-backed securities had become dysfunctional. On 9 August BNP Paribas froze three of its investment funds after what it called the 'the complete evaporation of liquidity in US credit markets.' Overnight interest rates rose sharply. To the surprise of the markets, the Governing Council of the ECB swung into action, dousing the market with liquidity amounting to EUR 94.84 billion, followed by a further EUR 61.05 billion the next day.[5]

The initial reaction of the Governing Council to the liquidity crisis of August 2007 was to focus on the rise in interest rates: the benchmark overnight interbank interest rate had risen well above the four percent minimum bid rate in the Eurosystem's main refinancing operations. However, the real problem was not that financial institutions could not borrow at a reasonable interest rate using the good-quality collateral demanded by the Eurosystem. Instead, it was that they could not sell their asset-backed securities or use them as collateral because the markets for these assets had dried up.

The appropriate response to the situation where some markets become dysfunctional is not to offer additional liquidity in return for collateral that is still traded in functioning markets. Instead, it is to restore the functioning of the markets that have frozen. For once, however, Mr Trichet was lucky in the institutional design of the Eurosystem that he had inherited. Since its inception the Eurosystem has been able to accept a wide variety of financial assets as collateral, including private securities and asset-backed securities rated A by at least one of the major ratings agencies. However, the ECB's response probably would have been more effective if the Governing Council had immediately further expanded the set of types of securities that it accepted as collateral. This would, however, have presented a significant technical challenge as it would have had to devise some way of pricing these assets appropriately as the normal market prices no longer existed, and it would have had to additionally impose a haircut to compensate for these assets' loss of illiquidity.

As the liquidity crisis continued and widened into a solvency crisis, the ECB's policies evolved. When the spread between the three-month LIBOR and the overnight indexed swap rate widened, the ECB responded sensibly by undertaking liquidity-providing longer-term refinancing operations with a maturity of three months and offsetting these with their main (short-term) refinancing operations. They also conducted US dollar liquidity-providing operations using a temporary swap line with the Federal Reserve. In March of the following year they ventured into refinancing operations with a maturity of six months. On 8 October 2009 the ECB announced that it would provide unlimited liquidity in its weekly main refinancing operations at a fixed rate; this was later extended to its longer-term operations as well. In May 2009 the ECB announced that it would conduct unlimited liquidity-providing operations with a one-year maturity at a fixed rate.[6]

[5] An unexpected dramatic move by a central bank can reassure the markets that policy makers are taking matters seriously or it can cause them to wonder what bad news the central bank knows that they do not.

[6] The ECB had hoped to phase these non-standard monetary policies out in 2010 but they remain in place to deal with the on-going sovereign debt crisis.

It was not until 15 October 2008 that the Governing Council of the ECB made the necessary and massive changes in what was to constitute eligible collateral. Marketable debt instruments issued in the euro area, but denominated in dollars, pounds and yen, were made eligible subject to a uniform additional haircut of eight percent. Euro-denominated securities issued in the United Kingdom became eligible and, most importantly, the credit threshold for marketable and non-marketable assets was lowered from A- to BBB-, with the exception of asset-backed securities. An additional haircut of five percent was be added to all BBB-securities.

The Governing Council of the ECB's response to the liquidity crisis was a least as good as that of other central banks. But, as was the case with other central banks, the ECB appears to have been somewhat unprepared for its role of lender of last resort and market maker of last resort. The liquidity crisis of 2007 came as a complete surprise to Mr Trichet and the ECB. At the post-policy meeting press conference on 3 August 2006, Mr Trichet was asked, '[D]o you believe that concerns about financial stability or financial imbalances in the euro area have increased since the early months of this year?' He responded with, 'I will not comment on financial stability. I do not see any element that would be significant at this stage.' A year later (2 August 2007) he commented that, 'We are in an episode where prices that were under-assessing an element of risk in a number of markets are normalising. I will not give any other qualification to the situation: it is a process of normalisation.'

That the ECB was unprepared for the liquidity crisis and somewhat slow to respond is perhaps a reflection of its expertise. The freezing of credit markets – probably to a great extent due to adverse selection problems associated with asymmetric information – is a problem that is not something most macroeconomists and central bankers are especially qualified to deal with. And, not being recent practitioners it seems quite possible that many members of the Governing Council could not have explained what a collateralised debt obligation was prior to 2007. Jean-Claude Trichet's expertise and interest is clearly in the area of monetary policy, not in the area of financial markets. It is a design flaw of most central banks that the same person is in charge of both monetary policy and financial stability matters when each of these activities requires its own expertise and is a full time job.

3.2. Did the ECB's Handling of the Liquidity and Solvency Crises Enhance its Legitimacy?

When the ECB values marketable securities as collateral, it uses market prices, if they are available. If not, it computes theoretical prices. Unfortunately, the public is not informed, even with a lag to protect market-sensitive information, what these prices are. Nor will the ECB divulge its methodology or models. Without knowing how it computes these prices, outside observers cannot evaluate whether the ECB is pricing risk correctly, or instead is subsidising or taxing particular counterparties.

After deciding the value of a security, the ECB imposes a 'haircut'. Haircuts are not typically thought of as a penalty for default risk as this is supposed to be reflected in the security's value. Instead, they might be viewed as a compensation for a loss of liquidity or, perhaps, they might also be viewed as compensation for taking on the correlated default risks of the ECB's counterparty and of the issuer of the security offered as collateral by the counterparty. If there is a non-trivial risk that a systemically important institution might default and if it is not known which potential borrowers from the Eurosystem would be in danger of defaulting if that institution defaulted, then it is reasonable to increase the haircut on the debt of the systemically important institution above what it would otherwise be.

Unfortunately, the ECB does not tell us how it computes its haircuts or even what it believes a haircut is supposed to be a penalty for. Moreover some of the ECB's haircut policies seem inexplicable: why do haircuts increase rapidly with an asset's maturity even when the potential illiquidity does not necessarily do so? Haircuts that rise sharply with the remaining maturity of the collateral also encourage the issuance of short-term debt. It is therefore no surprise that euro area banks are facing massive short-term debt refinancing requirements during a period that they are also trying to access the markets for additional capital. One is left wondering if the ECB even *has* a coherent theory of how to determine haircuts.

This opacity about collateral policies is potentially much more damaging than the lack of transparency in monetary policy. In deciding what securities to accept as collateral and how to value and haircut them the Eurosystem is redistributing income and wealth.

Members of the ECON committee in their Quarterly Dialogue with the ECB have attempted to extract information about ECB's policies regarding collateral from President Trichet. However, at the December 2009 Dialogue when a member asked, 'To increase its legitimacy, the ECB should publish the minutes of the Governing Council meetings … And should not this transparency also apply to the internal models used to value [il]liquid collateral?' Trichet ignored the question and said, 'We have transformed the way transparency is looked at.' When another member asked about how asset-backed securities are valued, Trichet said, 'This is done by the system in ways which I considered appropriate but that we can improve at any time if we judge that they should be improved – as we have demonstrated very recently, because the last improvement dates from only a few days ago.' In other words: I'm not going to tell you and only our opinion matters. As long as the Governing Council is seen as competent, this view – which might almost be interpreted as verging on arrogance – may be tolerable, but on the chance that someday events may cause it to not be seen so, it would be better for the legitimacy of the organisation if the president were a little more forthcoming.

In its attempt to maintain financial stability the ECB and Eurosystem have had to walk a fine line between providing just enough liquidity to keep potentially solvent institutions afloat and subsidising the financial sector. Given the ECB's lack of transparency it is not easy to judge how well they have done at this, but a couple of examples show that they occasionally – through design or otherwise – strayed into the quasi-fiscal subsidisation and transfers territory. One example is the national central bank of Luxembourg's policy of allowing Icelandic banks to borrow from it using each other's debt as collateral. Another is the unlimited one-year fixed rate liquidity provision announced on May 2009. In June of that year 1121 banks, eager to offer up their BBB- collateral collected EUR 442 billion from the Eurosystem. An act of generosity that Willem Buiter estimates may have cost the ECB (ex ante) about a billion euros.[7] Subsidising banks – Icelandic or otherwise – is not part of the ECB's mandate. Unelected bodies should not play Santa Claus with taxpayer funds and these episodes did not enhance the ECB's legitimacy.

[7] Buiter, Willem, 'Recapitalising the Banks through Enhanced Credit Support: Quasi-Fiscal Shenanigans in Frankfurt, Maverecon, *Financial Times*, 28 Jun 2009.

4. THE TRICHET PRESIDENCY AND THE SOVEREIGN DEBT CRISIS

Jean-Claude Trichet was initially adamant that the ECB should not meddle in national governments' fiscal policy. In response to a question about whether he was worried about downgrades of member states' debt at the 8 December 2008 Quarterly Dialogue, he stated that, 'our position has always been crystal clear: governments are responsible for their fiscal policies'. Nevertheless, the ECB may have played a role in exacerbating the sovereign debt crisis and it has been forced to play a role in trying to contain it. In this section I consider how the ECB's collateral policies and the ECB's Securities Markets Programme (SMP) have been used in ways both good and bad to mitigate it.

That an unelected monetary policy maker has been pressured into playing a fiscal role was never going to be good for the central bank's legitimacy. I also consider how the actions of Trichet and the Governing Council made things better or worse than they could have been.

4.1. The Sovereign Debt Crisis and Collateral

Despite Mr Trichet's reluctance to meddle in Member States' fiscal affairs, there was one area where the Governing Council should have been responsible for assessing member countries' fiscal policies and that was in deciding when to accept and how to haircut the sovereign debt offered as collateral to the Eurosystem. Initially the policy of the Eurosystem was that all members' sovereign debt was acceptable as collateral as long as it was not rated less than A- and it was all treated identically as far as haircuts were concerned. As early as 2005, members of the European Parliament pressed Mr Trichet on the wisdom of this. At the November 2005 Quarterly Dialogue John Purvis asked, 'No member state is anywhere near down to A- and some of them are pretty profligate, so do you think the line should be a little bit tougher on what you would accept in the way as collateral?' At the same meeting Pervenche Berès asked about the wisdom of relying on the ratings agencies' judgment, given the debate on the 'credibility and quality' of their work. Mr Trichet was not to be drawn in and avoided answering either question.

It appeared that, in Mr Trichet's view, the market would appropriately price sovereign debt and that it was inappropriate for the ECB to impose any further penalties. At the December 2005 post-policy press conference he commented:

> 'We were told very often by parts of the economists' community and by a lot of good advisors that we were – and this was exactly the contrary observation – too benign, too positive vis-à-vis government paper, that we should practice a lot of haircuts and so forth, or practice haircuts combined with the Stability and Growth Pact implementation – or non-implementation. We thought that this was not appropriate. We said that it was not appropriate for us to invent a new sanction that would apply for non-compliance with the Stability and Growth Pact via this collateral mechanism. We felt that we should not do that. But we mentioned also very clearly to market people that we were taking the paper at its market value, so that if the markets would assess that the paper was less credible and the spreads would augment, then the value of the paper that we would take as collateral would diminish. And then we were sticking to this appreciation by the market itself.'

Trichet should have not have interpreted haircuts as 'sanctions' but as compensations for liquidity risk or correlation. Greece is systemically important and even in 2005 had a non-trivial default risk: the fortunes of the Greek sovereign and the financial institutions offering sovereign Greek debt as collateral were linked and the Eurosystem should have been paid a premium for this. The Eurosystem should also have exercised some discretion: banks that were known to be sufficiently exposed to Greece should not have been allowed to offer Greek sovereign debt as collateral at all.

Unfortunately, Mr Trichet's policy of allowing the markets to properly price sovereign debt was not a success. The interest rate differential between 10-year Greek and German government bonds was only about half a percent through 2007. By the end of 2008 it had reached 2.25 and was only 2.41 at the end of 2009. One explanation for this is that the market observed the complacency of policy makers and may have been perceived them as being better informed. That ECB policymakers did not speak out about the state of Greek finances, even though they must have realised by 2004 that Greece was verging on insolvency, and that they continued to accept Greek sovereign debt on the same terms as they accepted German sovereign debt must have suggested to the market that there were two possibilities. First, the ECB had superior information that suggested Greece was unlikely to be insolvent or, second, the ECB knew that euro area policy makers (or the ECB itself) would bail out Greece – or at least its bondholders and other creditors – if Greece were to become insolvent.

4.2. The Securities Markets Programme (SMP)

On 9 May 2010 the Governing Council decided, 'To conduct interventions in the euro area public and private debt securities markets (Securities Markets Programme) to ensure depth and liquidity in those market segments which are dysfunctional.' Such a programme could and would be used for two purposes.

The programme was introduced to support the price of Greek government debt and to support euro area banks that held this debt. The measure was introduced along with a suspension of any minimum threshold rating for Greek sovereign debt, announced on 3 May.[8] While it must have been deeply distasteful for Mr Trichet (and many others as well) for the Eurosystem to have to act as a fiscal player taking outright sovereign risk, the hope that it would stave off Greek insolvency until it could be handled in a more orderly way in 2013 when the European Stability Mechanism comes into force and all EU Member States ought to have created Special Resolution Regimes for their banks, may have made this a less unpalatable option then allowing Greece to default in May 2010.

The second purpose of such a programme is to prevent markets from becoming dysfunctional or to restore the functioning of dysfunctional markets. Asymmetric information problems can cause adverse selection problems that shut down a market. Or, there may be a bad outcome in a scenario where multiple outcomes are possible. Investors might refuse to hold an asset in the belief that other investors will refuse to hold it, although they would hold it if they thought other investors planned to. Undoubtedly there are various behavioural anomalies and pathologies that can also cause markets to cease functioning. If such market failures occur, it is reasonable for the central bank to intervene. If fears of contagion cause the market to shun, say, Italian sovereign debt, when it would otherwise hold it, then the ECB may be justified in purchasing Italian debt in its role of market maker of last resort. As long as the ECB

[8] The ECB suspended its minimum ratings threshold for Irish sovereign debt on 31 Mar 2011. Perhaps it was supposed to be implicit that that they required the Greek and Irish sovereigns not to be in default.

prices the debt prudently, then the ECB is acting within its capacity as a monetary authority.

For the ECB to be able to ensure markets remain functional it must be credible that it will purchase as much debt as it takes at the price it deems sensible. The ECB's purchases of small amounts of Portuguese and Irish debt and its refusal to intervene in the markets for Spanish and Italian debt clearly did not send the right message on Thursday 4 August 2011.

The Securities Market Programme has made the ECB's continued insistence on secrecy particularly damaging. A counterparty who can sell, say, Greek government debt to the Eurosystem at a price that it could not get in the market is better off than another potential counterparty that is not given that opportunity and it gains at the expense of the Eurosystem. Because the Eurosystem's purchase of Greek sovereign debt at prices above fair value (which appears to have been the case, as the average discount to face value paid for the Greek debt acquired under the SMP is widely believed to have been no more than 20 percent) amounts to a taxpayer subsidy of the Eurosystem's select counterparties, the ECB must be transparent about how it has chosen and continues to choose its counterparties for Securities Market Programme transactions. Once sufficient time has passed to ensure that the information is no longer market sensitive, the details of these outright purchases should be publicly available. Otherwise, one does not have to be a conspiracy theorist to imagine that the euro area taxpayers are being called upon to subsidise German and French banks after their own governments and government agencies failed to exercise proper regulation and supervision.

5. THE CHALLENGES FOR THE NEW PRESIDENCY

Incoming ECB president Mario Draghi does not face an enviable situation. The sovereign debt crisis is gaining strength, dampening the economic recovery that might have otherwise been expected to follow the liquidity and solvency crises. The institution inherited by Mr Draghi is not fit for purpose. His predecessor set a relatively high standard for competency, but damaged the legitimacy of the organisation.

It is clear that the Eurosystem as monetary policy maker and financial supervisor needs to be reformed and this requires a change in the Treaty which is no mean feat. A very thin silver lining in the economic black cloud is that it may be that crises facilitate reform. It is argued that crises shake up entrenched interest groups, increase the acceptance of the need for change and makes groups realise that their political interactions must change.[9] The current situation may be conducive to policy change.

The Governing Council of the ECB is a preposterously badly designed monetary policy committee. Making monetary policy is primarily a technical task and requires discussion. Committees with well over twenty members do not have discussions. The Executive Board or the Governing Council might be allowed to choose the precise definition of price stability, but it would be better to make the committee that sets the policy rate to attain that target a separate and independent entity with about seven members. Perhaps it might have three members from the Executive Board and four external members – and preferably not Governors of Eurosystem national central banks. Externals reduce the possibility of groupthink and lend expertise that senior policymakers do not always have. There is no reason to require that the externals be euro area or even EU citizens: for a complex technical activity, whether its monetary policy or neurosurgery, it is generally best to get the most competent people you can afford. Objections that all countries need a voice should be recognised as counter to the spirit Article 7 of Protocol 4 of the Treaty (consolidated version) that says governments of the Member States are not to seek to influence the members of the decision-making bodies. Monetary policy decisions, other than choosing the policy rate, might be delegated to the Executive Board.

The Governing Council of the ECB was also not well designed to deliver financial stability. As prior to August 2007 its efforts were primarily focused on monetary policy, it lacked the necessary expertise. Moreover, those members of the Executive Board who were actively involved in formulating monetary policy and explaining it to the public, press and policy makers already had a sizable job. If the monetary policy committee were made separate from the Governing Council and Executive Board then some Executive Board positions could be filled by micro-economists, financial economists, recent practitioners and experts in money and banking.

Monetary policy committees need to be independent so that they are protected from politicians who might be tempted to use monetary policy opportunistically. Central banks do not have a similar need to be independent. It would not be optimal to have the ECB completely subject to legislators – as is the Federal Reserve – but the European Parliament's role as overseer might be enhanced. The Quarterly Dialogue should be renamed the Quarterly Testimony.

[9] See, for example, Drazen, Allan, *Political Economy in Macroeconomics*, Princeton, Princeton University Press, 2000, ch. 10. This hypothesis is difficult to test because of the difficulty in measuring crises and reforms.

As a protector of financial stability the Eurosystem needs to act as lender and market maker of last resort. To be credible it must be willing and able to commit an unlimited amount of funds. If it prices assets correctly and haircuts liquidity and correlation risk appropriately this involves no *ex ante* fiscal cost. If it is credible that the ECB is willing and able to do this it may avert many financial crises associated with adverse selection and multiple equilibria without ever 'acting' in the sense of actually making asset purchases or injections of funding liquidity. However, if it must act then there is always the possibility of an *ex post* loss. This suggests that arrangements for recapitalising the Eurosystem should be in place.

To protect its legitimacy the ECB must realise that there is an important distinction between accountability and providing a post-policy-meeting statement, even if it is five pages long. This is true even if the post-policy-meeting statement is not 'pre-cooked' the way is has been up till now. The monetary policy committee should start taking votes, reporting the outcomes and publishing the minutes.[10] The Governing Council should publish its models for determining haircuts and theoretical prices of illiquid marketable assets.

In addition to improving its accountability, the ECB should resist roles that are not assigned to it. While Mr Trichet may have felt that he had no choice other than to purchase Greek debt under the Securities Market Programme, it is not the proper function of the Eurosystem to redistribute tax payer money. He should only have agreed to do so as a fiscal agent, not as a fiscal principal, that is, with a full joint and several guarantee for all SMP purchases from the euro area governments. His successor should insist on releasing the details of how counterparties were chosen and the prices that the ECB paid.

[10] Recent public disagreements within the Executive Board may get it used to the idea that it need not speak as one.