Changing of the Guard
Monetary Dialogue
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COMPILATION OF BRIEFING NOTES

Abstract
On 31 October 2011, the eight years term of Mr Jean-Claude Trichet as ECB President will end. Mr Mario Draghi will succeed in office. This change of leadership in the ECB comes at a pivotal time for the euro area and the European Union as a whole.

In this compilation nine monetary policy experts review the Trichet Presidency, especially evaluate the difference that the President has made through his own person and evaluate the challenges with which the new ECB President, Mr Draghi, has to deal with.
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EXECUTIVE SUMMARY AND ABSTRACTS

Nine experts reviewed the ECB Presidency of Mr. Trichet and evaluated the challenges lying ahead for the incoming ECB President Mr. Draghi.

Mr. Trichet's Presidency

According to a majority of the experts Trichet delivered well on the primary task of the ECB during his term: guaranteeing price stability. Some experts accredited him also for his effective communication to the press and the guarding of the independence of the institution.

Crisis management got a far more controversial reaction from the panel. Acknowledging an unprecedented crisis, making unconventional policy measures necessary, the range of views expressed reached from ‘[h]andling the financial crisis was Trichet's master piece’ (Collignon) or ‘[b]y using extraordinary and unconventional monetary policy measures he avoided through his personal courage so far a worst case scenario’ (De la Dehesa) to '[t]he track record during this period is decidedly mixed and worrisome' (Wyplosz). Especially the Securities Market Programme drew criticism, as Daniel Gros puts it: 'Continuation of the Securities Market Programme (SMP) on a large scale risks fracturing the Governing Council, but abandoning the SMP totally might lead to an even bigger financial crisis and the end of the euro.' Anne Sibert examines the transparency of the ECB and argues that '[t]he Securities Market Programme has made the ECB's continued insistence on secrecy particularly damaging'. She sheds also some light on the legitimacy and effectiveness of the ECB during the term of Mr. Trichet. She concludes that '[h]is notorious opacity about the decision-making process, however, has probably damaged the ECB's input legitimacy', especially '[t]he ECB's opacity about collateral policies is potentially much more damaging than the lack of transparency in monetary policy'.

'But his legacy is unfinished' (Wolff) and 'the effects from Trichet's previous policy actions are still in the pipeline' (Belke).

Mr. Draghi's Challenges

There is no doubt that the incoming ECB President Mr. Draghi will face a lot of difficult challenges, mainly related to the financial and sovereign debt crisis.

'Major tasks during the new Presidency will be preventing a deterioration of the crises, pushing harder for a fiscal union within his mandate and taking further steps making the ECB more accountable and efficient' (De la Dehesa). One of the challenges will be 'a clear separation of responsibilities between the ECB and ESRB for monetary policy and macro-prudential supervision and the EFSF for fiscal policy and structural reforms in the Member States facing austerity measures' (Eijffinger). Daniel Gros points in the same direction by stating that '[t]he key challenge for Mario Draghi will be to redefine the role of the ECB in the context of the euro crisis. The core problem is simple: the European Financial Stability Fund (EFSF) simply does not, and will not, have enough funds to undertake the massive bond purchase required to stabilise financial markets'. He recommends to register the EFSF as a special credit institution with 'access to re-financing by the ECB in case of emergency'.

The newly emerged role of the ECB is also acknowledged by Guntram Wolff. He recognises the transformation of the ECB 'into an institution with far reaching executive authority and competencies', as a result of 'the lack of strong political leadership' and 'the absence of alternatives'. However, this new 'role of the ECB needs to be re-calibrated in the future' and '[o]verall, the ECB's role will likely be reduced in the future and the roles exercised will have to be matched by an increase in democratic accountability'? Additionally he adds a new dimension to the discussion by stating 'trust of citizens in the ECB has fallen according to
the Eurobarometer survey and needs to be regained by addressing the challenges outlined.‘
Besides this he concludes that the most important task will still be ‘to credibly continue to
anchor inflation expectations’.

The development of an adequate 'exit strategy' is another challenge: 'Trichet has handed
over to Draghi the problem of "addict bank" that are reliant on ECB liquidity' (Whelan).
Finding and adequate 'exit strategy' will be one of the main challenges handed over to Mr.
Draghi.

Charles Wyplosz address explicitly ‘the issue of how Board members are appointed. The
current "spoil system", which reserves a seat for each of the four largest countries, should
not be tolerated any further. We need the best possible candidates that Europe can offer'.
Guntram B. WOLFF - 1. Changing of the guard - Huge challenges ahead for the new ECB President

Jean-Claude Trichet deserves the highest praise for fighting inflation and for his handling of the crisis. But his legacy is unfinished and we still have to see whether he will be the one who saved the euro.

The ECB has become an institution with far-reaching executive authority and competencies. This has been the result of a combination of factors, the lack of strong political leadership in the euro area and the absence of alternatives being the most important one. But this strong increase in executive powers has come at a price, and the role of the ECB needs to be re-calibrated in the future: i) The trust of citizens in the ECB in programme countries has fallen dramatically. The ECB should reconsider its strong involvement in the design of financial assistance programmes. It should soften the stance on sovereign debt restructuring and burden-sharing and in the case of Greece it should become the advocate of a clear debt cut at the expense of the financial sector; ii) Since the Security Markets Programme has been very controversial in some Member States, the ECB has to make greater efforts to explain its policy actions and needs to continue arguing for a viable fiscal solution to replace the lender-of-last-resort function; iii) The most important task for the ECB will be to credibly continue to anchor inflation expectations, iv) I have not discussed the changes of monetary policy strategy implied by the new emphasis on financial stability. To what extent should the ECB lean against the wind with monetary policy when it sees asset market bubbles emerging? How would its greater financial stability responsibility shape its monetary policy strategy? What should be done in case of a trade-off between inflation and stability? What role should the European Parliament have in holding the ECB to account?

Overall, the ECB’s role will likely be reduced in the future and the roles exercised will have to be matched by an increase in democratic accountability.

Charles WYPLOSZ - 2. Changing of the guard at the ECB

President Trichet's first half of mandate has run smoothly and strengthened the ECB's credibility as a dedicated inflation fighter. It has been marked by the Great Moderation, years of sustained growth in Europe and in the world, with few episodes of inflationary pressure.

The second half has brought extraordinary challenges, especially as sovereign debt crisis is spreading through the euro area. Although is has been made even more difficult as the result of poor institutions and dithering governments, the ECB's responses to the crisis have been unsatisfactory. Through its President statements, the ECB ruled out key steps that proved to be unavoidable and, more generally, failed to anticipate market reactions.

Why is the record of the ECB during the crisis open to serious criticism? Besides the extreme difficulty of the task and the continuous interferences from dazzled political leaders, the ECB has left an impression of disarray. Whether it is 'group think' that has cut if off from external debates, or whether internal divergences have led the ECB to focus on finding agreements rather than anticipating the next steps of the crisis, there will be a clear need to evaluate its performance.

The crisis has also reminded us that, beyond the presence of some highly talented individuals, the overall quality of ECB management does not compare favourable with what can be found in most other leading central banks. This raises the issue of how Board members are appointed. The current 'spoil system', which reserves a seat for each of the four largest countries, should not be tolerated any further. We need the best possible candidates that Europe can offer.
Sylvester C.W. EIJFFINGER - 3. Changing of the Guard

The enlargement of the EFSF should be part of a comprehensive approach of strengthening the Stability and Growth Pact. As a consequence the Securities Market Programme (SMP) could be terminated and the ECB’s portfolio of government bonds could be transferred to the EFSF for the ECB’s book value. This would reduce the tensions within the ECB Governing Council and enable the ECB to focus on its direct mandate for monetary stability and its indirect responsibility - through the European Systematic Risk Board - for financial stability. This would result in a clear separation of the responsibilities between the ECB and ESRB for monetary policy and macro-prudential supervision and the EFSF for fiscal policy and structural reforms in the Member States facing austerity measures.

The ECB will be confronted with possible trade-offs between monetary and financial stability, which could be solved by changing its mandate for price stability from the medium term to the longer term (longer than two years). Consequently, the two-pillar strategy of the ECB could be adapted that its economic analysis focuses on price stability in the medium term and its monetary analysis on financial stability in the longer term. The Bank of Japan’s analysis and strategy could be taken as an example to merge the responsibilities for monetary and financial stability in the medium and longer term. The two-pillar strategy offers an excellent framework for a time-consistent approach of preserving monetary and financial stability.

It is up to Mr. Draghi as the new President to give guidance to the ECB through this terra incognita.

Daniel GROS - 4. Change of Guard at the ECB: How to limit the damage

The ECB is clearly not responsible for the era of lax supervision and fiscal policy of the mid-2000s and fought valiantly against the relaxation of the Stability and Growth Pact. However, during that long period of excessive credit growth, it could have acted by using the interest rate tool to pursue price stability and structural measures to pursue financial stability. Moreover, the ECB would have kept its reputation intact and maintained cohesion within the Governing Council if it had recognised earlier that Greece represented a problem of insolvency.

The incoming President now faces one key challenge that might be put in fairly stark terms: save the ECB and fracture the euro or fracture the ECB to save the euro? Continuation of the Securities Market Programme (SMP) on a large risks fracturing the Governing Council, but abandoning the SMP totally might lead to an even bigger financial crisis and the end of the euro.

We show that there is a middle ground that preserves the euro, but avoids deepening the internal split within the Governing Council of the ECB by transferring the responsibility for secondary market intervention to the EFSF, while giving it access to ECB liquidity.

Guillermo DE LA DEHESA - 5. Changing of the Guard - Trichet’s Track Record and Challenges Ahead for Draghi

During his term as ECB President Jean-Claude Trichet has faced huge challenges and under these difficult situations he has shown his leadership and courage. Most of the challenges were derived from euro area design failures, difficult to face, because he did not have any political decision making power, but only influence. He had to deal with two major, interconnected crises, a great financial crisis and a subsequent sovereign debt crisis. Overall, his track record is quite positive. By using extraordinary and unconventional monetary policy measures he avoided through his personal courage so far a worst case scenario. Among his pluses are: i) He introduced a major improvement in communicating...
the Council policy rate to the markets, which increased the ECB's credibility and efficiency.

ii) After the financial crisis and the recession that followed the Council was able to avoid bringing the policy rate level to zero. iii) His personal courage, with the support of the majority of the Council, for taking extraordinary and necessary measures.

Among his minuses are: i) the Governing Council was too slow to raise policy rates at the beginning of his mandate and it was too quick to raise policy rates up to 4.25% in July 2008. ii) When the Stability and Growth Pact failed in 2003, financial markets did react by disciplining that relaxation. Accordingly, the ECB should have taken a more leading role in disciplining them by discriminating the price of governments bonds that it accepts as collateral. iii) The ECB's accountability and transparency, both by transforming the "Monetary Dialogue" with the ECON Committee into a true "Monetary Hearing" and by publishing the minutes and voting records of the ECB Council decisions.

Mr. Mario Draghi is going to inherit an extremely difficult and uncertain financial situation. Major tasks during the new Presidency will be preventing a deterioration of the crises, pushing harder for a fiscal union within his mandate and taking further steps making the ECB more accountable and efficient.

Anne SIBERT - 6. Changing of the Guard

In assessing Mr. Trichet's tenure it is important to judge the performance of the ECB and the effect of his tenure on the institutions legitimacy. Its legitimacy effects its future effectiveness. The ECB performed well in targeting price stability prior to August 2007 and the policy decision had been explained well by Mr. Trichet. However, his notorious opacity about the decision-making process has probably damaged the ECB's input legitimacy. 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 certainly in the area of monetary policy, not in the area of financial markets. The ECB's opacity about collateral policies is potentially much more damaging than the lack of transparency in monetary policy. In its attempt to maintain financial stability the ECB have had to walk a fine line between providing just enough liquidity and subsidising the financial sector. Occasionally Mr. Trichet has strayed into the latter territory. Mr. Trichet's policy of allowing the markets to properly price sovereign debt was not a success. The Securities Market Programme has made the ECB's continued insistence on secrecy particularly damaging.

Mr. 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.

Karl WHELAN - 7. Trichet's ECB Presidency: A true age of turbulence

Under Jean-Claude Trichet, the ECB achieved an average rate of price inflation in line with its target. In this sense, Trichet achieved the principal goal that has been set for the ECB, and thus his term has been a success. In addition, Trichet's performance at the ECB press conferences and other public events have been incredibly effective in communicating the organisation's independence and commitment to price stability. However, while the ECB's initial response to the global financial crisis was effective, its response to the euro era debt crisis has been far less impressive. Trichet has been dogmatic and unhelpful on the question of debt defaults and significant questions remain about the long-run impact of the Securities Market Programme of the ECB and the future of the euro.

Mr. Draghi faces an exceptionally difficult set of challenges: i) In relation to monetary policy decisions, there are severe tensions between the core of the euro area, which has been
undergoing a modest recovery, and the periphery, which is still struggling with recession. ii) A sceptical German public has to be convinced, that he is the right man for the job. iii) The ECB has embarked on a rate-hiking cycle at a time when many believe the world economy is heading for a double-dip recession; iv) Many euro area banks are reliant on ECB liquidity. With bank funding tensions on the rise again, the ECB is again moving away from talk about its 'exit strategy'. Working out when and how will be a difficult task.

Of course, the sovereign debt crisis will be one of the main challenges. The ECB's official view is that the Securities Market Programme is only temporary. However, it is not clear, that the European Financial Stability Facility (EFSF) will be big enough to backstop Spain and Italy for the next few years.

Ansgar BELKE - 8. Change of Guard from Trichet to Draghi - Watch or not to watch money under political constraints

The effects of Trichet's monetary policy actions are still in the pipeline and will become the challenges for the term of Mr Draghi. Most important, excessive money creation has finally led to excess liquidity, excess credit and a persistently increased leverage in the euro area. Mr. Trichet abrogated the market based interest rate mechanism for sovereign debt throughout the euro area. The costs and benefits of this venture are evaluated against the backdrop of the fact that the potential scope for public debt is much lower for a country within a monetary union because it should not and cannot resort to seigniorage and the inflation tax to finance it.

Among the main challenges for Mr. Draghi is the potential dramatic worsening of the euro area debt crisis since up to now no sustainable institutional solution is found. On top of that that Mr. Draghi will be confronted to a larger extent than his predecessor with challenges concerning international liquidity spillovers and the reform of the international monetary system.

Stefan COLLIGNON - 9. European monetary policy under Jean-Claude Trichet

Since January 1999, the ECB has gone through three major phases: foundation, consolidation and financial crisis. Through all this period the ECB has achieved its primary and secondary objectives with remarkable precision. We estimate a reaction function and find that under Trichet, increased credibility and a more stable macroeconomic environment allowed monetary policy to shift focus in favour of employment and financial stability. Handling the financial crisis was Trichet's master piece, although Member States have not made it easier for the bank.

Mr. Draghi will face the following major challenges: i) Solving the debt crisis. ii) Terminating non-standard monetary policy operations as the situation in European financial markets normalises. An important distinction may have to be made between the liquidity situation in the money market and in bond markets, which will remain distorted by sovereign debt for a considerable period of time. iii) Since the present level of interest rates is not sustainable over the medium run and probably not even compatible with the present level of core inflation, it has to be decided about the speed of raising interest rates back to levels above 2%, i.e. to levels where expected interest rates are positive in real terms. iv) An additional challenge is the evolution of the global economy, especially the risks of a global recession. v) The global economy will profoundly change over the next eight years - shifting of the growth centres to Asia and Africa, an aging population will require new social and fiscal policies.

We conclude by saying:

Bravo et merci, Monsieur Trichet! And Buona fortuna, President Draghi!
BRIEFING NOTES - CHANGING OF THE GUARD
Changing of the Guard – Huge challenges ahead for the new ECB President

Guntram B. Wolff

BRIEFING NOTE 1

Abstract
Jean-Claude Trichet deserves the highest praise for fighting inflation and his handling of the financial crisis. But his legacy is unfinished and we still have to see whether he will be the one who saved the euro. Important challenges remain for the incoming president. First, a rate cut should be considered at this point in time but political pressure to increase inflation needs to be resisted in the future. Second, the ECB’s stance on Greece needs to be reversed both as regards financial sector participation and SMP. The SMP for Italy can be justified but can only be a temporary solution. The ECB will therefore have to further push for a fiscal lender-of-last-resort back-stop that can also exercise conditionality. Third, trust of citizens in the ECB has fallen according to the Eurobarometer survey and needs to be regained by addressing the challenges outlined.
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LIST OF ABBREVIATIONS

**ECB**  European Central Bank

**EONIA**  Euro OverNight Index Average

**EFSF**  European Financial Stability Facility

**ESM**  European Stability Mechanism

**ESRB**  European Systemic Risk Board

**GDP**  Gross Domestic Product

**IMF**  International Monetary Fund

**MRO**  Main Refinancing Operation

**SMP**  Securities Markets Programme
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EXECUTIVE SUMMARY

During the eight years of Jean Claude Trichet’s presidency, the ECB has faced unprecedented challenges. Under Trichet’s leadership, the ECB has become an institution with far-reaching tasks and responsibilities. History books will emphasise that Trichet’s ECB fully discharged its primary mandate of maintaining price stability. The ECB under Trichet’s leadership has received, and deserves, the highest praise for its handling of the financial crisis of 2007-2009, having been very quick to react and effectively avert a Great Depression and financial melt-down. But Trichet’s legacy is unfinished. We still have to see whether he will be the ‘man who saved the euro’ and a lot will depend on whether his successor and the other key decision-makers in the euro area will rise to the remaining challenges.

I focus on three main challenges for the incoming president and the institution he will lead.

First, the ECB will have to continue to focus on price stability. At the current juncture, a rate cut should be considered. At the same time, the ECB needs to remain credibly committed to its primary mandate and fend off rising demands for higher inflation to solve the debt crisis.

Second, the ECB will have to rethink its role in the sovereign debt crisis. This involves reversing the policy stance on Greece and supporting a solution that shares the burden more broadly, including with the financial sector. Admitting that the Greek Securities Markets Programme (SMP) was a mistake will also allow it to more forcefully justify the need for an SMP in the current situation concerning core euro area countries.

At the same time, the ECB will have to continue Trichet’s legacy in advancing the formation of a true euro area fiscal authority that can take up the lender-of-last-resort function and exercise conditionality. The executive role of the ECB in the design of financial assistance programmes should be revisited in light of the new EFSF.

Third, the ECB president and euro area leaders will have to regain the trust of citizens in the ECB. Eurobarometer data document a dramatic fall-off in trust during the sovereign debt crisis.

I argue that trust will be regained with more democratic accountability, by addressing the second challenge related to the role of the ECB in the debt crisis and by continuing to credibly defend price stability. The European Parliament is key in reshaping the role of the different institutions in the emerging new governance structure and in holding all actors to account.
1. THE TRICHET PRESIDENCY

When Jean-Claude Trichet took office as the president of the European Central Bank on 1 November 2003, he started on what has turned out to be a long journey. Nobody at the time expected his presidency to be marked by the events that we have seen in the last eight years.

Commentators of the time were giving him credit for his uncompromising stance in keeping inflation in check. The Süddeutsche Zeitung, for example, had the headline: ‘Trichet’s accession - new ECB president for a strong euro’. Newspapers trusted that the ECB would continue to focus on price stability and German media praised Trichet’s emphasis on sticking to the Stability and Growth Pact. Commentators were divided on whether he should raise or lower rates. The Spanish newspaper La Razon thought that: ‘Trichet, known for his pragmatism and adherence to the principle of price stability, is not expected to try to make fundamental changes in monetary policy.’

How different is our view of the ECB now, and how much has happened in these eight years. Jean-Claude Trichet will be remembered as the most important person in the euro area besides Angela Merkel and Nicolas Sarkozy. He will be remembered as the person who transformed the ECB from a normal central bank into an institution whose influence extends much beyond its formal mandate.

Under Jean-Claude Trichet’s leadership, the ECB successfully fulfilled its primary mandate of preserving price stability. Average annualised inflation in his eight-year term has been 2.02%. This is about as close as one can get to ‘close but below 2 percent’ in the circumstances. This is a major achievement for him personally as well as for the whole eurosystem.

Jean-Claude Trichet will be remembered for revolutionising ECB communication with the market and public at large. He was elected ‘European Banker of the Year 2007’ by the journalists’ association ‘The Group of 20+1’ for his clarity in communication that supported the credibility of the euro. This helped markets to understand and anticipate future ECB action. Certainly, Mr Trichet managed to impose discipline over ECB communication.

Jean-Claude Trichet will also be remembered for calling for strong structural reforms and strict adherence to the Stability and Growth Pact from the outset of his presidency. In the early years, his analysis of problems may sometimes have underestimated the relevance of intra euro area divergences and the consequences this may have for monetary policy. But he was clearly among the loudest and most vocal defenders of structural reforms and fiscal rigour. At the latest as of 2007, he and the ECB were very vocal in asking for the divergence in unit labour costs in the euro area to be addressed. In these warnings, he was clearly ahead of other institutions such as the European Commission in its outside communication, for example in the Eurogroup. Also in the recent discussion on the governance reform of the euro area, the ECB played a prominent role.

The ECB under Jean-Claude Trichet’s leadership will be remembered for addressing the financial crisis of 2007-2009 forcefully and avoiding major damage to the euro area and global economy. When the fall-out of the financial crisis appeared, the ECB did not hesitate to do what was necessary to safeguard the stability of the financial system.

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1 See for example the speech by Jean-Claude Trichet in Helsinki, at the Bank of Finland 200th Anniversary Conference (5th May 2011).
system. On 9 August 2007, the Dow Jones Industrial Average fell by nearly 400 points due to credit worries. Canadian and European stocks also fell. The European Central Bank, United States Federal Reserve and Bank of Canada all injected money into their credit markets to ease concerns. In fact, the ECB provided liquidity to banks even before the Fed acted. Together with the Federal Reserve, the ECB was the key player in preventing a global great depression. Jim O’Neill, at the time head of global economic research at Goldman Sachs judged that: ‘The speed at which the ECB responded and its steady tone [...] have been quite impressive.’ Only the July 2008 rate hike was a monetary policy mistake in this period, even though it is of comparatively minor significance. Overall, the ECB fully rose to the exceptional challenge of the financial crisis and fulfilled its lender-of-last-resort function to the financial system.

**Under Trichet’s leadership, the ECB became an institution with far-reaching competencies and broad executive authority.** The ECB was initially conceived as a purely monetary policy institution. Some people even perceived the institution as only deciding on the interest rate. The ECB has taken on a leading role in assuring financial stability in the euro area. In the new financial supervisory architecture, the ECB president plays a leading role in assuring systemic financial stability by heading the European Systemic Risk Board (ESRB). In discussions in the Eurogroup and Euro Working Group, the ECB has become the central actor with its voice in many instances carrying great weight even in areas that are the primary responsibility of the European Commission, such as the Stability and Growth Pact. Jean-Claude Trichet and his board have plugged a huge gap in the discussions about the future governance of the euro area. They have developed ideas about how to design the macroeconomic and fiscal surveillance of the euro area in a different way, and Jean-Claude Trichet has sketched a vision of a common European finance minister.

**Jean-Claude Trichet’s true legacy is about how he has transformed the ECB as an institution in the overall set-up of EMU. However, the jury is necessarily still out on whether he will be the man who saved the euro.** Certainly, history books will remember him as the man who took extraordinary, strong, courageous and sometimes controversial steps to save the euro in the sovereign debt crisis – the most controversial certainly being the Securities Markets Programme (SMP). But unfortunately the crisis is not over. Whether he will go down history as the ‘man who saved the euro’ or as ‘the central banker who went too far’ is therefore not yet decided. It will depend on whether Mario Draghi and euro area policymakers will be up to the task of solving a number of important challenges which still hang over the euro. In the next section, I want to focus on three of these challenges faced by the euro area as Mario Draghi prepares to assume the presidency of the ECB at this crucial time.

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3 For a description of the ESRB, see Wolff and Merler (2011)
2. CHALLENGES AHEAD FOR THE NEW ECB PRESIDENT

2.1. Defining the right monetary policy stance and keeping inflation expectations well anchored

The core mandate of the ECB is to maintain price stability. Therefore, the new President will have to continue to keep a clear and vigilant eye on any risk of missing the inflation target. The ECB governing council has decided to increase the main interest rate twice this year. The first rate hike on 13 April 2011 by 0.25 percentage points to 1.25% was fully justified. Inflation expectations as derived from inflation swaps had been increasing since August 2010, and 2, 5, and 10-year expectations had clearly exceeded the definition of price stability by the ECB of close but below 2 percent (see Figure 1). Also other measures of inflation expectations such as the consensus forecast had been on an increasing path.

It is more difficult, however, to follow the logic of the second rate hike to 1.5 percent on 13 July 2011. One and two year inflation expectations had already been below 2 percent before the meeting, and five-year inflation expectations were standing at 2.01 percent before the meeting on 11 July 2011. Only 10-year inflation expectations were standing above the medium-term inflation target. In addition, at the time of the July meeting, it had already become clear that economic data for Germany showed a significant weakening of activity, and activity in other major euro area economies had been weak for some time already.

Policymakers have, however, been caught by surprise by the massive fall in stock markets in recent weeks. This decline in asset prices further contributes to a weakening in activity as it constitutes a fall in wealth, thus dampening consumption and investment. I would therefore advise to consider afresh the case for a gradual reduction in the interest rate. A reduction in the main ECB rate (main refinancing operations - fixed rate tenders) would also bring the monetary policy stance into line with liquidity

Source: Datastream

Source: Datastream, ECB
provision of the ECB to the euro area banking system. Since the beginning of the crisis, liquidity provision of the ECB has been too large compared to the monetary policy stance (see Figure 2). *De facto*, there has thus been a more accommodative stance. The increase in the main ECB rate was clearly meant to signal a normalisation of monetary policy conditions. The simultaneous decline in the EONIA, however, indicates that the ECB rate decision was in disconnect with the liquidity needs to the financial system.

All in all, given the weak economic activity data, the recent global slowdown as well as the clear downward trend in inflation expectations, a clear case can be made to carefully consider the case for a rate reduction. At the same time, the ECB president and the governing council will need to keep a close eye on the medium- to long-term inflation expectations and the rising debate about inflation as the best way to address the euro area debt crisis. If market participants start to believe that ECB independence and commitment to that goal may be weakened, inflation expectations will pick up very quickly, putting the economic system under heavy stress.

The ECB will also need to step up its communication effort so that economic actors better understand that a credible inflation commitment does not imply that inflation rates will be equal in all euro area countries. In fact, inflation rates in German and the core euro area countries will have to exceed two percent in the coming years. In turn, inflation rates in the southern European countries with competitiveness adjustment needs will need to be below two percent. This logic is still not widely understood.

2.2. Revisit the role of the ECB in the debt crisis

The new ECB president will need to carefully reconsider the role the ECB should play in the debt crisis. This task has various dimensions.

A) The ECB has taken a strong stance in the question of burden-sharing for insolvent governments. In the case of Greece, the ECB initially argued that all the burden of adjustment should be placed on the Greek taxpayer. I know of only very few economists who believed that this would be a strategy that would work.

From the outset, Greek debt sustainability was questioned by independent economists as well as by the IMF. Very soon after the details of the first Greek programme were announced (10 May 2010), most economists agreed that there was a high probability that the programme would not work, especially given the high interest rates charged on the assistance loans. The IMF entered into the programme with Greece despite considerable uncertainty as regards the solvency of Greece. The IMF considered the risks to the programme to be high (IMF staff report, 'Request for Stand-By Arrangement', 5 May, 2010). It nevertheless entered into the programme with the purpose of ‘safeguarding financial sector stability and reducing the risk of international systemic spillovers.’

The policy community including the ECB continued to act as if in denial of the Greek facts for more than one year, thereby contributing to uncertainty. Only on 21 July 2011 did the European Council accept that the programme would not work and came up with a new programme. This long period of denial of reality is remarkable. In the eyes

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5 It is questionable whether liquidity provision and the monetary stance can be fully separated, suggesting that the monetary policy stance was also more accommodative.


7 While the fundamental mistakes of charging very high interests rate without any debt reduction was acknowledged, the new programme also still falls short of what is needed.
of many, it undermined trust in euro area policymaking. Moreover, the looming uncertainty about the eventual course of action given the inevitable also contributed to market stress.

The most convincing argument for having entered into the Greek programme was that this would give time for the market and for policymakers to prepare for the inevitable. In particular, it was hoped that delaying necessary restructuring would help the banking system to regain strength. However, euro area policymakers did not prepare for a restructuring. They also did not do enough to force the banking system to recapitalise.

In preparation for the 21 July summit this year, which aimed at solving the Greek problem, the ECB again took a strong position. It refused to contribute to a solution that would involve private investors. It is unprecedented that a technocratic institution could play such a role. De facto, the ECB committed taxpayers’ money without the consent of national parliaments. Unfortunately, the deal for Greece is unfinished with two still unresolved issues: the extent of involvement of the private sector and the guarantees creditor countries will get in exchange for further loans.

While certainly financial stability considerations are an important argument for reducing private sector involvement in the Greek deal, the ECB should have provided compelling evidence to convince policymakers and the national sovereigns that the euro area financial system would not be able to withstand a loss in the order of magnitude of 1% of euro area GDP. Another argument advanced was that a debt restructuring in one country would lead to the exit of that country. However, Darvas (2011) convincingly shows that this is a very far-fetched assumption. Finally, the argument was made that preventing a Greek debt restructuring would avoid any increase in spreads in other euro area economies. This strategy obviously did not work. Markets reassessed sovereign bonds all across Europe in the face of the lingering uncertainty created by euro area policymaking and in light of structural news from other economies, including of course political instability in Italy recently.

The incoming president should consider carefully whether such a strong role is appropriate for a non-elected technocratic institution and whether it may undermine the legitimacy of the ECB and its ability to take unpopular monetary policy decisions.

B) The ECB has become a very strong player in designing the nuts and bolts of the programmes and the associated conditionality. This is a remarkable increase in power and scope of what a typical central bank does. This increase in scope of action is certainly also the result of the interest of a number of member states. The new ECB president should nevertheless carefully consider whether such a strong executive role is desirable in the new framework. Certainly, an EFSF/ESM with enlarged powers and staff could take over many of the tasks currently performed by the ECB. The European Parliament should ask for a reconsideration of the respective roles of the Commission, ECB and ESRB in this regard.

C) Opinions on the Security Market Programme (SMP) of the ECB are divided across Europe. This division of opinion by itself has become a problem for the ECB as I will show below (section 2.3).

Any discussion of the SMP needs to take into account the incomplete institutional set-up of the euro area, which led the ECB into taking responsibilities for which it

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8Of course, other reasons may explain the ECB position on Greek debt restructuring. The ECB itself always argued that such a restructuring would have had negative consequences for financial stability and lead to a second ‘Lehman Brothers’. However, if that had been the main motive of the ECB, it should have provided much clearer evidence in this regard. Within the ESRB as well it failed to advance the discussion sufficiently in this direction.
was not originally designed. In fact, the euro area crisis has exposed deep deficiencies in the governance of Economic and Monetary Union. It took several months – after the start of what was initially the Greek crisis – for the euro area to put in place instruments which, although useful, are still proving insufficient to extinguish the fire. To date, the euro area still does not have a full, unified lender of last resort. Irrespective of what one thinks of the wisdom of the SMP itself, one has to acknowledge that only the ECB has the technical capability to do this. If a decision had been taken to buy Greek government bonds, only the ECB could have done it. Obviously the ECB could have used its independence and refused such purchases. It would then, however, have known that no other institution could have played this role.

Buying government bonds of the insolvent Greek government constitutes a significant risk to the balance-sheet of the ECB and may have undermined the independence of the ECB. For a government that is fully taken off the market by a financial assistance programme, the buying of its bonds on the secondary market, as done by the ECB, has no fiscal implications. The ECB always argued that it entered into the SMP to improve monetary policy transmission. However, there is only very limited evidence of why the SMP would have mattered for monetary policy transmission in Greece. Certainly Greek banks continued to get access to ECB liquidity at generous terms. The programme also foresaw a significant amount of capital to recapitalise the Greek banking system if needed. Greek banks therefore had the liquidity needed to conduct their normal banking business. It is also clear that fiddling around with the price of Greek bonds in the secondary market helped little to change market assessments of other euro area bonds. It is therefore very difficult to understand the rationale for buying Greek bonds. The Greek SMP came at a price: it contributed to the ECB’s balance-sheet exposure to Greece. This may have undermined the independence of the ECB and may explain the tragic role played by the ECB in the subsequent discussions on Greece. I therefore argue that the Greek SMP was a mistake not only with the benefit of hindsight.

On the other hand, the ECB in the current incomplete euro area architecture has to perform a lender-of-last-resort role in order to avoid liquidity crises becoming self-fulfilling solvency crises. This is needed to avoid bad equilibria from happening. The current European set-up does not have any institution besides the ECB that is in a position to provide the liquidity needed to credibly deter betting against solvent governments.

The Italian situation is different from the Greek one, both in terms of debt sustainability and in terms of the banking sector. A malfunctioning sovereign bond market in Italy seriously undermines the proper functioning of monetary policy as it affects the banking system of the third largest economy of the euro area. This should remain the main argument of the ECB for its SMP programme in Italy. The ECB should make an effort to explain why and how the SMP helped to stabilise the monetary transmission mechanism in Italy. In addition, an Italian SMP comes with lower risks. Most economists agree that Italy is solvent at the interest rate it had to pay before the recent increase in spreads. Assuming that this is a correct assessment, a credible commitment by the ECB to buy Italian bonds to an unlimited extent if needed would fend off all market speculation against Italy immediately (again: assuming solvency).

After basically having suspended the SMP since January 2011, the ECB decided to enter into a new SMP in August 2011. It bought EUR 22 billion of government bonds

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9 Suppose that policymakers actually believed in Greek solvency. In that case, it would have been inconsistent to ask for high interest rates on official loans while at the same time trying to lower rates on the secondary market via SMP. Such a policy is not suited to fending off liquidity crises. Irrespective of who was the main driver of the penalty interest rate on assistance loans, once this was known, no SMP programme could have changed the insolvency equation as all maturing debt was rolled over under the conditions of the programme anyway.

10 For a recent discussion see De Grauwe (2011).
followed by EUR14 billion, then another EUR 5.3 billion in August. While the ECB does not disclose which government bonds it buys, there is a general agreement that most of these purchases went to Italy and to some extent to Spain. As in the previous SMP, the effect of the SMP on aggregate liquidity was offset by fixed-term deposit operations.

**Was it necessary to take up the SMP for Italy at this particular point in time?** There was certainly considerable concern that the widening spreads would seriously undermine the stability of the Italian banking sector. The ECB therefore had to act. Fiscally, there was no immediate urgency. Italian debt is long-term debt and refinancing needs for Italy up to the end of the year amount to EUR 170 billion. The fiscal implications of a spread of four percentage points are therefore very limited, not exceeding EUR 8 billion a year.\(^{11}\) This is money that certainly matters but that does not fundamentally change the solvency equation for Italy. On the other hand, in the current recessionary environment, an additional fiscal tightening of the order of €8 bn certainly would have had negative consequences on growth.\(^ {12}\) The ECB therefore decided to go ahead with the SMP and help Italy to fend off market doubt early on. In exchange, there was apparently a secret letter by the current and incoming ECB presidents to the Italian prime minister. This letter reportedly set out the conditions attached to the Italian SMP, and Italy moved quickly to pass a budget law and enact structural reforms.

**On balance, the SMP deal with Italy therefore is more sensible than in the case of Greece.** There is a clearer case as regards monetary policy transmission. Moreover, the SMP was connected with ECB-imposed conditionality and in exchange provided budget relief. However, without a true euro area fiscal backstop, the ECB can only temporarily pursue such a policy as it would accumulate too much risk and lose its independence. Moreover, ECB-imposed conditionality in exchange for SMP can only be a temporary solution. The European Parliament should demand democratic accountability in any future deal of this kind.

In the long run, the new ECB president will have to find a way of solving the tension between being the only institution with the necessary firepower to fend off liquidity crises while on the other hand avoiding to be forced to buy large amounts of bonds over a long period. Continuing with the SMP at the current rate for a prolonged period of time will not be possible. It would imply a massive increase of the holding of Italian debt, thereby leading to a substantial increase of risk for the balance-sheet of the ECB. In addition, sterilising such large amounts of liquidity from the banking system will not be possible without frictions and possible distortions in the distribution of liquidity in the banking system. **Ultimately, the new ECB president will therefore have to push European governments to finally form a fiscal mechanism that can serve as the European lender of last resort.** This mechanism would need to have far-reaching executive authority as regards national fiscal policy. The outgoing president has rightly identified the need to develop a vision of a European finance minister.\(^ {13}\)

**The agreement of the European Council of 21 July 2011 can be seen as a first step in this direction.** An enlarged EFSF will take over some of the functions currently performed by the ECB, including the buying of sovereign bonds on the secondary market. It is also planned that the EFSF will get some additional staff, potentially in order to have a greater executive role. But the agreement of 21 July is unfinished business.

\(^{11}\) Assuming EUR 30 billion deficit financing needs.

\(^{12}\) The fiscal advantage of ECB action is difficult to quantify. Assuming that spreads would have widened in the absence of ECB action, the potential gains could be in the order of magnitude of 2%-4%*200bn=4-8bn.

\(^{13}\) See Trichet’s speech ‘Building Europe, Building Institutions’ in receiving the Karlspreis (Aachen, 2 June 2011)
2.3. Regain the trust of the general public in the ECB and the euro

One of the most serious challenges the ECB and European policymakers in general face is the rising mistrust in the euro project itself by both financial markets and the wider public. The mistrust of financial markets is in the daily news: interest rate spreads between national sovereign bonds have been considerable for some time now, and financial markets do not believe that a solution has been found to the problems in Greece in particular. I refrain from further discussion of financial market trust.

Instead, I want to focus on the mistrust of the general public in the euro and the ECB. The latest available data from the Eurobarometer\textsuperscript{14} shown in Figure 1 until Figure 4 in the annex document that support for the euro has been falling in the last couple of years in all countries except Greece. The most dramatic fall can be seen in France, Germany and Portugal. The drop is significant, and beyond the typical volatility observed in the survey (as can be seen from the last column giving the standard deviation in the table in the annex).

This decline in the support for the euro has been matched by an even more worrying decline in the trust in the institution responsible for the euro, the ECB. In only 5 of the 12 euro member states does a majority of the population trust the ECB. The most dramatic decline can be seen in Germany, the Netherlands, but also Greece, Belgium, Ireland and Spain. In France, trust in the ECB is the lowest of all the 12 euro area countries in the sample: less than one third of the French population trusts the ECB, and more people distrust rather than trust the ECB.\textsuperscript{15}

The time profile of net trust in the ECB is interesting. In particular in Germany, but also in France, the Netherlands, Austria, Finland and even Belgium, a particularly strong drop is visible in the June 2010 data. This is of course the month right after the first Greek programme. These data suggest that the Greek programme was not popular.

\textsuperscript{14} The standard Eurobarometer is a survey consisting of approximately 1000 face-to-face interviews per EU country. It is published twice a year (Spring and Autumn) and data can also be retrieved from the Interactive Search System online.

\textsuperscript{15} French absolute figures may be distorted by the fact that the ECB is called a bank and public opinion about banks is not very favourable. In France there is of course also a long tradition of scepticism towards an independent central bank with an exclusive focus on fighting inflation. There was already back in 2007 a lot of public criticism towards the ECB on both sides of the political spectrum that the strong euro was allegedly destroying French industry and that there was no need to keep pushing rates up. However, it is therefore all the more surprising to see that support for the ECB dropped when it expanded its mandate beyond inflation fighting.
Note: Data were obtained by the Eurobarometer Interactive System. The Section is "Trust in European Institutions" and the relevant question is QA18.4 “And, for each of them [i.e. European Bodies], please tell me if you tend to trust it or tend not to trust it? - The European Central Bank”

The numbers are computed as the difference between the percentage of respondents who "Tend to Trust in the ECB" and those who "Tend not to trust"
These figures are worrying as ultimately, the euro can only be successful if the population supports the euro and the ECB. Unfortunately, the Eurobarometer has no further question giving an indication of why trust has gone down and so it is up to me to hypothesise on this. I would argue that the ECB and the euro have lost support in the different countries for different reasons:

In Germany, Austria, Finland and the Netherlands, there is growing fear that the ECB is misusing its independence to carry out fiscal policy operations in favour of southern Europe. The particularly steep decline in Germany in June 2010 may be explained by the effect of the SMP and the subsequent public debate, with Axel Weber heavily opposing such a programme. A further indication that the controversial SMP discussion played a role in Germany is the fact that there was a much steeper drop in net trust in the ECB than in support for the euro. It appears that German public opinion felt particularly betrayed by the ECB. Also now, there is a growing group of politicians that claim that the ECB is exceeding its mandate and monetising government debt. These politicians fear that this ECB policy will become inflationary.

Such public debate by high-ranking state representatives, national central bankers and commentators at large is harmful to the ECB. In order to avoid this criticism, the new ECB president will have to make a significant communication effort to justify the SMP with monetary policy operations. Clearly, the current statement that the transmission of monetary policy is not functioning properly when spreads are high is not perceived to be sufficient. Instead, I recommend that the ECB is pro-active in using its intellectual fire-power to convince academics, journalists and other stakeholders that large spreads are a serious issue for monetary policy. With such a pro-active strategy, the ECB may be able to regain the lead in the debate and thereby regain trust in this group of countries.

In the three countries under financial assistance programmes, the public view of the ECB is certainly heavily influenced by the role the ECB played in the design and implementation of programmes. The public perception is that the IMF has become the good ‘cop’, understanding the real problems, while the ECB has become the ‘bad cop’. The most obvious evidence in this regard is the strong disconnect between support for the euro, which has dramatically increased in Greece since 2008 and the trust in the ECB, which has fallen dramatically in Greece since the start of the programme. Also in Ireland, trust in the ECB has fallen dramatically despite a continuously strong support for the euro. The ECB has played a role in preventing a larger participation of the financial sector while at the same time shifting the burden onto local taxpayers. This strong interference in national sovereignty has not been popular. The ECB may have been right in its policy but again it has not done enough to convince citizens and informed observers of this.

In all fairness, it needs to be admitted that not only trust in the ECB has declined considerably, but other European institutions and national governments are also affected. Similar declines in trust in the European Commission and also national governments can be observed, while trust in the European Parliament and national parliaments has kept up comparatively well. It is beyond the scope of this paper to further discuss this.

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16 The most prominent example is certainly the speech by German President Christian Wulff in Lindau, http://www.bundespraesident.de/SharedDocs/Reden/DE/Christian-Wulff/Reden/2011/08/110824-Wirtschaftsnobelpreistrager.html?jsessionid=00337775E370574E9F069EE120A03899.2_cid030. But there are several politicians in a number of countries that openly criticise the ECB.
3. CONCLUSIONS AND POLICY RECOMMENDATIONS

The European Central Bank has been transformed into an institution with far-reaching executive authority and competencies. This has been the result of a combination of factors, the lack of strong political leadership in the euro area and the absence of alternatives being among the most important ones. But this strong increase in executive powers has come at a price, and the role of the ECB needs to be re-calibrated in the future.

1) I have shown that popular trust in the ECB has fallen dramatically in programme countries. The ECB should reconsider whether its strong involvement in the design of financial assistance programmes is desirable. It should also consider softening its stance on sovereign debt restructuring and burden-sharing, thus yielding to the primacy of taxpayers and supporting those. In the case of Greece, the ECB should become an advocate of a clear debt cut at the expense of the financial sector, thereby finally ending uncertainty.

2) The Securities Markets Programmes have been very controversial in Germany and other creditor countries and it is difficult to justify SMPs for insolvent governments in assistance programmes such as Greece. This has seriously undermined trust in the ECB. In the case of Italy, the SMP can be justified both for monetary policy reasons and lender of last resort functions. The ECB needs to make a much greater effort to justify this policy action, in particular when the order of magnitude is reaching the current levels of EUR 10-20 billion per week. In addition, the ECB president needs to continue arguing for a viable fiscal solution to replace the lender-of-last-resort function.

3) The most important task for the ECB will be to credibly continue to anchor inflation expectations. We will see very strong calls for higher inflation targets to solve the debt crisis. It will therefore be important that market participants as well as the population at large continue to trust the ECB to fulfill its primary mandate.

4) I have not discussed the changes in monetary policy strategy implied by the new emphasis on financial stability. To what extent should the ECB lean against the wind with monetary policy when it sees asset market bubbles emerging? How would its greater financial stability responsibility shape its monetary policy strategy? What should be done in case of a trade-off between inflation and stability? What role should the European Parliament have in holding the ECB to account? Pisani-Ferry and Weizsäcker (2009) as well as Setzer, van den Noord and Wolff (2011) offer some thoughts on this.

Overall, the ECB’s role will likely be reduced in the future and the roles exercised will have to be matched by an increase in democratic accountability.

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17 See for example Eichengreen, ‘The big Cannoli’, Eurointelligence, 17 August 2011, for a discussion.
REFERENCES

DATA SOURCES


- Thomson Reuters – Datastream
ANNEX

Figure 1: Support for the EMU: Belgium, Germany, France

Figure 2: Support for the EMU: Netherlands, Austria, Finland

Source: EUROBAROMETER.

Note: Data were obtained by the Eurobarometer Interactive System. The Section is “Trust in European Institutions” and the relevant question is QA20.1 “What is your opinion on each of the following statements? Please tell me for each statement, whether you are for it or against it. A European economic and monetary union with one single currency, the euro”

The numbers are computed as the difference between the percentage of respondents who are “For” and those who are “Against”

Figure 3: Support for the EMU: Greece, Ireland, Portugal

Figure 4: Support for the EMU: Italy, Spain

Source: EUROBAROMETER.

Note: Data were obtained by the Eurobarometer Interactive System. The Section is “Trust in European Institutions” and the relevant question is QA20.1 “What is your opinion on each of the following statements? Please tell me for each statement, whether you are for it or against it. A European economic and monetary union with one single currency, the euro”

The numbers are computed as the difference between the percentage of respondents who are “For” and those who are “Against”
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Note: Data were obtained by the Eurobarometer Interactive System. For the Section "Trust in European Institutions" the relevant question is "And, for each of them [i.e. European Bodies], please tell me if you tend to trust it or tend not to trust it? - The European Central Bank (The European Commission; The European Parliament". For the Section "Trust in Institutions" the relevant question is "For each of the following institutions, please tell me if you tend to trust it or tend not to trust it? – The European Union (the [NATIONALITY] Parliament; the [NATIONALITY] government"). The numbers are computed as the difference between the percentage of respondents who "Tend to Trust" and those who "Tend not to trust"
Abstract
President Trichet’s first half of mandate has run smoothly and strengthened the ECB’s credibility as a dedicated inflation fighter. The second half has brought extraordinary challenges, especially as sovereign debt crisis is spreading through the euro area. Although it has been made even more difficult as the result of poor institutions and dithering governments, the ECB’s responses to the crisis have been unsatisfactory. Through its President statements, the ECB ruled out key steps that proved to be unavoidable and, more generally, failed to anticipate on market reactions. This may signal the limits of the consensus model of decision-making or a dangerous tendency toward “group think”, both of which are a matter for the President to deal with.
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EXECUTIVE SUMMARY

The changing of the guards provides a good occasion to look inside the box and ask whether the internal workings of the ESCB are as good as possible. The sovereign debt crisis has revealed a worrisome series of shortcomings that should encourage a thorough review of the situation.

In most central banks, including at the ESCB, committees carry out policy decision-making. The head of the central bank is intended to be primus inter pares but experience shows that (s)he is more than that. This is not surprising, nor is it to be regretted. The President must be the communicator who explains the central bank’s thinking and actions. Committee decision-making tends to be slow and conservative, which requires that the governor develops enough authority to improve the committee’s work. Historically, central banks have been innovative, which requires taking risk, which a committee alone is unlikely to do, unless prodded by an intellectually powerful leader. In brief, the personality of the President matters a lot.

The ESCB has a particularly complicated decision making structure. Formally decisions are made by the Governing Council. Currently composed of 23 members, the Council is clearly too large to conduct in-depth analyses. Although details are not made public, it seems that the decisions are prepared within the Executive Committee (consisting of six members). It is plausible that the President discusses on the side with (some) governors of National Central Banks (NCBs) to make sure that an agreement can be reached. It is also known that the President comes to the meeting with a draft of the text that will be presented at the ensuing press conference. This means that the President plays a pivotal role.

In addition, the tradition so far has been that decisions are made by consensus, implying no vote taking. Consensus means that dissent is not recognised, quite possibly frowned upon. Given the inherent complexities of monetary policy, it is unlikely that true consensus can be achieved at all times. In fact, during the crisis, there have been instances where it has proven impossible to uphold the myth of consensus. Moving to a more realistic approach, which encourages debate, is the task of the President.

The first half of President Trichet’s mandate has been marked by the Great Moderation, years of sustained growth in Europe and in the world, with few episodes of inflationary pressure. During this period, the ECB has achieved a high degree of credibility as a dedicated defender of price stability. The second half of the mandate has been marked by a historical financial and economic crisis, followed by a no-less historical sovereign debt crisis in Europe. Dealing with such exceptional challenges was extraordinarily difficult, especially as European political leaders dithered repeatedly and as the euro area’s governance flaws came to be recognised. The track record during this period is decidedly mixed and worrisome. The ECB has repeatedly staked out positions (no recourse to the IMF, no bailout of member governments, no default) that were untenable. Fortunately, the ECB has changed in mind, but it did so late and often under visible government pressure. On the other side, the President has been able to prod reluctant political leaders to making hard decisions that they would have rather avoided to take.

Why is the record of the ECB during the crisis open to serious criticism? Besides the extreme difficulty of the task and the continuous interferences from dazzled political leaders, the ECB has left an impression of disarray. Whether it is ‘group think’ that has cut it off from external debates, or whether internal divergences have led the ECB to focus on finding agreements rather than anticipating the next steps of the crisis, there will be a clear need to evaluate its performance.
The crisis has also reminded us that, beyond the presence of some highly talented individuals, the overall quality of ECB management does not compare favourably with what can be found in most other leading central banks. This raises again the issue of how Board members are appointed. The current ‘spoil system’, which reserves a seat for each of the four largest countries, should not be tolerated any further. We need the best possible candidates that Europe can offer.
1. INTRODUCTION: DO PRESIDENTS MATTER?

Jean-Claude Trichet is the second President of the ECB to step down, the first one to have completed a full mandate of eight years. During his tenure, he has become the visible incarnation of the Bank and, in many respects, the ‘ultimate Mr Europe’.

The experience of other central banks shows that the personality of the President can matter. In the US, Paul Volcker is credited for having redefined monetary policy, shifting from ambiguous and time-varying strategies to the adoption of the interest rate instrument; a shift that has been subsequently adopted by most central banks in the developed countries. The chairmanship of Alan Greenspan has been famously associated with tolerance to the build-up of financial price bubbles and, by his own subsequent admission, misguided reliance on self-regulation in the financial markets. In the UK, Mervyn King has forcefully developed the concept of flexible inflation targeting, borrowed from New Zealand, which has been adopted by a large number of other central banks.

Central bankers, including governors, are unelected officials appointed to serve the public good. In contrast with elected leaders, who campaign on explicit programs and are subject to judgment by their voters, bureaucrats are not intended to have personal opinions. They should implement best practice using state-of-the-art understanding and techniques. In addition, for good reason most central banks, including the ECB, rely on committees, of which the governor is primus inter pares.

This is not how things work in practice. Quite often, central banks have changed the state of the art. This was the case with interest rate setting, inflation targeting, bank rescues, quantitative easing and more. Central bankers must be bureaucrats but with the legal and intellectual ability to innovate. The governor must also be the communicator who explains to politicians, experts and the public at large the central bank’s thinking and actions. As such, the governor is bound to be more than primus inter pares. In addition, as noted by Blinder (2004), committee decision-making tends to be slow and conservative, so the governor must develop enough authority to improve the committee’s work. Furthermore, central banks must avoid the cacophony that follows unscripted comments by committee members, as happened at the beginning of the euro. The governor must be able to shape the central bank’s communication.

It is therefore no surprise that the personality of the governor matters a lot, and there is nothing inherently wrong with this situation. At the same time, the governor must be sensitive to divergent views and criticism, both within and outside the bank. The chairmanship of Alan Greenspan offers an illustration of the dangers of a governor who becomes impervious. Formally, central bankers are subject to accountability procedures that allow elected officials to represent the 'wishes of the people'. In practice however, accountability can be weak, as in the case of the euro area, or misguided, as happens occasionally in the US. While there is no magic solution to the accountability riddle, part of the solution is open and frank debate within the policy-making committee, more generally within the central bank and with outside experts. This is the only way of combining the necessary independence – a hugely important progress achieved over the last two decades – and control over decisions that are often complex because there is often not one best answer to the issue faced by the central bank.
On these various aspects, the ECB’s record is good but not perfect. Section 2 describes how the ESCB and the ECB operates. The following section provides a brief – and superficial – evaluation of the ECB performance during the eight years of Jean-Claude Trichet’s presidency. The shortcomings during the crisis suggest a number of interpretations, which are presented in Section 3, and a number of suggestions, which are the object of the last section.
2. HOW THE ESCB OPERATES

Policy decisions are formally taken by the Governing Board, which includes the six members of the Frankfurt-based Executive Committee of the ECB, and the governors of the National Central Banks (NCBs). This is a reasonable arrangement that reflects the federal nature of the euro area. There is a serious issue of size however. A Committee with 23 nominally-equal members is far too large to allow for in-depth discussions of complex issues. Reducing the size of the Governing Council is possible (for example along the lines of the US Federal Open Market Committee) but it would require a Treaty change, which is highly impractical. This issue is not pursued further here.

It is not known publicly how the Governing Council functions. All we know for sure is that the Council meets twice a month, with one meeting devoted to monetary policy decisions and one meeting dedicated to internal housekeeping. We also know that the policy-making meeting starts with a report by the Chief Economist, namely the Executive Board member who supervises the Economics Directorate General. Beyond that, what follows is informed guesswork, a first signal that transparency is limited.

It is believed that the Executive Board members try to agree among themselves ahead of each policy-making meeting. This would make the Executive Board the key decision-making body, which would be a fitting way of dealing with the Governing Council size problem. Yet, some NCB governors are known to be opinionated. The solution is for the President to involve those Governors ahead of time and, quite possibly, to act as go-between between dissenting governors and the Executive Board ahead of the meeting.

Normally, the President comes to the meeting with a draft of the text that he will read at the ensuing press conference, which is also attended by the Vice-President (why?). In other words, the decision is largely made before the meeting. While the Treaty explicitly mentions voting, President Trichet has long insisted that decision is always consensual (‘we are a team’) so that votes need not even be taken. Since the minutes are not published, it is not known what consensus – an extraordinarily weak concept – means. Occasionally, rumours suggest dissent. Since the beginning of the crisis, some dissenters have let their positions and views be known, revealing at the same time that votes are indeed taken, but still not revealed. In that respect, the ESCB is unique among developed countries’ central banks.

Like his predecessor, Wim Duisenberg, Jean-Claude Trichet has insisted on the pretence of consensus and on being the only one to present the bank’s viewpoint. This is in line with his role as consensus-builder. This role gives him unique power among his colleagues and the fact that consensus is achieved is the litmus test of his authority. This is a general phenomenon: dissent within policy-making committees tends to be seen as a signal that the governor is weak. This need not be the case. For instance, the Bank of England and the Swedish Riksbank, both of which publish minutes and voting records, project the image of frank and open intellectual debates. Occasionally, the governor is seen to be in the minority. As long as these instances are infrequent, there has been no suggestion that the governor is weak. In the Fed, on the other side, there is a view that putting the Chairman (who opens FOMC meetings and states his views) in the minority would be an affront.

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1 Emergency videoconferences are also organised.
2 At the very beginning, divergent opinions from Council members created the sense of cacophony. It took some time and much effort for President Duisenberg to restrain his colleagues.
3. TRACK RECORD

The eight years of Jean Claude Trichet have been rich and varied. A brief evaluation, like the one that follows, is inevitably superficial and unfair. Hopefully, it can still bring up some issues of general interest. By the time the crisis hit in 2007, half way through his mandate, the EBC President was unanimously considered as highly successful, an equal to the Fed Chairman. Over the next half mandate, the challenges became formidable and it would have been extraordinary to sail through the storm without making mistakes. Of course, the situation of the ECB is uniquely difficult as it must deal with many governments that tend to disagree on important issues. It is also important to note that the ECB is caught in a governance structure of the euro area that has now been unanimously recognised as imperfect, if not dysfunctional.

3.1. First half of mandate

With hindsight, the period 2003-07 has been called the 'Great Moderation'. Sustained growth and subdued inflationary pressure meant that central banks around the world could limit themselves to achieving price stability, however defined. The ECB succeeded in keeping euro area HICP\(^3\) inflation close to the 2% upper limit, rarely below however. Yet, as the figure below shows, expectations have been anchored in the 1.5%-2% range identified by the ECB as its objective. The difference is surprising. It is widely interpreted as an indication that the ECB has achieved a great degree of credibility. The ECB President had obviously impressed the markets. He deserves full credit both for his stewarding of monetary policy and for his communication skills.

**HICP inflation: actual and foreseen**

![Graph showing HICP inflation: actual and foreseen](source)

**Source:** ECB

**Note:** Two-year ahead forecasts from the Survey of Professional Forecasters.

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\(^3\) HICP: Harmonised Index of Consumer Prices; the HICP is an internationally comparable measure of inflation, see [http://www.ecb.int/stats/prices/hicp/html/index.en.html](http://www.ecb.int/stats/prices/hicp/html/index.en.html).
3.2. Crisis years

Once the crisis started, the challenge has become enormous. As is always noted, this is a crisis of historical proportions, fully mindful of the 1929 crisis. While much is known about the previous event, current policymakers have not been exposed to anything similar. Properly responding to the crisis required a rare combination of intimate knowledge of the 1930s and ability to innovate because two crises are never alike.

The ECB was the first to provide ample liquidity to the banking system in August 2007. In part, it was lucky since its statutes allowed it to accept as collateral a much wider range of assets than many other central banks. The Fed, for instance, had to change its procedures when it found it impossible to provide the banking system with amount of liquidity needed.

The rest of the crisis history is less compelling so far. While inconsequential, the June 2008 interest rate increase was seen as a signal that the ECB was overemphasizing inflation – the result of sharp increases in oil, commodity and food prices – and underestimating the gravity of the financial situation. That decision was reversed in November 2008, in a move that was late and followed by further slow moves. The resistance to officially bringing the refinancing interest rate to as close to zero, while effectively allowing the EONIA rate to get there, remains puzzling, even if of little consequence.

The European sovereign debt crisis, which started at the end of 2009, has raised many disquieting questions. Jean-Claude Trichet famously stated that Greece should not go to the IMF at a time when most experts considered that to be unavoidable, urgently needed in fact. On 9 May 2010, he surprisingly joined the euro area governments in bailing out Greece, against the impression that he had created beforehand. This decision involved internal dissent, suggesting that this was a decision backed by the President. Two years later, he regularly expresses keen discomfort with the fact that the barrier between monetary and fiscal policy has been broken, but this was predicated by the 9 May decision. We saw a repeat of this event in August 2011, when the SMP was restarted, this time to purchase Italian and Spanish debts, a step that the ECB had sought to rule out earlier. On this occasion, again, dissent within the Governing Council has been widely reported.

Furthermore, the ECB has repeatedly argued that a debt default is not acceptable in the euro area. While we would not expect the ECB and the political authorities to publicly call for debt defaults in member countries, this has always been a plausible option, indeed one that many experts have recommended since early 2010. Ruling it out and pressuring governments to avoid it arguably paved the way for another embarrassing turnaround in August 2011.

One should not underestimate the difficulties created by the unsteady leadership of the European governments since the onset of the debt crisis. It is known that Jean-Claude Trichet has repeatedly had to convince the political leaders to take actions that they were unwilling to take. At the same time, he has given the impression, wrongly or rightly, that he was overly concerned that the ECB should not take large financial risks. At the end of the day, the ECB cannot avoid intervening as lender of last resort and one has to be grateful that it did, even though that meant reversing its previous stance. Sharp disagreements have clearly made the President’s task far more difficult than is often appreciated.

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4 SMP: Securities Markets Programme; ‘Interventions by the Eurosystem in public and private debt securities markets in the euro area to ensure depth and liquidity in those market segments that are dysfunctional. The objective is to restore an appropriate monetary policy transmission mechanism, and thus the effective conduct of monetary policy oriented towards price stability in the medium term. The impact of these interventions is sterilised through specific operations to re-absorb the liquidity injected and thereby ensure that the monetary policy stance is not affected.’, see ECB Monetary Policy Glossary, http://www.ecb.int/home/glossary/html/act4s.en.html.

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3.3. And now?
The changing of the guard occurs at a most delicate time. Unless a miracle happens, the crisis will get deeper and wider in the coming months. The fact that Italy is likely to be the next country in full-blown crisis will undoubtedly complicate the task of Mario Draghi, the new President. One could hope that the current President sets in motion a comprehensive solution before his successor takes office. The window of opportunity is very small and closing rapidly.
4. IMPROVING THE ECB BOARD’S EFFECTIVENESS

4.1. Group think vs. hardening positions

The crisis has exposed various limits of the ECB. Most glaring is the perception that the ECB has been 'behind the curve', meaning thinking and acting with a delay to events unfolding in the financial markets. It would be totally unfair to blame the President alone for this underperformance. The reason why central banks are run by committees is to introduce enough diversity of opinions to challenge the wisdom of the day. Yet, the disconnect between ECB statements and actions on one hand, and views held by financial market participants and experts on the other hand, has been striking. It has created the potentially misleading impression that the ECB Board has been subject to 'group think'. An alternative interpretation is that internal disagreements have been deep, leading to inaction or delayed action. This latter interpretation, however, does not fully explain the strong but ultimately abandoned positions taken by the ECB on some key issues (IMF involvement, bailing out of public debts, defaults). It could be that both previous interpretations ought to be combined: internal disagreements among policymakers, many of whom are individually not well-aware of broader views, led to poor-quality compromises that were destroyed and had to be rebuilt when they failed to deliver.

A different interpretation is that Board members were not prepared from their previous experience to face the crisis. It is often observed that most Board members have very similar profiles, coming from Treasuries and central banks. Most other central banks include in their boards former academic and market economists whose instincts are to challenge conventional wisdom and who easily recognise mistakes. Within the ECB, instead, it could be that different Board members and NCB governors staked out positions and were led to harden them as the situation deteriorated and called for ever more audacious steps.

Group think and hardening positions may reflect insufficient room for debate within the Board. In the absence of the kind of detailed information needed to assess this interpretation (provided in other central banks by published minutes), we can only make superficial and possibly misinformed observations. One possibility, which is widespread among central banks, is that not all individual Board members have access to adequate information. The ECB has a large and competent staff of professional economists who are perfectly aware of analyses developed outside of the bank. Are they encouraged to submit views that are not congruent with the prevailing position taken by the bank? If they do, how widely disseminated are these views? The impression is that the Economics Directorate works exclusively for the President and the Chief Economist and that the other Board members do not have routine access to the analyses thus developed, nor can they ask for independent analyses. If so, the remedy is straightforward.

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5 Examples: the President and Vice-President of the Fed, the Governor and Deputy Governor of the Bank of England, the three members of the Board of the Swiss National Bank, the Governor and Deputy Governor of the Bank of Norway, the Governor of the Central Bank of Chile, the Governor and most of the Deputies of the Bank of Canada. This list is not exhaustive.
4.2. Transparency

The foregoing discussion amply illustrates that we know very little of the debates that may go on within the ECB and even on its internal functioning. The absence of minutes plays an important role but there also seems to be a culture of opacity within the bank. It can only be hoped that, when the crisis is over and the dust settles, there will be an influential inquiry to determine whether some things went wrong and to draw the lessons. This inquiry must not be internal, for obvious reasons. The European Parliament is perfectly poised to take the initiative and set up a high-quality independent committee that will perform this task, with a request that the ECB opens up its file as needed.

4.3. Appointments

One of the judicious features of the ECB statutes is that the Executive Board members cannot be reappointed.\(^6\) We have countless examples of highly successful central bank governors who are appointed over and over again. Long-serving officials become less interested in being challenged by internal and external colleagues and they tend to rely increasingly on their own judgments. The turnover at the head of the ECB has so far gone smoothly. Yet the appointment system is deeply flawed.

To start with, the 'spoil system', which reserves a seat for each of the four largest countries, should not be tolerated any further. It could have made some political sense at the very beginning but it is becoming increasingly dysfunctional and a mockery of the principle that members serve in their own capacity and do not represent their home countries. Each country is currently represented on the decision-making Council by its own central bank governor. A reform to streamline the Council could guarantee a seat to each of the large countries, in exchange for giving up the current unwritten arrangement. It would also provide incentives to NCBs to appoint as governors highly competent people who stand to be strong voices in the Council. According to many, several NCB governors do not have the competence and experience to be active participants in the Council deliberations.

As a consequence of the spoil system, the choice of four of the six Executive Board members is effectively delegated to each of the four large countries. This precludes an open search for the best-qualified people. As for two remaining seats, they often involve horse-trading among countries over various positions in the European galaxy. This applies to the position of President. While Mario Draghi is certainly one of the most qualified Europeans for the position, the painful saga of his appointment clearly illustrates the shortcomings of current practice. The same can be said of the impending resignation of Lorenzo Bini-Smaghi, a very able Board member whose only failure is to hold an Italian passport.

Another consequence is that, beyond highly talented individuals, the overall quality of ECB management does not compare favourably with what can be found in most other leading central banks, with the notable exception of the Bank of Japan, which bears a heavy responsibility for two decades of economic stagnation there.

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\(^6\) Disclaimer: I have no personal interest in any position at the ECB.
Abstract
The enlargement of the European rescue fund EFSF should be part of a comprehensive approach of strengthening the Stability and Growth Pact both in terms of its corrective arm by using automatic sanctions and in terms of the preventive arm by introducing the European fiscal semester. The consequence would be that the Securities Markets Program could be terminated and the ECB’s portfolio of government bonds (presently around EUR 100 billion) could be transferred to the EFSF for the ECB’s book value. This would reduce the tensions within the ECB Governing Council and enable the ECB to focus on its direct mandate for monetary stability and its indirect responsibility - through the European Systemic Risk Board - for financial stability. This would result in a clear separation of responsibilities between the ECB and ESRB for monetary policy and macro-prudential supervision and the EFSF for fiscal policy and structural reforms in the Member States facing austerity measures.

The ECB will certainly be confronted with possible trade-offs between monetary and financial stability. This problem could be solved by changing the ECB’s mandate for price stability from the medium term to the longer term (longer than two years) as financial stability is prerequisite for monetary stability in the longer term. Consequently, the two-pillar strategy of the ECB could be adapted in such a way that its economic analysis focuses on price stability in the medium term and its monetary analysis (e.g., credit and money growth) on financial stability in the longer term. The Bank of Japan’s analysis and strategy could be taken as an example to merge the responsibilities for monetary and financial stability in the medium and longer term. The two-pillar strategy offers an excellent framework for a time-consistent approach of preserving monetary and financial stability. It is up to Mr Draghi as the new President to give guidance to the ECB through this terra incognita.
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1. INTRODUCTION

On 31 October 2011, the eight years term of Mr. Jean-Claude Trichet as ECB President will end. Mr. Mario Draghi will succeed him in office. This change of leadership in the ECB comes at a pivotal time for the euro area and the European Union as a whole. Furthermore, the ongoing crisis in the euro area may exacerbate the impact of this change in monetary leadership. As he will take office Mr. Draghi will face many challenges, the most important of which is probably maintaining ECB’s independence during the crisis.

To see how he should do this, I shall first review the performance of Mr. Trichet as President of the ECB. Then, I will look at the challenges Mr. Draghi faces and how he should deal with them. Finally, I will argue that the enlargement of the European rescue fund EFSF (European Financial Stability Facility) is of paramount importance to make it possible for Mr. Draghi to properly do his work as an independent central banker.

\footnote{The author gratefully acknowledges the very helpful comments of Professor Lex Hoogduin and Mr. Edin Mujagic, Msc. and the excellent research assistance of Mr Rob Nijskens, Msc.}
2. THE TRICHET PRESIDENCY

Jean-Claude Trichet has proven to be a good crisis manager, who has managed to safeguard the ECB’s independence during both the financial crisis of 2007-2009 and the current Euro crisis. He has operated in a pragmatic way: he did what was necessary to protect the euro, but always kept in mind the independent position of the ECB.

The 2007-2009 banking crisis is a very good example of this. When the crisis broke, the ECB provided virtually unlimited liquidity to keep the European banking sector afloat. However, this long liquidity position was soon decreased as soon as inflationary pressures were appearing again in 2010. Personally, Mr Trichet has always assured the public that the ECB would put inflation stability above anything else.

By acting in this way, the ECB has been able to maintain both monetary and financial stability while only having one official instrument (the interest rate) at its disposal. Balancing these two goals will be only more difficult since the ECB is now also officially responsible for financial stability (through the ESRB). I will elaborate upon this in the next section.

During the ongoing Euro crisis Mr. Trichet has been under fire, especially in Germany and the German press, for putting the ECB’s independence in jeopardy. After the first large-scale buying of government bonds in May 2010 he faced massive criticism, not in the least from his German colleague Axel Weber. However, there was no other option: the ECB is the only European institution that can react with enough speed and firing power to resolve a crisis as large as this one.

Additionally, through his appearances in the media Mr. Trichet has managed to ensure the public that the ECB did not cave in to political pressure, that its monetary policy was unchanged and that its actions would not spur inflation². For instance, in an interview with the Frankfurter Allgemeine Zeitung he emphasized again that the ECB’s “line is price stability”, and that its “credibility is derived from achieving this objective over the medium term”³. As the effectiveness of the monetary transmission mechanism was severely hampered by the problems on the sovereign bond markets, the ECB’s actions were only to restore this effectiveness. Furthermore, Mr. Trichet insisted that, in contrast to the actions by other major central banks (notably the Fed), the ECB’s actions were sterilized and thus did not lead to an increase in money supply. In speeches he has also resolutely maintained the position that the ECB is “fiercely and totally independent”⁴, despite all allegations that it has become increasingly a political institution.

Another example of this is the increase of ECB interest rates over the last year. Despite market pressures (both from Europe as well as from the US), to keep interest rates low to stimulate economic recovery, Mr. Trichet saw inflationary pressures mounting and has pushed for higher interest rates. This has led to an increase of 25 basis points in April 2011, and another one in July. The ECB has stuck to this policy even though the Fed has insisted it will keep interest rates low for the coming two years, and despite the ongoing crisis in the euro area. This course of action shows that the ECB is still independent from market and political pressures.

² The Economist, After the Fall, 20.05.2010
⁴ The Economist, The Price of Pragmatism, 11.05.2010
Finally, last July it turned out that the ECB again had to buy government bonds, also from Italy and Spain this time. In this case, Mr. Trichet showed how clever and forward-looking he is: he emphasized strongly that this ECB action should be temporary. He has convinced Mrs. Merkel and Mr. Sarkozy that the European rescue fund EFSF has to be ratified and implemented, after which this fund should take over the responsibility of resolving sovereign debt problems. Furthermore, to be eligible for assistance by the ECB, Spain and Italy have to accelerate the implementation of their austerity plans. By tackling the sovereign debt problem in this way, Mr. Trichet has gone a great deal towards restoring trust in the ECB and the euro area.

In sum, Mr. Trichet can be described as an independent central banker and a good, pragmatic crisis manager, always reassuring the public that he was in charge of the situation. He has proven responsible and reactive in times of crisis, but also always kept his composure and watched for his own independence and that of the ECB. In acting as he has done, he has managed to keep a careful balance between monetary and financial stability; a task that will prove to be increasingly difficult in the future.
3. SUCCESSION BY MR DRAGHI

It is up to Mr. Draghi to face the task of balancing monetary and financial stability. As The Economist put it in February of this year: "[w]hoever takes over from Mr Trichet will have to share his pragmatic approach" and "will need to inherit his ability to forge a consensus and to communicate it clearly". However, together with Edin Mujagic I also set out which additional criteria a new ECB president has to fulfill. Among these are the willingness to resist political pressure, an excellent knowledge of monetary matters and the ability to build support for the ECB’s independence. Mr. Draghi possesses all these qualities, but also faces major challenges: resolving the sovereign debt crisis, reacting to inflationary pressures and, ultimately, balancing monetary and financial stability. I will elaborate on the first challenge in the next chapter, so let us focus on the second and third.

Mr Draghi does not have the best papers to be perceived an inflation hawk because his background as an investment banker and as the chairman of the Financial Stability Board may suggest that he will choose for financial stability rather than monetary stability. This could mean, for instance, that he leaves market liquidity high and the interest rate low for too long, such that banks can recover but also inflationary pressures may mount. Since the ECB has only one instrument, namely the interest rate, it is clear that the two stability goals may conflict. To keep the ECB’s independence and thus its credibility as an inflation fighter, Mr. Draghi will have to give prevalence to price stability over financial stability in case they conflict. This will prove to be a daunting task, especially in these times of crisis.

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5 The Economist, Seventeen characters in search of a central banker, 12.02.2011
6 Eijffinger, Sylvester and Edin Mujagic, Who next at the ECB helm?, Project Syndicate, 17.01.2011
4. MORE FIRING POWER

Resolving the sovereign debt crisis is a necessary step to be taken so Mr. Draghi can fulfill his duties as an independent central bank president. Although the ECB has averted the default of large countries like Italy and Spain, the buying of their government bonds can only be temporary to not jeopardize the ECB’s independence. Of course, a temporary intervention by the ECB should pose no problems as long as it is small. As an illustration, the current sovereign bond position of the ECB is still below 4% of its balance sheet. However, the longer the ECB keeps these positions, the more it risks losing on these bonds and creating inflationary pressures (as not all interventions can always be sterilized).

Therefore, these temporary measures have to be replaced by a permanent mechanism to stave off further sovereign debt crises; this mechanism has to be able to deal with large shocks. As has been noted by many commentators recently, the current EFSF is not up to this task. The situation will be especially dire if large countries such as Spain and Italy are not able to set their finances straight and have to call on the EFSF. This is illustrated in Figure 1 below.

Figure 1: Scope of the Euro Rescue Fund and the Financial Needs of Crisis Countries (EUR billion)

![Figure 1: Scope of the Euro Rescue Fund and the Financial Needs of Crisis Countries (EUR billion)](image)

This means that the EFSF cannot deal with the problems of large countries, giving it an immediate credibility problem. One should also remember that together, Italy and Spain provide 30 percent of guarantees and capital of the EFSF, meaning that if those two countries have to turn to the EFSF, the already insufficient fund would become even more insufficient, unless the other euro area Member States increase their share, something that would highly likely counter fierce political opposition. If politicians do not see a way to enlarge the EFSF in a pre-emptive way, i.e. before new countries call in the EFSF to help them out, the ECB will have to keep intervening if large problems ensue, even after September 2011 when the fund will be fully operative. Also in 2013, when the permanent
European Stability Mechanism (ESM) will be put in place, this problem will not be solved since the ESM’s envisaged size still falls short of the possible financing needs of large problem countries (see Figure 2).

**Figure 2: Defences against Default (bailout measures, EUR billion)**

- **April 2010**
  - Rescue Package for Greece
  - Total loans made available: €110 bl.

- **May 2010**
  - EU Euro Rescue Fund
  - Emergency loans and credit guarantees for troubled euro-zone countries, expires in 2013
  - Up to €750 bl.

- **From 2013 onwards**
  - European Stability Mechanism (ESM)
  - Available Capital / Guarantees: Approximately €620 bl.*
    - Including over-collateralization in order to maintain a top rating


EU leaders have to commit to a credible long term solution for the sovereign debt crisis. The current EFSF is inadequately equipped and, as Charles Wyplosz7 puts it, “a continuation of the central mistake made by policymakers – the belief that it is enough to buy little bits of debts now and then to quiet financial markets until things get better.” Commitment to the EFSF and its enlargement are necessary to establish credibility, also for the ECB and the Member States facing austerity measures. This warning is also issued by a gathering of VoxEU commentators, who have issued a call to action and state that “the very survival of the euro is at stake”. They urge EU leaders to agree on a plan that prevents further escalation of the crisis8.

First of all, such a plan should contain a pre-emptive enlargement of the EFSF. An increase of the fund’s firing power before the crisis takes a turn for the worse will lend it much more credibility in dealing with large countries’ debt problems. Furthermore, the fund should be able to make banks withstand a sovereign default without triggering a new banking crisis. To obtain funding, the EFSF should be allowed to operate in secondary bond markets and given more operational flexibility and independence.

Of course such changes are politically very hard to implement, but they are also inevitable to guarantee the future of the monetary union. The euro crisis can only be successfully solved if Europe designs such a crisis-solving mechanism that it can act pre-emptively instead of only to react to escalation of the crisis. One part of this mechanism should be enlargement of the EFSF. That would enhance the credibility of the EFSF. Credibility is

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7 Wyplosz, Charles, *They still don't get it*, 08-08-2011
8 VoxEU, *A call to action: EU leaders must act to save the euro and avoid a recession*, 20.07.2011
paramount to be able to withstand crises like the current one. Furthermore, the paradox of an EFSF enlargement may be appealing to politicians and their constitutions: if the EFSF is large, it is a credible threat to deter speculators and will not have to be used!

Another advantage of enlarging the EFSF and giving it more powers is that the independence of the ECB is preserved. Yves Mersch, the central bank governor of Luxembourg, has already stated that as soon as the EFSF is operational at the end of September, the ECB will start to stop buying sovereign bonds\(^9\). Since the EFSF will relieve the ECB of the pressure to intervene in sovereign bond markets, the central bank can concentrate again on keeping price stability.

\(^9\) Wall Street Journal, Q&A: ECB’s Mersch on Economic Outlook, Bond Purchases, 11.08.2011
5. CONCLUSION

The enlargement of the European rescue fund EFSF should be part of a comprehensive approach of strengthening the Stability and Growth Pact both in terms of its corrective arm by using automatic sanctions and in terms of the preventive arm by introducing the European fiscal semester. The consequence would be that the Securities Markets Programme could be terminated and the ECB’s portfolio of government bonds (presently around EUR 100 billion) could be transferred to the EFSF for the ECB’s book value. This would reduce the tensions within the ECB Governing Council and enable the ECB to focus on its direct mandate for monetary stability and its indirect responsibility - through the European Systemic Risk Board - for financial stability. This would result in a clear separation of responsibilities between the ECB and ESRB for monetary policy and macro-prudential supervision and the EFSF for fiscal policy and structural reforms in the Member States facing austerity measures.

The ECB will certainly be confronted with possible trade-offs between monetary and financial stability. This problem could be solved by changing the ECB’s mandate for price stability from the medium term to the longer term (longer than two years) as financial stability is prerequisite for monetary stability in the longer term. Consequently, the two-pillar strategy of the ECB could be adapted in such a way that its economic analysis focuses on price stability in the medium term and its monetary analysis (e.g., credit and money growth) on financial stability in the longer term. The Bank of Japan’s analysis and strategy could be taken as an example to merge the responsibilities for monetary and financial stability in the medium and longer term. The two-pillar strategy offers an excellent framework for a time-consistent approach of preserving monetary and financial stability. It is up to Mr. Draghi as the new President to give guidance to the ECB through this terra incognita.
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**Change of Guard at the ECB: How to Limit the Damage**

Daniel Gros

**BRIEFING NOTE 4**

**Abstract**

The ECB is clearly not responsible for the era of lax supervision and fiscal policy of the mid-2000s and fought valiantly against the relaxation of the Stability and Growth Pact. However, during that long period of excessive credit growth, it could have acted by using the interest rate tool to pursue price stability and structural measures to pursue financial stability. Moreover, the ECB would have kept its reputation intact and maintained cohesion within the Governing Council if it had recognised earlier that Greece represented a problem of insolvency.
LIST OF ABBREVIATIONS

ECB  European Central Bank
EFSF  European Financial Stability Facility
EFSM  European Financial Stability Mechanism
EMU  European Monetary Union
ESM  European Stability Mechanism
GDP  Gross Domestic Product
IMF  International Monetary Fund
QE  Quantitative Easing
SMP  Securities Markets Programme

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EXECUTIVE SUMMARY

‘Let bygones be bygones’, as the saying goes. When assessing the challenges facing the incoming president it seems of little use to dwell on the performance of his predecessor.

The main criticism we would address to President Trichet is that under his leadership the ECB failed to take any action against a too rapid expansion of money and credit, which at an average annual growth rate of 7% far exceeded the ECB’s own target of 4.5%. The ECB was prevented from taking action by its exclusive focus on price stability. Financial stability should have been considered as important even before the boom turned to bust.

It would have been very useful if the ECB had succeeded in moderating credit growth at least to some degree: the European banking system would then be more stable today and the euro crisis less virulent.

The incoming president now faces one key challenge that might be put in fairly stark terms: save the ECB and fracture the euro or fracture the ECB to save the euro?

Continuation of the Securities Markets Programme (SMP) on a large scale risks fracturing the Governing Council, but abandoning the SMP totally might lead to an even bigger financial crisis and the end of the euro.

We show that there is a middle ground that preserves the euro, but avoids deepening the internal split within the Governing Council of the ECB by transferring the responsibility for secondary market intervention to the EFSF, while giving it access to ECB liquidity.
1. INTRODUCTION

On 31 October 2011, the eight-year term of Jean Claude Trichet as Head of the European Central Bank (ECB) comes to an end and Mario Draghi will step in as his successor.

The first seven years of the Trichet term are considered by most to have been a success in that it achieved price stability and intervened promptly and decisively at the onset of the financial crisis in 2007. However, we would not exonerate the ECB from criticism or Mr Trichet for having presided over a long period of excessive expansion, during which its own (intermediate) growth target for money supply was ignored.

The policy of the ECB over the last year, in particular after the spring of 2010, has clearly been much more controversial and Mario Draghi will, in particular, have to deal with its legacy. This includes, in the first instance, the decision to buy the public debt of peripheral countries under the so-called Securities Markets Programme (SMP).

The change of guard could represent an opportunity to limit the damage and clarify two issues:

1) For the long term: an acknowledgement that financial stability is part of the mandate of the ECB, and,

2) For the short term: a clarification of the relative roles of the ECB and the EFSF (ESM after 2013) as lenders of last resort.

The rest of the paper is structured as follows. Section 2 briefly assesses the Trichet era, emphasising the limits of a narrow approach to price stability. Section 3 focuses on the possible division of roles between the EFSF and ECB in dealing with the crisis. The last section concludes.
2. THE TRICHET ERA: All eyes on price stability

When the ECB was set up only one target was clearly identified: price stability. Under the presidency of Trichet the ECB clearly achieved this target. Over the past ten years, the inflation rate in the euro area has remained below but close to 2%. At the start of the Trichet presidency this led to the characterisation of the ECB as the “ultimate narrow central bank” with a very limited role in ensuring financial stability (confined to ensuring the smooth functioning of the TARGET payments system).1

We would argue that the exclusive focus on price stability led the ECB not to take action when money and credit growth remained at elevated levels leading to an excessive build-up of leverage. Unfortunately this mistake cannot be easily undone.

2.1. The run-up to the crisis period

It will be remembered that in its initial monetary policy strategy, the ECB had set for the growth rate of M3 a reference value (intermediate target) at an annual rate of 4.5% for guiding the economy towards price stability. However, the ECB then ignored this target completely, as can be seen from the money gap displayed in Figure 1, below.  

Figure 1. Money growth in the euro area, theoretical and actual (1999=100)

![Figure 1. Money growth in the euro area, theoretical and actual (1999=100)](image)

Source: ECB Statistical warehouse.

This figure shows that the actual growth rate of M3 continuously exceeded the reference value of 4.5%. The actual growth rate of M3 was above 7% on average per year. Only after the bust of 2008 did the M3 growth rate fall back below the target (but was then probably too low).

During the boom years the failure to control the growth rate of monetary and credit aggregates did not seem to matter because inflation remained low. The reason was, of course, that the excessive expansion of bank credit was channelled mainly into asset

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1 See, among others, Schinasi (2003).
markets, while leaving goods markets relatively unaffected. In other words, excessive credit growth materialised in the form of asset price inflation rather than goods price inflation, which was the only relevant indicator in the ECB policy setting.

The counterpart to the excessive expansion of money can be seen by looking at a measure of leverage in Figure 2, which shows the debt levels of the different sectors of the economy relative to GDP. This has increased significantly since the creation of the monetary union, in particular in the financial sector.

Excessive leverage is an essential ingredient in any major financial crisis and the one is not an exception. In financial markets, leverage is defined as the ratio of debt to equity financing; when this ratio increases in general the capacity of a firm to absorb losses declines and hence its fragility is increased. In macroeconomic terms, leverage is better defined as the ratio of debt-to-GDP and the concept can be applied to all sectors of the economy. 'Leverage defined this way increases when credit expands without a consistent adjustment in GDP. Since regular cash flows are proportional to GDP, this implies that many agents have issued promises to pay a certain nominal amount but do not necessarily have the ‘expected’ regular cash flow to honour these promises (see Minsky, 2008, for the classical description of leverage schemes leading systems towards instability). 'It is impossible to establish an absolute benchmark for leverage, as different financial systems can support quite different ratios of credit to GDP.' Rapid and persistent increases in this ratio constitute alarm signals, however, which have been identified as reliable predictors of financial crisis. These signals were clearly sounding before 2007 but they were ignored. Figure 2 shows that over the last decade euro area private debt relative to GDP increased by almost 200 percentage points and the increase took place mostly in the financial system, whose fragility became apparent first in 2008 and then again in May 2010.

**Figure 2. Euro area leverage over the last decade**

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2 The following paragraph is basically taken from Gros and Alcidi (2009), pp. 255-256.
3 Gros and Alcidi (2009), p 250.
5 Gros and Alcidi (2009), p. 250.
Excessive leverage in the banking sector was mostly due to a combination of lax financial regulation and the generalised absence of risk aversion, for which the ECB certainly cannot be blamed. Yet the ECB could at least have tried to limit the phenomenon by invoking the separation principle it uses today: interest rate tools to achieve price stability and using structural measures, like reserve requirements, to limit the ability of banks to extend credit. This could have made the crisis less virulent, at least to some extent, but these measures were not deployed.

To be fair to President Trichet, one has to acknowledge that the ECB uttered a few warnings about potential asset price bubbles, but it was wrong to claim that it could do nothing to prevent a bubble from forming.\(^6\)

### 2.2. The ECB response to the sovereign debt crisis

The ECB is right in viewing the sovereign debt crisis as falling entirely under the responsibility of the national fiscal authorities. Monetary policy can certainly not be responsible for a lack of fiscal discipline in the euro Member States; if anything it should be remembered that President Trichet fought valiantly against any relaxation of the Stability and Growth Pact and applied pressure when he thought that heads of state were not acting responsibly. But in the end fiscal troubles did emerge and the ECB was thrust into an objectively difficult position. This occurred, notably in May 2010, when financial markets got into a vertiginous tailspin about possible Greek insolvency, despite the financial safety network (EFSF) newly established by the euro area governments with a headline figure of EUR 750 billion. However, the decision of the ECB to begin a purchase programme of government securities in the secondary markets, the SMP, was not the right answer to the Greek problem, which was one of insolvency, not just liquidity.

The official justification for this controversial decision was to re-establish the functioning of some broken monetary policy transmission mechanisms. But this goal was not achieved, as theory would predict, given that the problem was one of insolvency. Figure 3 shows the evolution of the spreads of Greece, Ireland and Portugal (GIP), the countries under an official emergency programme, against the amount of the ECB purchases. The chart indicates that the spreads are on a clear upward trend, after the first significant fall coinciding with the beginning of the programme suggested a limited overall effect. The SMP might have been justified for a few days after May 10\(^{th}\), but it should have been stopped immediately rather than continuing over the summer.

\(^6\) See De Grauwe and Gros (2009) for a more detailed investigation of this point.
The SMP was not the only extraordinary measure taken by the ECB. The ECB had also adopted, on three separate occasions, changes in the eligibility of debt instruments issued or guaranteed by the governments of the most troubled countries, namely the three countries under the emergency programme.\footnote{The ECB changed eligibility rules for Greece, Ireland and Portugal, see its press releases for 3 May 2010: \url{http://www.ecb.europa.eu/press/pr/date/2010/html/pr100503.en.html}; for 31 March 2011: \url{http://www.ecb.int/press/pr/date/2011/html/pr110331_2.en.html}; and 7 July 2011: \url{http://www.ecb.europa.eu/press/pr/date/2011/html/pr110707_1.en.html}.}

These repeated decisions negatively affected the credibility of the ECB, which had previously asserted that it would never undertake any such measure in favour of any individual country. Instead it should have recognised the severity of the problem earlier and established a sliding scale of haircuts much earlier.

Moreover, the ECB continued to oppose any ‘private sector involvement’ long after a decision on this had been taken by the Heads of State and Government of the Monetary Union. The ECB might even feel vindicated in this opposition but the threat to no longer accept Greek collateral should Greece be rated in ‘default’ or even ‘selective default’ was clearly not appropriate.

### 2.3. The Trichet legacy

The Trichet legacy at the ECB is therefore a complex one because, whether it liked it or not, over the last year the influence and the responsibility of the ECB for the resolution of the crisis has grown enormously. The legacy comprises a financial sector that is still highly

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**Sources:** ECB statistical Data warehouse and Bloomberg.

**Note:** GIP stand for Greece, Ireland and Portugal.
leveraged and thus fragile combined with a Governing Council that is split over the future of the SMP and more generally over the decision to buy the government bonds of the one country with a real solvency problem. The ECB should have been more prudent in the case of Greece, which is clearly insolvent, to be now more credible when asserting that it is buying Italian and Spanish bonds because these countries only face a liquidity problem and not a solvency problem.\footnote{We do not dwell here on the positive aspects, which include a sterling reputation for price stability.}
3. CHALLENGES AHEAD: DEFINING ECB AND EFSF ROLES

The key challenge for Mario Draghi will be to redefine the role of the ECB in the context of the euro crisis.

The core problem is simple: the European Financial Stability Fund (EFSF) simply does not, and will not, have enough funds to undertake the massive bond purchases required to stabilise financial markets. It was sized to provide emergency financial support only to small peripheral countries like Greece, Ireland, and Portugal.

Does this imply that the ECB is condemned to just continue its SMP and buy potentially hundreds of billions of Spanish and Italian government bonds?

We would argue that it cannot be the role of a central bank to support the bond prices of any particular member country or group of member countries.\(^9\)

What could be done to extricate the ECB from this predicament? Gros and Mayer (2011b) argue that given that the existing cascade structure of the EFSF is part of the problem, the solution cannot be a massive increase in its size. Rather, the EFSF could simply be registered as a (special) credit institution with access to re-financing by the ECB in case of emergency. The new EFSF would then have access to ECB funding as do other banks, for which the central bank acts as a lender of last resort.

Should another big liquidity crunch arise the EFSF could then access normal ECB facilities by using the government bonds it is purchasing as collateral. Assuming that the ECB insists on the top quality of the assets it takes for collateral – as for instance assured by a high rating – it would ensure that it only lends in case of a liquidity crunch and not when a country suffers insolvency. The decision to intervene to buy national government bonds in order to protect financial stability would be taken by the EFSF, based on expert assessments and under the supervision of Finance Ministers, in conjunction with the ECB and the European Systemic Risk Board (as already foreseen in the Conclusions to the July 21st European Council). Hence, the ECB, whose task it is not to determine fiscal policy in specific countries, would again be able to look after price and financial stability for the euro area as a whole.

The ECB would still be able to control liquidity developments for the entire euro area because once financial markets have returned to normal it could simply stop its policy of full allotment. At this point any refinancing by the EFSF would simply crowd out financing to other banks and thus not increase area-wide liquidity.

Backstopping the EFSF via the ECB – i.e. by creating a European Monetary Fund (EMF)\(^10\) – would have the advantage over the current mess in that it leaves the management of public debt problems in the hands of the finance ministries, and provides them with the liquidity backstop that is needed when there is a generalised breakdown of confidence. In a crisis of confidence the fundamental problem of banks and governments is always one of liquidity. This is exactly when a lender of last resort is most needed.

But would our proposal be consistent with the European Treaties? We think so. Article 123, Paragraph 1 of the TFEU forbids direct ECB credit to public institutions so as to avoid monetary financing of fiscal deficits. However, Article 123, Paragraph 2 exempts banks owned by the public sector from this prohibition. Thus, public banks such as the European

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\(^9\) One cannot justify the SMP with a reference to the quantitative easing (QE) undertaken on a large scale by the Federal Reserve. QE for the ECB would mean that it buys \textit{pro rata} the bonds of all member countries.

\(^10\) Note the IMF finances its own lending mostly by ‘drawing’ the currencies of its stronger member countries from their national central banks. In other words the IMF is mostly financed through the creation of liquidity. Allowing the EFSF to do the same would make it into a real analogue to the IMF.
Investment Bank or the German KfW (which extends the German part of funds for the adjustment programme to Greece) have access to ECB windows. Moreover, Council Regulation No. 3603/93 from 13 December 1993 exempts the IMF and the balance-of-payments-assistance-facility (renamed as the EFSM) from the prohibition of receiving ECB funds. Hence, we do not see a serious legal obstacle to giving emergency access to ECB funds.
4. CONCLUDING REMARKS

Save the ECB and fracture the euro or fracture the ECB to save the euro? One is tempted to put the problem facing the incoming President Mario Draghi in these stark terms.

We would argue that there is a middle ground that preserves the euro, but avoids an internal split within the ECB by transferring the responsibility for secondary market intervention to the EFSF, while giving it access to ECB liquidity.
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Changing of the Guard
Trichet's Track Record and Challenges Ahead for Draghi

Guillermo De la Dehesa

BRIEFING NOTE 5

Abstract

During his term as ECB President Jean-Claude Trichet had to deal with two major, interconnected crises, a great financial crisis and a subsequent sovereign debt crisis. By using extraordinary and unconventional monetary policy measures he avoided through his personal courage so far a worst case scenario.

Mr Mario Draghi is going to inherit an extremely difficult and uncertain financial situation. Major tasks during the new Presidency will be preventing a deterioration of the crises, pushing harder for a fiscal union within his mandate and taking further steps making the ECB more accountable and efficient.
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EXECUTIVE SUMMARY

Jean Claude Trichet took over from Wim Duisenberg, as President of the ECB, the 1st of November 2003 and is due to leave his position on the 31st October 2011. Subsequently, Mr Mario Draghi takes over as new President.

During his 8 years in office he has faced huge challenges and under these difficult situations he has shown his leadership and courage. Most of the challenges were derived from euro area design failures, difficult to face, because he did not have any political decision making power, but only influence. His two main challenges have been to undertake a reasonable monetary policy during the great financial crisis of 2008-2009 and the sovereign debt crisis of 2010-2011, which, unfortunately have not faded out yet. Overall, his track record is quite positive. Faced with extreme and complex situations in the euro area, he has been able to tackle them by making very tough decisions, on the verge of illegality. At the same time, he was being able to get a large majority backing from the ECB Governing Council.

Among his pluses under his presidency, which he has to share with his two successive Vice-Presidents and most of his permanent members and governors of the ESCB in the Governing Council, three should be mentioned:

First, he did introduce a major improvement in communicating the Council policy rate decisions to the markets, which has helped to improve the ECB’s credibility and policy efficiency.

Second, after the financial crisis and the recession that followed, the Council was able to avoid bringing the policy rate level to zero, as the US did, risking a liquidity trap, while, at the same time, reducing the OIS and the Euribor rates, by means of a clever management of liquidity.

Third, his personal courage, with the support of the majority of the Council, for taking extraordinary and necessary measures; first to reduce the impact of the financial crisis on euro area banks and, later, to fight the euro area sovereign debt crisis, most often alone and going even beyond his mandate provided by the Treaty and by the ECB statutes. Moreover, he has been able to convince some euro area political leaders to take decisions, which may have never been taken. At the same time, he has also taken decisions almost breaching the ECB rules, to avoid a collapse of the banking system and therefore of the euro area as a whole. He has understood that in extraordinary situations, extraordinary unconventional measures need to be taken to avoid even worst outcomes.

Among his minuses under his presidency, three should be mentioned:

First, the Governing Council was too slow to raise policy rates at the beginning of his mandate, when they were at 2% since June 2003, by keeping them flat until December 2005, because Germany, France and Italy were growing very little, which helped to produce an asset bubble in the faster growing euro area periphery.

By contrast, the Governing Council was too quick to raise policy rates up to 4.25% in July 2008, just two months before the Lehman default, and later too slow to bring them down, as they were still 3.25% until early November 2008 and later to increase them too early in April and July 2011, when the sovereign debt crisis was scaling up still. These movements show a weak guessing of medium term inflation expectations and/or weak economic forecasting.

Second, when the Stability and Growth Pact failed in 2003 when it needed to be applied to Germany and France, many Member States decided to relax their fiscal controls. The
financial markets did react by disciplining that relaxation. Accordingly, the ECB should have taken a more leading role in disciplining them by discriminating the price of government bonds that it accepts as collateral for its open market operations to provide liquidity to the banking system of the euro area by Member States.

Third, the Governing Council should have been able to increase the ECB’s accountability and transparency, both by transforming the “Monetary Dialogue” with the ECON Committee into a true “Monetary Hearing”, resembling that of the FED Governor in the US Congress, and by publishing the minutes and voting records of the ECB Council decisions.

Mario Draghi, as incoming new President, is going to inherit an extremely difficult and uncertain economic and financial situation, due to the unresolved sovereign debt crisis and due to the related, yet unfinished, euro area banking crisis. Nevertheless, his long time stay at the Italian Treasury, his five year experience as President of the Financial Stability Forum, which he transformed on Board, and later being Governor of the Bank of Italy and member of the ECB’s Governing Council will help him greatly to address the euro area banking situation as well as its sovereign debt problems.

But this is not enough. In order to prevent the present scenario becoming even more difficult, his major challenge as ECB President is going to be to keep pushing harder for achieving a fiscal union within his mandate: First by trying to achieve the issuance of Eurobonds and, second by continuing to appeal for the idea of a euro area Ministry of Finance. Additionally, he could take further steps to make the ECB more transparent and accountable in order to improve its efficiency. Finally, he will also need to find a proper interpretation of Article 123 of the Treaty on the Functioning of the European Union (TFEU) in order to allow the ECB to buy sovereign bonds in the secondary markets when the ECB finds it necessary and avoid dealing again with extraordinary situations without the support of the Treaty.
1. JEAN CLAUDE TRICHET’S TRACK RECORD AS PRESIDENT OF THE ECB

1.1. Monetary Policy

Trichet started his eight year term as President of the Governing Council of the ECB on 1 November 2003. His first challenge was having to deal with one of the euro area design failures, that is, a single monetary policy that may not fit all the different economic situations of the euro area Member States. For this reason, the monetary policy target had been defined as the harmonized consumer price index HICP, weighted by the relative weight of every Member State in the total GDP of the euro area.

As Germany, France, Italy and the Netherlands (weighting more than 70% of the total euro area’s GDP) where growing at a slow pace, policy rates were kept low at 2%. Nevertheless, these rates were too high for Italy, (growing at 0.0% in 2003), for Germany (-0.2%) and for the Netherlands (0.3%), were more correct for France (0.9%) and the euro area average (0.8%), but they were too low for Spain (3.1%), Ireland (4.4%) and Greece (5.9%).

Therefore, for the now called “periphery”, with higher growth and inflation rates, the 2% level of the policy rate ignited bubbles in each of them, (with the exception of Portugal, which had a very negative growth of -0.9%). The reason for the bubbles was that real interest rates, after deducting inflation, were close to zero or even negative in these 3 Member States having inflation rates above 3% in the case of Spain and Greece and around 2.5% in the case of Ireland.

In terms of monetary policy, looking in retrospection, three mistaken decisions have been taken by the Governing Council under Trichet’s presidency:

The first was keeping interest rates low for too long. Wim Duisenberg had kept policy rates at 2% since June 2003 until October 2003 when Trichet became President of the Governing Council. The Council kept the policy rate at 2% for two years and two months, until December 2005, when it was increased only by 25 basis points. At that time, Spain was growing at 3.8%, Greece at 4.0%, Ireland at 6.0% and France at 2.0%. Germany at 1.2% and Italy at 1.3% were the two slow growers in the euro area. Moreover, the euro area harmonized inflation rate was slightly above the target: 2.2%. Since then, policy rates were raised by the Council steadily up to 4% in June 2007, but the euro area inflation rate fell only from 2.2% in 2006 to 2.1% in 2007.

The second mistaken decision was taken at the beginning of 2008, when a sudden, but very short-lived, increase in the oil and food prices prompted the Governing Council to increase the policy rate to 4.25% in July 2008, just in the middle of the financial crisis and just two months before the Lehman default. After Lehman, policy rates were brought down at high speed to achieve 1% in May 2009. It was like a roller coaster.

The third mistaken decision was been taken in 2011. The Governing Council increased twice the policy rate by 25 basis points, in April and June, again because of oil price increases. At the same time inflation expectations were low, as recent growth data in the second quarter shows a large growth deceleration and a fall in the price of oil. Today, the euro area is closer to achieve another recession than the US. Most analysts think that Trichet has given more weight to growth in the euro area than his predecessor at the time of making decisions, but not in these three decisions.
To avoid these mistakes the Governing Council could study seriously the possibility to move from the HICP index to a harmonized GDP deflator, because the ICP has never been designed as a target for monetary policy, but for estimating purchasing power of households. If this alternative is not possible, at least to be able to give more weight, when necessary, to core inflation than to headline inflation when making decisions in uncertain and volatile commodity markets.

By contrast, the ECB has done an outstanding job in controlling the monetary transmission mechanism of monetary policy on two occasions: First, during the financial crisis, when liquidity dried up and the interbank market, which is the primary channel for the implementation of monetary policy, stopped functioning because of liquidity risk shoot up, and so did the spread between the overnight interest swap rate (OIS) (in the case of the euro area, the Euro Overnight Index Average or EONIA) and the ECB policy rate. Second, after Lehman bankruptcy, the spread shoot up again, this time, also driven by counterparty and credit risk for fear of default by other banks.

Steering overnight interest rates is always crucial for the central banks, as it provides an anchor for the term structure of interest rates. In normal times, the spread between the EONIA and the policy rate was very low, around 4 to 5 basis points, but during the crisis both the “EONIA spread” as well as its volatility increased and so did the spread between the 3 month EURIBOR rate and the minimum bid rate, the so called “term spread”.

During this liquidity crisis, the ECB was ready to increase liquidity until achieving a liquidity surplus that made the EONIA rate to fall below the minimum bid rate (MBR) in the main refinancing operations (MRO) even further than in the non-crisis times, when EONIA normally trades above the MBR rate. Later, during the added counterparty risk crisis, the ECB was quickly able to accept a large variety of assets as collateral for its MRO independently of their rating or even without it and brought back confidence again.

The great advantage of the ECB versus the Fed or the Bank of England is that it had already a very wide definition of eligible collateral and also a very wide range of counterparties. The ECB usually operates with 300 banks, but 1700 other can access open market operations and additional 700 financial institutions can access its overnight standing facilities. As a result it was more able to maintain under control both the overnight spread and the term spread, than the FED and the Bank of England where a much more limited number of banks and more limited eligible collateral are allowed.

Therefore, the monetary policy of the ECB particularly its policy to frontload liquidity and its commitment to satisfy all counterparty bids in main refinancing operations has helped to restore confidence among euro area banks and to reduce their counterparty risk fears, contributing decisively to the recovery of the interbank markets in the euro area and to the smoother monetary transmission of monetary policy.

1.2. Communication, Transparency and Accountability

Effective communication is very important in monetary policy, even more for a young institution such as the ECB, with a short track record and dealing with a multilingual setting. Moreover, monetary policy is not only a matter of effective control of overnight interest rates but even more a matter of managing market expectations. Therefore, transparency and communication are also essential for the effective conduct of monetary policy.

Alan Greenspan pioneered the practice of using effective communication to explicitly manage market expectations. He was the first to manage expectations by telling, in 2003, that the Fed would keep the federal funds rate low for a “considerable period of time".
Something similar has stated Ben Bernanke very recently announcing that the present federal fund rates will be kept unchanged until 2013.

Central banks’ monetary policy achieve to control directly short-term interest rates, but consumption and investment decisions are made based on longer term expectations, so that longer-term interest rates are more important for both of them. The same can be said for central banks, the whole yield curve is the more relevant for the effectiveness of monetary policy than the EONIA.

What banks, financial markets, analysts and the public in general want is transparency and medium term predictability of monetary policy and what central banks need is medium term predictability of agents and markets behaviour to make monetary policy more effective, so that both feed each other making an advantageous fit for both parties.

Trichet has improved effective communication from his predecessor. He has started using “coding” to communicate the ECB stances, which has given more predictability to the ECB. He is also very able to give hints or signals (more often in the Q&A than in his introductory statement) that help markets to understand better the Governing Council intentions. He has made a very positive effort to be more explanatory, didactic and clear with financial markets, analysts, media and the public in general because he strongly believes that effective communication is an important tool to stabilize effectively medium term inflations expectations.

His main drawback in this area is that he has not been able to make much further advances on transparency and accountability, partly because he has not the legal authority to do so and partly because he has felt comfortable with the present situation. The fact is that today, there is not an elected political institution that can impose sanctions on the Governing Council members should they perform poorly or engage in agency shirking. Therefore, the ECB being without any doubt the most independent central bank in the world\(^1\), its transparency and accountability should try to match its level of independence, what is not yet the case today.

The relationship between both has been a major issue of debate in the last years given that other economists think that there is not a trade-off between independence and accountability if both concepts are adequately defined, in the sense that accountability is considered by them a complement of and not a requirement of independence.

Moreover, following the tradition of European integration, it is well known that the ECB is an institution which is based on the idea of technocratic decision-making, which is comparable to the High Authority of the European Coal and Steel Community. Therefore, the only way to achieve institutions that are accountable to politically elected institutions, both in the euro area and in the European Union, would be through eventually achieving a full political union, as a federation or confederation of Member States.

But the true fact is that in several rankings for transparency and accountability of central banks published on both accounts, the ECB ranks low. On transparency, the ECB ranks low because it is considered to be more opaque than the large central banks (Fed, Bank of England and Bank of Japan) mainly because it fails to publish voting records, minutes or some other timely account of deliberations of its Governing Council meetings. Its present so-called “procedural transparency” receives one of the lowest scores.\(^2\)

Therefore, there is an increasing need for the ECB to publish voting records to give more transparency and credibility to its decisions and to match what the Fed and the Bank of England already do. "The ECB and ESCB statutes only say that “save as otherwise provided

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1 For the following paragraphs see also De la Dehesa (2009)
2 See De la Dehesa (2009)
by for in this statute, the Governing Council shall act by simple majority of the members having voting right and, in the event of a tie, the President shall have a casting vote”.

Nevertheless, it appears that the Council does not use or has never used that decision system but, instead, takes its monetary policy decisions by consensus (as it has been said many times by its [two consecutive] presidents)\textsuperscript{3}. The problem is that the word “consensus” is even less clear than simple majority. It can mean unanimity or general agreement or any other greater degree than simple majority. The ECON Committee of the European Parliament, supported by resolutions of the Parliament, in several occasions, has urged the publication, in its Annual Report, of the minutes and the non attributed voting records of its Governing Council meetings.\textsuperscript{4}

Even if the ECB’s main objective is to achieve price stability over the medium term it needs also to take into account its effect on the real economy. This is the reason why most central banks report their forecasts on these two variables at the same time. But the ECB has traditionally presented them as “staff projections”, emphasizing that the Governing Council do not necessarily share its staff views, reducing even more the information value of its forecasts.

Since December 2005, Trichet has reacted to this need and has introduced an improvement in his "Introductory Statement, by complementing the staff forecasts with an explicit statement of the Governing Council view on the “balance of risks”, either to the outlook or to the projections. Nevertheless, the publication of the monetary policy committee’s own expectations would provide a much clearer view of what [the ECB] thinks because [it] needs a negotiation among its members.”\textsuperscript{5} Other central banks publish also the “expected interest rate path” because interest rate assumptions are crucial, given that the short/term interest rate is their key monetary policy instrument, being much more under their control than other variables. Therefore, the ECB could use its balance of risks to price stability to provide more guidance about the next interest rate move.

Finally, in terms of accountability, the quarterly Monetary Dialogue with the ECON Committee does not fulfil its expectations because it becomes more a “dialogue” than a “testimony” or a “hearing”. The ECB’s President, in its initial speech, tends not to say much more than what is already known. He rather tends to give more insights and signals about the ECB monetary stance at the press conferences following the meetings of the Governing Council than at his Monetary Dialogue meetings with the ECON Committee. Nevertheless, the backbone of the Monetary Dialogue should be to discuss more about the ECB medium term strategy, in order to be accountable by being totally transparent and predictable, than about its short term open market operations and exchange rate interventions.

There are three problems for addressing ECB accountability. The first one is that ECB “Governing Council members are not nominated on the basis of a fully European procedure. The Governing Council members are accountable only to the European Parliament and to the European Council, but both bodies however do not play any role in the appointment of the national central bank Governors [of the euro area Member States], given that their membership in the Governing Council is automatic, not being subject to confirmation by any European body, as in the case of the Court of Justice or in the Commission.”\textsuperscript{6}

The second one is that of the 50 articles of the ECB statutes, only section 3 of Article 15 titled: “Reporting Commitments” mentions that the ECB should present its Annual Report to

\textsuperscript{1} De la Dehesa (2009)  
\textsuperscript{4} See De la Dehesa (2009)  
\textsuperscript{5} De la Dehesa (2009)  
\textsuperscript{6} De la Dehesa (2009)
the European Parliament in compliance with Article 284(3) of the Treaty on the Functioning of the European Union (TFEU).

The third one is that the ECON Committee includes 48 MEPs from all political stances and nationalities, which makes it more difficult to conduct real “hearings”, as the Congressional hearings of the Fed Chairman where the number is very low.

Nevertheless, the ECB could do more to enhance the status of these meetings in the sense that the ECB President could use the Monetary Dialogue, not in every quarter, but from time to time, to provide important signals to the MEPs at the ECON Committee. Alternatively, the ECB President and the rest of the members of the Governing Council, should stick to their mandate and have only one very important meeting a year, where they present the ECB Annual Report, followed by a very well structured and long hearing which would raise great expectations on financial markets, analysts, the press and the public in general and get similar importance to the Congressional hearings of the Fed.

1.3. Financial and Sovereign Debt Crises

Trichet’s best performance has been seen in the way he has faced and dealt with two extremely dangerous economic and monetary events that, according to past history, happen only once in a century. It is in extreme events and situations in which the president of an institution in charge of price and financial stability needs to show his leadership and courage to avoid their worst outcomes. Trichet has come out very well, even more given his narrow mandate and the wide and diverse Governing Council who he chairs.

He has been a decisive actor convincing top leaders in the euro area to act speedily on issues relevant to the financial stability of the euro area and to avoid a default of any of its Member States.

First, several times, Trichet criticized the European Commission for not making the Stability and Growth Pact (SGP) sanctions automatic and for repealing the changes made to the SGP in 2005.

Second, at the start of the Greek fiscal drama in October 2009, given that the euro area institutions did not have either expertise or funds to avoid a restructuring or even a default by Greece, Trichet was ready to help the IMF, which came to intervene, do its job and help Greece getting out of its debt problems, as a duty for one of its 187 members. Unfortunately, the euro area leaders did not accept the IMF and ECB to participate while Greece economy was deteriorating.

Third, Trichet then asked for the creation of a European Monetary Fund (as the IMF for the world) for the euro area without any result. Finally, eight months later without acting on Greece, while the deterioration of its economy was much worse, he helped in the creation of the second best alternative, the European Financial Stability Facility (EFSF), asking for a much larger size, enough to be able to bail-out Greece, Ireland and Portugal and avoid their banks to default and later, cooperated with the IMF in the programmes applied to the three Member States.

In the meantime, he was temporarily avoiding a default of both these Member States and their banks, by providing huge loans to their banks and / or buying their sovereign debt in the markets. For instance, at a given point in time, the ECB had directed to Ireland, which is only 2% of the euro area GDP, 25% of the total loans given to the euro area banks, before the EFSF was able to give loans to Ireland, to avoid its default.

Fourth, he and his colleagues at the ECB Governing Council, have fought decisively to stop the euro area leaders intention to allow for a restructuring of, and therefore a “credit event“ on, the Greek debt, because it would have produced a huge contagion effect on
other Member States, similar to the one experienced after Lehman’s default in 2008 on other banks, avoiding another huge banking and financial crisis in the euro area.

Fifth, he and most of his colleagues at the ECB Governing Council decided to buy sovereign debt in the secondary markets from these three Member States, because they were forced because, incomprehensively, the EFSF had not been allowed to do it by the European Council and also because they had to do it in any case, in order to avoid another banking crisis. They did so, because they felt to be responsible in the last instance, while they were heavily criticized by several important euro area politicians, who maybe preferred the end of the euro to braking bureaucratic rules.

Sixth, once the EFSF had been finally allowed, by the European Council, to buy sovereign debt in their secondary markets (almost fifteen months after its creation) but much before the Member States parliaments are going to ratify it, the ECB has been forced again to buy pre-emptively some debt from Italy and Spain in their secondary markets, after suffering serious attacks, while, again, several prominent euro area politicians were saying that it was illegal to do it by the ECB, according to the Treaty. The total euro area sovereign debt in the balance-sheet of the ECB is, as of today, close to EUR 100 billion.

Seventh, after Merkel and Sarkozy proposed that the only way to give long term confidence to the markets was to introduce a structural balanced-budget rule in all constitutions of the euro area Member States, Trichet has sent letters to the prime ministers of Italy and Spain asking them for several fiscal and structural reforms, including the introduction of the balance-budget rule in their national constitutions, supposedly, as a prerequisite to continue further with buying their debt in the secondary markets.

Eighth, on several occasions, Trichet has been discussing together with Merkel and Sarkozy, prior to meetings of the Euro Council, what new steps need to be made. His contributions may have been decisive to try to solve the problems or to improve the policy decisions.

In sum, Trichet’s contribution to avoiding very serious mistakes or at least, to soften them, that were going to be made by some euro area political leaders, even going beyond his mandate and attributions, deserves a lot of gratitude and makes his stature grow unambiguously at the end of his term, making it difficult for his successor to beat his eight year track-record.
2. CHALLENGES LEFT TO MARIO DRAGHI

The present economic and financial situation of the euro area, after a financial and a sovereign debt crises, which unfortunately are not yet resolved, looks even more challenging for the new President than ever before in the short history of the ECB and also of European monetary integration. To help to solve it, Mario Draghi needs not only knowledge and expertise, which he has well in excess, but mainly, more political leadership and determination from the decisive part of the euro area political leaders, which have proved to be, until now, rather weak. For this reason he needs to use his accumulated knowledge and expertise and his conviction capacity to help them made the right and most productive decisions.

The ECB has a mandate to achieve price stability but also to supervise and monitor financial stability (together with the ESCB). Both are key for the proper functioning of the monetary transmission mechanism, for maintaining price expectations stable as well as for avoiding another financial crisis. If the present sovereign debt crisis does not end or may even get worse, as it may seem to be the case right now, it could end producing another financial and banking crisis. This may entail a double dip or even another recession and in turn, a further deterioration of the present sovereign debt crisis, because both crises feed on each other.

In order to avoid the worst under such a scenario, the ECB will need to try to break the nexus of both self-feeding crises. Therefore, he could be forced to take, once again, dramatic and unconventional decisions in order to avoid even a deflation in the euro area. Among these unconventional decisions, one could be increasing the present inflation target and, another, buying further sovereign debt and expanding further its balance-sheet in order to save most of the euro area Members States, their banks and eventually, the euro.

Moreover, in order to prevent such a terrible outcome, he should start his mandate by trying to push forward the following measures:

First, pushing for larger interventions (buying debt in the secondary market) by the reinforced EFSF.

Second, the creation of a European Debt Agency to be able to be issue Eurobonds and that could also replace the EFSF as buyer of last instance of debt in the secondary markets. In order to make Eurobonds more acceptable, Eurobonds should be exchanged for every maturing debt of every single Member State, including Germany, so it will be introduced softly up to achieve 60% of the GDP of the euro area.

Third, the transformation of the present EFSF into a true European Monetary Fund which can intervene, impose programmes and help Member States not to default.

Fourth, the creation of a European Ministry of Finance that can tax euro area Member States to pay for their debts.

Fifth, the achievement of a clearer and more extensive mandate for the ECB, both in the Treaty and in its statutes, about what really the ECB can do as a lender of last resort.

Finally, the new President will have to improve further the level of transparency and accountability of the ECB and to show the same courage and leadership as his predecessor under extreme situations. He is without any doubt extremely capable to do it, his present track-record shows that he can do it, and now he has the chance to prove it.
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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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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. MR. 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. 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**

![Graph showing monthly annual percentage changes in the euro area inflation rate](image)

*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.

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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 1, below.

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<th>Country</th>
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<td>ECB</td>
<td>Decision</td>
<td>none</td>
</tr>
<tr>
<td>Japan</td>
<td>Decision and vote</td>
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<tr>
<td>United States</td>
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As can be seen in Table 1, 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.\(^3\)

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\(^2\) 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

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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 added to all BBB-securities.

The Governing Council of the ECB’s response to the liquidity crisis was at 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 [illiquid 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. 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.

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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. 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. 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.

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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 \textit{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 \textit{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 has been up till now. The monetary policy committee should start taking votes, reporting the outcomes and publishing the minutes.\textsuperscript{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.

\textsuperscript{10} Recent public disagreements within the Executive Board may get it used to the idea that it need not speak as one.
Trichet’s ECB Presidency: A True Age of Turbulence

Karl Whelan

BRIEFING NOTE 7

Abstract

Under Jean-Claude Trichet, the ECB achieved an average rate of price inflation in line with its target. In this sense, Trichet achieved the principle goal that has been set for the ECB, and thus his term has been a success. In addition, Trichet’s performances at ECB press conferences and other public events have been incredibly effective in communicating the organisation’s independence and commitment to price stability. However, while the ECB’s initial response to the global financial crisis was effective, its response to the euro area debt crisis has been far less impressive. Trichet has been dogmatic and unhelpful on the question of debt defaults and significant questions remain about the long-run impact of the Securities Market Programme on the ECB and the future of the euro.
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1. INTRODUCTION

While it is natural to use the period before someone’s departure from their position to assess their performance, in the world of central banking reputation often depends crucially on what happens after a departure.

When Alan Greenspan ended his period as Chairman of the Federal Reserve in January 2006, he was widely hailed as a monetary policy maestro. Greenspan’s autobiography, published in September 2007, was titled “The Age of Turbulence”. One might image that the title was a hint of what was to come for the world economy but, in fact, the title reflected Greenspan’s belief that he had presided over an age of unprecedented economic turbulence. The book contains chapters on energy security, corporate governance and long-term pension problems. Sub-prime mortgages, however, are barely mentioned and the only sentence on the negative consequences of the popping of the housing bubble is “More recently, the unwinding of the housing boom has hurt some groups.” The verdict on Mr. Greenspan’s term these days is far less positive than it was on his departure as he is now widely seen as having been negligent in failing to prevent the biggest economic crisis since the Great Depression.

Jean-Claude Trichet has been less fortunate than Alan Greenspan in relation to the economic world he has had to deal with. What Greenspan called “the Age of Turbulence” was also dubbed by many academics “the Great Moderation” because of the low volatility of GDP growth and inflation that prevailed during this period. While the early years of Trichet’s reign coincided with this deceptively stable era of low volatility, his later years have involved challenges greater than perhaps any Federal Reserve Chairman has ever faced.

A learned man with a deep historical perspective, Trichet will know that history’s judgment on him will depend to a large extent on how the euro area debt crisis pans out over the next few years. However, he will have the small compensation of knowing that his own book, should he choose to write one, will be more interesting than Greenspan’s—certainly he will be more entitled to call it “The Age of Turbulence”.

In the rest of this paper, I provide a brief review of the many positive aspects of Trichet’s presidency. I then discuss some of the less positive aspects. These largely relate to the way the ECB has reacted to the euro area debt crisis over the past eighteen months. Of course, the problems largely reflect the wider failure of European governments. However, the ECB’s performance during this period has been overly dogmatic at times and weak and indecisive at others. I conclude with a brief discussion of the prospects for Trichet’s successor. For all Mr. Trichet’s successes, it cannot be denied that Mr. Draghi will be inheriting an extremely difficult set of challenges.

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2. TRICHET’S POSITIVE LEGACY

Without denying the serious current problems of the euro area, Jean-Claude Trichet’s stewardship of the ECB has had many positive aspects. Here I focus on the maintenance of price stability, Trichet’s strength as a communicator and his response to the global financial crisis in 2008/2009.

2.1 The Prime Directive: Price Stability

I have little doubt that when Jean-Claude Trichet provides his own assessment of his term as ECB chief, he will point to his achievement in fulfilling the ECB’s principal goal of price stability. While the statute governing the ECB does not define price stability, the ECB interprets it as a rate of price inflation for the Harmonised Index of Consumer Prices (HICP) of just below 2 percent. By my calculations, the average rate of year-over-year HICP inflation since Jean-Claude Trichet assumed the presidency of the ECB in November 2003 has been 2.03%. Effectively, Trichet’s ECB has hit the bullseye with regard to meeting their principal objective.

Figure 1: Euro Area Year-over-Year HICP Inflation

Source: ECB Statistical Warehouse

This ex post achievement of the target level of inflation is impressive enough. However, every central banker knows that they have little control over short-term movements in headline inflation: the Trichet era saw inflation rate as high as four percent as well as a short period of outright deflation. What is perhaps more important has been the ability of the ECB to keep inflation expectations closely aligned with its target level.

It is well known that long-term inflation expectations have remained anchored at 2 percent. However, it appears that the public has generally expected deviations from the target level to be relatively short-lived. Figure 2 compares actual HICP inflation with the average rate
expected two years later by members of the ECB’s panel of independent professional forecasters. At no point during the ECB history, including the turbulent later years of Trichet’s presidency, have the swings in observed inflation translated into a loss of confidence that the ECB will get back towards its price stability target.

At this point, one could quibble that perhaps the ECB’s “inflation first” constitution restricts its flexibility to deal with financial stability problems or that its inflation target is perhaps too low and risks regular flirtation with the dangers associated with deflation and liquidity traps. Indeed, I am sympathetic to both of those arguments. However, Trichet did not design the ECB’s institutional framework. His job was to meet the organisation’s stated goals and to a significant extent the ECB has met those goals under his leadership.

**Figure 2: HICP Inflation and Expected Inflation in Two Year’s Time from the ECB’s Survey of Professional Forecasters**

![Graph showing HICP Inflation and Expected Inflation](source: ECB Statistical Data Warehouse)

### 2.2 The Man as the Message

Trichet would probably be the first to stress that meeting the price stability goal represents an achievement of the whole team of Governing Council representatives. However, we know little about how the team arrives at its decisions. The Governing Council does not release minutes and, with rare exceptions, its decisions are said to be taken with unanimity. This means that, much more so than most other central banks, the ECB relies heavily on its “captain of the team” to explain its actions to the public, most importantly in the monthly press conferences that follow the Governing Council’s monetary policy meetings.

Press conferences of this sort are a risky proposition for central bankers. In contrast to a carefully thought out post-meeting statement, a press conference carries the risk that the intended message about policy will get muddled or that unintended signals about future policy will be given. Given these difficulties, I believe Trichet’s performance at ECB press conferences to have been incredibly effective. Always articulate and energetic, he has used these appearances to consistently emphasise key themes such as the Governing Council’s commitment to price stability and its independence. He is patient with journalists (and allows questions on all sorts of issues) despite just emerging from an intense Governing Council meeting. However, he is far too wily to get dragged into discussing areas that he
sees as beyond his remit or for which he is not yet prepared to discuss the agreed position of the Council.

Jean-Claude Trichet has consistently emphasised the importance of the ECB’s independence from political interference in its monetary policy decisions. One of my favourite moments of the Trichet era came in September 2007, when Nicolas Sarkozy claimed while the ECB Governing Council press conference was still in progress that a decision to hold rates steady showed that his public lobbying had some impact. When asked about these comments, an unusually truculent Mr. Trichet told the watching journalists firmly and very slowly that “we are in-de-pen-dent” before delivering a stinging response. A cynic might argue that Sarkozy has been just the sort of pantomime political villain that Trichet has been happy to use to make his point about ECB independence, but the point has been made well all the same.

Unfortunately, as I discuss below, the economic crisis afflicting the euro area at present has provoked complex problems which have meant that the ECB is now deeply intertwined with a process in which political decisions affect the Bank and Bank’s decisions have political implications. Through little fault of Trichet’s, the ECB will end his era with its independence more in question than it was at the start of his presidency.

2.3 Crisis Response: Autumn 2008 to Spring 2010

While the ECB has often been criticised for various actions (or lack of actions) during the euro area debt crisis over the past two years, it is worth remembering that Trichet’s ECB took decisive and significant steps to address the impact on the European economy of the global economic crisis that went into overdrive with the failure of Lehman Brothers in September 2008. The key policy rate was cut from 4.25 percent in October 2008 to 2 percent in January 2009 and then down to 1 percent in May 2009, where it remained for two years.

Perhaps more important than the rate cuts was the willingness of the ECB to be flexible in its operational procedures. The Bank moved from auctioning off fixed amounts of credit to fixed rate tenders in which banks could borrow as much as they wished, provided they had sufficient eligible collateral. Rules in relation to collateral were also eased. The result was a rapid increase in ECB lending, with the ECB stepping in to provide necessary liquidity as interbank markets seized up. While these measures did not avoid a severe recession, they undoubtedly helped to limit the size of the dip in activity and have helped to coax the Euro area economy out of recession. For these decisions, Trichet deserves significant credit.

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Figure 3: ECB’s Lending From Monetary Policy Operations (in millions of euros)

Source: ECB Statistical Data Warehouse
3. TRICHET AND THE EURO AREA DEBT CRISIS

While the Trichet era has seen many things go right, it cannot be denied that it is ending in the middle of a severe crisis, one that may at some point lead to the end of the Euro project for which Trichet has been such a passionate advocate.

I believe there are a number of areas where Trichet’s ECB can be fairly criticised to one degree or another. Here I focus on the failure to diagnose the upcoming crisis, an overly-dogmatic approach to the question of sovereign and bank defaults, and uncertainty in relation to the ECB’s role in the sovereign debt crisis.

3.1 He Didn’t See It Coming (But Then Not Many Did)

A number of euro area countries are currently suffering from severe debt crises. Greece, Portugal and Ireland are all receiving funds through formal EU-IMF programmes and Spain and Italy are under severe pressure, with the ECB currently (and controversially) intervening to purchase their sovereign bonds in the secondary market.

These crises did not stem from any single source. Neither Ireland nor Spain were running large deficits prior to the global financial crisis. Their current difficulties are a result of the bursting of large housing bubbles and their associated construction booms. Greece and Italy, on the other hand, have long had poor debt records. Given the extent to which fiscal problems have plagued the later years of Trichet’s reign, it is fair to ask whether he played a sufficiently strong role in preventing these problems emerging.

A look at the historical record shows that Trichet began his presidency with a strong interest in fiscal issues. During this period, there had been a number of violations of the three percent deficit limit and in November 2003, Trichet’s first month in the job, the ECOFIN Council decided to put on hold the excessive deficit procedures for France and Germany. In his opening press conference, Trichet was extremely critical of this decision, arguing “the proposals of the Commission push the room for interpretation of the rules and procedures to the limit.” However, his warnings on fiscal policy eased somewhat in subsequent years. By September 2007, with the global financial crisis looming into view, Trichet was issuing weak warnings such as “structural fiscal consolidation remains slow and there are risks that some countries will pursue expansionary pro-cyclical fiscal policies.”

In relation to the housing bubbles that proved so ruinous for Ireland and, to a lesser extent, Spain, again there is little sign that Trichet had any idea of the risks that were being run. At a May 2007 Governing Council press conference in Dublin, when asked a question about the Irish economy’s over-reliance on the property sector, Trichet responded that “very often, I and my colleagues of the Governing Council are mentioning the Irish economy as a role model in many respects for the euro area.” There is also little evidence that Trichet’s ECB saw the risks to the European banking system stemming from the huge investments of European banks in US subprime mortgage backed securities.

Taken together, I think there is an argument that Trichet’s Governing Council underestimated the fragility of the euro area construct. The ECB could have benefitted from a leadership that gave fewer speeches about the remarkable success of the Euro and how its critics have been proved wrong and that focused a little more on the weaknesses identified by those critics.

That said, these substantive failures largely reflect deficiencies in the euro area’s economic governance structures rather than problems with Trichet’s leadership. Responsibility for fiscal policy lay with national governments and oversight lay with the European Commission. Even if Trichet’s warnings on fiscal policy had been stronger and more insistent, it’s not at all clear that they would have been heeded. Similarly, responsibility for banking regulation lay with national authorities and while the ECB did focus on European financial stability issues, the truth is that very few people understood the fragilities in the global financial system that were exposed during 2008.

The lesson from the failures to see the fiscal and financial frailties that now dominate debate about the euro area is that Europe needs new structures to better monitor these areas. Some progress is being made in the area of enhancing the Stability and Growth Pact. It remains to be seen whether the new European Systemic Risk Board can have more influence on financial stability issues than the ECB has had up to now.

### 3.2 Default Dogma

If the ECB gets high marks for its initial response to the global crisis, it has been less impressive in dealing with the euro area debt crisis that has emerged over the past two years. It has also been less impressive in its approach to the problems associated with weakly capitalised or insolvent banks.

This performance is perhaps not too surprising when one considers the usual patterns associated with financial crises. Typically, the intense stage of a financial crises starts with a liquidity squeeze. Participants in financial markets are unsure which institutions are safe to lend to and which are not. In this situation, a central bank is typically relied on to play its role as lender of last resort and the ECB’s switch to supplying unlimited liquidity helped avoid bank failures throughout Europe.

However, as Carmen Reinhart and Ken Rogoff (2009) have documented, once the panic phase of a financial crisis is over, economies often emerge with governments and banks facing serious solvency problems. These solvency problems are harder to deal with than liquidity crises as they are generally resolved via one of a number of uncomfortable options: default, inflation or financial repression.

In my opinion, Trichet’s response to solvency problems in the euro area has been inadequate. For both banks and sovereigns, ECB officials have generally tended towards denial, clinging dogmatically to the idea that defaults by banks or sovereigns are unthinkable.

**Bank Debt**

In relation to banks, the ECB’s liquidity policy is supposed to conform to the old adage of lending only to solvent institutions against sound collateral. However, after the initial panic phase of the crisis, the ECB continued lending to institutions that were pretty clearly insolvent.

In particular, I would highlight the ECB’s policy in relation to Irish banks, particularly Anglo Irish Bank and Irish Nationwide Building Society (INBS). Well after it was clear that these institutions were insolvent, the ECB continued to lend them huge amounts of money. And when they ran out of ECB-eligible collateral, the Governing Council approved massive emergency liquidity assistance loans (where the risk upon default lay with the Irish government rather than the Eurosystem).

The result of this ECB policy was that private creditors of wildly insolvent banks were paid back in full. In contrast, once the scale of the insolvency of these banks was revealed, the
burden for repaying the enormous debts to the ECB (as well as repaying the emergency liquidity assistance) lay firmly on the Irish taxpayer. The cost of recapitalising Anglo and INBS (now dead banks whose principal raison d’etre is the repayment of ECB and ELA loans) has added debt of over 20 percent of Irish GDP, a burden that ultimately lead to Ireland being shut out of the sovereign debt market and into an EU-IMF programme.

Without doubt, the Irish government lead by Brian Cowen should take most of the blame for their ruinous policy of supporting insolvent banks. However, Trichet’s ECB were a key “partner in crime”. Rather than encourage the Irish government to place these banks in a resolution regime, the ECB continued to prop up insolvent institutions.

The motivation for this policy appeared to be a belief on the part of Trichet and other senior ECB staff that any defaults on senior bank bonds would trigger a further financial crisis along the lines of the chaos provoked by the Lehmans bankruptcy. I suspect that the ECB has learned the wrong lesson from Lehmans. Rather than proving that all senior bank debt must be repaid in full at all times, the Lehmans incident showed the need for clear rules about when financial institutions are wound up and how this process works. The damage of the Lehmans bankruptcy, in my opinion, stemmed from the uncertainty about which institutions would be saved and which would not.

Three years after the Lehmans incident, Europe still does not have a common agreed framework for winding down insolvent banks and avoiding all costs falling on the taxpayer. With the EU’s bank stress tests largely discredited and significant risks related to sovereign debt exposures, the state of the European banks represents a major risk factor for the global economy.

No less an authority than Christine Lagarde, managing director of the IMF and until recently the French finance minister, has said that European “banks need urgent recapitalization. They must be strong enough to withstand the risks of sovereigns and weak growth. This is key to cutting the chains of contagion.” However, the predictable response from EU politicians and senior ECB officials has been to say they don’t know what Ms. Lagarde is talking about.

This cycle of insistence that no financial institutions can fail, lack of preparation for any failure, and yet refusal to recapitalise them to defend against failure, threatens to blow up in the faces of European taxpayers. The ECB under Trichet has not been the only player in this unsatisfactory process but they deserve a fair share of blame.

**Sovereign Debt**

Prior to his ECB presidency, Jean-Claude Trichet spent a number of years as chairman of the Paris club, which is responsible for rescheduling official loans to developing countries with unsustainable debt burdens. One might have imagined that from this experience, Trichet would have a comparative advantage over other European leaders in spotting unsustainable debt burdens and in working on coming up with debt restructuring solutions that maintained financial stability.

In truth, from the first moment that it became clear that Greece’s public debt problem may be unsustainable to the final moment in July when an official restructuring deal for Greek debt was agreed, Trichet and other ECB officials remained adamantly opposed to the idea of any sovereign debt restructuring. As late as the July 2011 Governing Council press conference, Trichet was repeating his mantra “our message is “no credit event, no selective default – no default!” It is as simple as that!”

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Trichet’s strategy to avoid a Greek debt restructuring involved threatening to end ECB lending to Greek banks on the grounds that “we can no longer accept as normal eligible collateral defaulted bonds issued by the government of that country.” In the end, the collateral issue was solved via an agreement by euro area countries to support Greek banks in a way that allowed them to continue accessing ECB funding. However, the threat to pull funding was neither realistic (as it would have triggered an even bigger crisis) nor well-founded, since the outcome of a debt restructuring would have seen Greek banks holding new debt instruments that were less likely to be subject to default.

Overall, I believe that Trichet’s handling of the Greek sovereign debt crisis has been misguided. His approach denied the reality of the severity of Greek public debt problem and his threats to pull funding from the Greek banking system (threats that his officials have also directed at the Irish banking system) risked destabilising an already precarious situation.

3.3 Stop-Go: The Securities Market Programme

The Securities Market Programme has been the most controversial of all the issues faced by Jean-Claude Trichet during his presidency.

From the earliest discussions of the design of economic and monetary union, the interaction between monetary and fiscal policy was a major issue. High debt levels can often lead to pressure on central banks to intervene to purchase sovereign debt. While the link between central bank purchases of sovereign debt and inflation is not as mechanical as many think (concerns about the inflationary effect of the Federal Reserve’s purchases of Treasury bonds have proved to be unfounded) there is little doubt that regular monetary financing of deficits will ultimately lead to high inflation. For this reason, the Maastricht Treaty included a so-called “no bailout” clause, aimed at preventing monetary financing of deficits.

However, the “no bailout” clause was weaker than many had thought. It prevents the ECB from purchasing sovereign debt at primary auctions but does not prevent it purchasing sovereign bonds in secondary markets. As pressure on Greece and Ireland mounted during May 2010, euro area Member States agreed to set up the European Financial Stability Facility (EFSF) to provide funding to Member States that were being shut out of sovereign debt markets. However, the EFSF required legal authorisation by each Member State before it could be brought into action, a process that took a number of months. Thus, pressure was put on the ECB to intervene in the secondary bond markets of those countries that were under pressure.

Ultimately, Trichet agreed to this request and started the Securities Market Programme (SMP), most likely sensing that a full scale financial market meltdown would occur if the ECB did not attempt to stabilise the situation. However, the decision was controversial within the Governing Council (with the German members voting against) and for good reasons.

Officially, Trichet has stuck to the argument that this is a “monetary policy operation” related to the “transmission mechanism”, that interest rates on sovereign debt taking on higher values than the ECB believes are reasonable interferes with its control over the euro area economy. Trichet also stresses that the interventions do not make it easier for countries to run budget deficits (“The purchases made on the secondary market cannot be

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used to circumvent the fundamental principle of budgetary discipline. The Securities Markets Programme strictly aims at correcting malfunctioning of markets."

Neither of these arguments are strong ones. The high interest rates on the sovereign bonds of various European markets reflect the market’s perception of default risk. Central banks around the world generally have to accept movements in risk spreads on bonds of various types—targeting these spreads is not part of the normal monetary policy activity. It is also pretty clear that there is a strong relationship between activity in the primary and secondary markets for debt. If a potential purchaser of government debt knows that there is no functioning secondary market for this debt, then they will be unlikely to want to buy the debt in a primary issue, since they may end up being required to hold the bond to maturity no matter what happens. The existence of a buyer with “deep pockets” in the secondary market will be a significant factor in keeping primary markets open.

It seems likely that Trichet is aware that his public statements about the SMP have limited credibility and it is clear that he and other Governing Council members are uncomfortable with the programme. Thus, once EFSF was put in place by Autumn 2010, they were not willing to scale up the SMP to assist Ireland. By early 2011, many believed that the SMP was being permanently wound down.

However, after the July 21st announcement (of the Greek restructuring combined with an increased size and increased powers for the EFSF) failed to calm market attitudes towards Italy and Spain, the process of May 2010 was repeated again. While the July agreement meant that EFSF was to have the power to purchase bonds on the secondary market, this requires a process of legal approval by Member States. So, once again, the ECB was leaned upon to intervene in the secondary debt markets.

On August 7, Trichet announced a reactivation of the SMP and the ECB has been active since purchasing Spanish and Italian bonds. Thus far, the intervention has been relatively successful, with Spanish and Italian bond yields down over a percentage point from their peaks prior to the ECB’s intervention. Again, however, it seems likely that the ECB will look to stop these purchases as soon as possible, leaving an expanded and more powerful EFSF to deal with any future market tensions.

I find it harder to criticise Mr. Trichet in relation to the Securities Market Programme than in relation to his approach to the sovereign debt problem. Each decision along the way could certainly be justified as the best compromise between various objectives. However, it’s hard to escape the feeling that he is leaving an ECB that is in a very muddled position.

By giving in to political pressure to purchase bonds, Trichet undermined the ECB’s reputation for independence that he had done so much to build up. On the other hand, having given in, the SMP has hardly been a resounding success. It did not stop Ireland and Portugal requiring bailouts and the current interventions have a temporary “sticking plaster” feel about them. One can argue that the limited benefit brought by the programme up to now is outweighed by the damage done by the decision to start the programme in the first place.

4. DRAGHI’S POISONED CHALICE?

Mario Draghi faces an exceptionally difficult set of challenges. Even if one sets aside the sovereign debt crisis, there are many tricky calls to be made.

- In relation to monetary policy decisions, there are severe tensions between the core of the euro area, which has been undergoing a modest recovery, and the periphery, which is still struggling with recession. Draghi will have a harder time keeping everyone on the same page than did Trichet.

- Despite his extensive qualifications, Draghi will face the same problem that Trichet did in convincing a sceptical German public that he is the right man for the job. Indeed, as an Italian, Draghi will face greater scepticism. It is important that Draghi resist the urge to be seen as particularly “hawkish” purely to allay these German fears.

- The ECB has embarked on a rate-hiking cycle at a time when many believe the world economy is heading for a double-dip recession. With the Federal Reserve essentially announcing that rates are on hold near zero until 2013, Draghi may soon be under pressure to reverse course.

- Trichet has handed over to Draghi the problem of “addict banks” that are reliant on ECB liquidity. Draghi has publicly noted his concern about this problem. In December 2010, he told the Financial Times “Sooner or later the ECB will have to go back to variable rate auctions. And by the time we do this, we want to make absolutely sure that our monetary policy is not going to be polluted by the addicted banks’ demands.” With bank funding tensions on the rise again, the ECB is again moving away from talk about its “exit strategy” but the time will come when the job of liquidity provision will need to be normalised. Working out when and how will be a difficult task for Mister Draghi.

But, of course, Draghi will not be able to set aside the sovereign debt crisis. On the face of it, the ECB’s position is clear. Its officials view the SMP interventions as temporary and Draghi’s public comments on the SMP would appear to place him on the more critical end of Governing Council opinion on this programme. So Draghi would like to end the programme once the EFSF’s new powers come into force.

It is not clear, however, that the EFSF is big enough to backstop Spain and Italy for the next few years. And the most recent Merkel-Sarkozy meeting pointed against there being any further enlargement of the EFSF in the coming months and also against any alternative funding solution such as Eurobonds being put in place without time-consuming and controversial changes to fiscal rules across Member States.

The time may come again when the ECB, this time lead by Mario Draghi, will be called upon to prevent Spain and Italy from financial crisis. It is possible that such a programme would require much larger ECB bond purchases than has been seen up to now. This will place Draghi, as an Italian, under extraordinary pressure.

My opinion is that, if Europe’s leaders fail to hammer out a fiscal solution to the debt crisis, then a large bond buying programme may well be required. I also suspect that such a programme would have more limited inflationary effects than its opponents would believe. However, my opinions don’t matter. If such an outcome comes to pass, it will be down to

8 http://www.ft.com/cms/s/0/658b982c-03ab-11e0-9636-00144feabdc0.html
Mario Draghi to figure out if he can prevent a massive sovereign debt crisis without taking decisions that threaten the participation in the euro of Germany and other “hard money” Northern European states.
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Change of guard from Trichet to Draghi - Watch or not to watch money under political constraints

Ansgar Belke

BRIEFING NOTE 8

Abstract

The aim of this briefing paper is twofold. First, it provides a review of the Trichet presidency and its main legacy. Special emphasis is laid on politico-economic considerations. What is more, it especially assesses the difference that the President has made through his own person. Second, it also delivers a preview of the Draghi presidency and evaluates the challenges the new President will have to deal with. Again, the ECB and its political constraints in the current euro area debt crisis are focused upon.

One of the important messages is that the effects from Trichet’s previous policy actions are still in the pipeline. Most important, excessive money creation has finally led to excess liquidity, excessive credit and to a persistently increased leverage in the euro area. Another observation is that Mr. Trichet abrogated the market-based interest rate mechanism for sovereign debt throughout the euro area. The costs and benefits of this venture are evaluated against the backdrop of the fact that the potential scope for public debt is much lower for a country within a monetary union because it should not and cannot resort to seigniorage and the inflation tax to finance it.

Since some consequences of Trichet’s monetary policy choices will manifest themselves only with a lag, the main legacies of the Trichet era also correspond to the main challenges for Mario Draghi. Among them is the potential dramatic worsening of the euro area debt crisis since up to now no sustainable institutional solution is found. On top of that Draghi will be confronted to a larger extent than his predecessor with challenges concerning international liquidity spillovers and the reform of the international monetary system.
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INTRODUCTION

Writing about persons and personalities is always a demanding and tricky task. In the ECB Governing Council, decisions are met on a majority basis. But how often did Jean-Claude Trichet as the ECB President participate in winning coalitions when voting over monetary policies? The answer is: always (Belke and Styczynska, 2006, and Belke and von Schnurbein, 2011). From this point of view one feels legitimized to ascribe a non-negligible part of the ECB’s actions to the President himself. We will later on argue in this briefing paper that in reality the euro area game is by far more complex and any ECB President has to acknowledge the strategic power of other players such as euro area governments and the commercial banks and their lobbies as well. Hence, in order to derive the idiosyncratic ECB President specific part of the overall economic outcome, all third factors have to be deducted. This is difficult enough and should be taken into account as a great caveat during the whole analysis in this briefing paper.

The above mentioned game-theoretic restrictions for ECB Presidents’ action are valid in spite of any formal ECB independence because the other players can put the ECB under massive pressure in the new world after Lehman by simply producing very bad economic outcomes as their threat points. The basic insight that Mr. Trichet was to a certain extent “caught in the chain of events” will finally change the balance to a favourable assessment of Jean-Claude Trichet’s term in office. In purely personal terms one could even not think of any better-suited person to correspond with the needs of the job as an ECB President than Mr. Trichet. Another important point has to be added. Although we ascribe a non-negligible part of the ECB’s actions to the President himself, this does not necessarily imply that the ECB should be held responsible for all the mess in the euro area since Lehman, given that one could argue that it was not alone within its power to achieve financial and sovereign debt stability (see on this issue also Gros and Roth, 2010).

On 31 October 2011, the eight years term of Mr. Jean-Claude Trichet as ECB President will end. Mr. Mario Draghi will succeed in office. It will be shown and documented in this briefing paper that this change of leadership in the ECB comes at a pivotal time for the euro area and the European Union as a whole.

The aim of this briefing paper is twofold. First, it provides a review of the Trichet presidency and its main legacy. What is more, it especially assesses the difference that the President has made through his own person. Second, it also delivers a preview of the Draghi presidency and evaluates the challenges the new President will have to deal with.
1. THE TRICHET PRESIDENCY– REVIEW AND MAIN LEGACY

After taking office in 2003, the former French Governor of the Banque de France, Jean-Claude Trichet, promised immediately that he will maintain his predecessor Duisenberg’s legacy and strictly stick to a stability-oriented monetary policy. Under the now 68 years old Trichet, the ECB had to pass her first big stress test when the U.S. investment bank Lehman Brothers went bankrupt in 2008. Together with other important central banks the ECB flooded the markets with money and thus prevented its collapse. Everybody who had the chance to listen to Trichet’s train of arguments regularly on different occasions, should have noticed that exactly this event has left a big mark on Mr. Trichet’s view of the world and from then on regularly served as the reference point for him whenever he has to make monetary policy decisions. What is more, the first breach of taboo of the ECB also falls into Mr. Trichet’s term of office: in 2010 the ECB began to buy up bonds of financially distressed countries in order to accompany their rescue. This encountered resistance mainly in Germany because it was not believed that sterilization of the bond purchases was really sufficient to prevent inflationary dangers of these operations in view of the parallel existence of standing facilities. Consequently, the ECB’s decision was then one of the reasons why former Bundesbank president Axel Weber did not run for the ECB presidency (Badische Zeitung, 2011, and own observations).

In order to assess the achievements of Mr. Trichet it is – due to the high degree of path-dependencies and the relevance of time lags of the effects of monetary policies and financial crises - worthwhile to look back at 2003 when he began his eight-year term as president of the European Central Bank on November 1st (Economist, 2003). The Economist (2003) is representative of the public feelings about the Trichet issue at that time: “He may have been an unelected technocrat, but at least he’s our unelected technocrat. That, at least, seemed to be the attitude of the French government back in 1998 when it secured a deal to replace Wim Duisenberg, the Dutchman who was the first President of the European Central Bank (ECB), with a Frenchman, Jean-Claude Trichet.” Mr. Trichet took over as president of the ECB on Saturday, November 1st, 2003, after some delays, package deals and hot debates about Wim Duisenberg’s “voluntary” retreat (Economist, 1998). In section 3, we show that history has repeated itself by the Bini Smaghi/Draghi case.

Also in 2003, it was expected by analysts that Mr Trichet’s nationality would evidently make little difference to European monetary policy. The ECB was seen to stand sufficiently independent from national politics. For instance the Economist (2003) pointed to the fact that Mr. Trichet himself already “… defended resolutely the independence of the Bank of France from political attack in the run-up to euro entry. But it was clear from the beginning that, if the ECB’s policies would remain untouched, the presentation of those policies would no doubt benefit from some Gallic charm. The ECB had been dismissive of its critics and unsympathetic to the dangers of deflation in Germany, the euro area’s largest economy. It was at that time still a very young institution, but in its eagerness to prove itself it does not always seize the chance to learn and to grow”. There is nothing to add.

\[1\] Both properties also immediately disclose a problem of objective imputability of merits to a specific ECB President. Maybe Mr. Trichet has harvested what Mr. Duisenberg has sown and so on for Mr. Draghi and Mr. Trichet. With these caveats in mind we now start our analysis.
1.1. Monetary policy in times of crisis – An analytic view of the Trichet era

Questions to be discussed in the context of Trichet’s achievements in monetary policy issues cover a rather broad area. The following ones are especially important because they have some bearing also on the coming Draghi era: How adequate was the ECB’s monetary policy before the Lehman crisis? How effective was the anti-crisis policy of the ECB - also in comparison to the FED; and the use of conventional and unconventional methods? Should - and for how long - the ECB buy government bonds? Is the balance sheet extension a problem for the ECB, or can it easily be reversed? What are the consequences of debt restructuring (e.g. in Greece) for the ECB? Are target accounts a hidden transfer to finance debtor countries?

The “ayatollah” of a euro fort?

The euro had been trading at the change in office from Duisenberg to Trichet 2003 at about the same rate to the dollar as it was in its first days of existence in 1999. Indeed, if the dollar continued to slide, euro strength, not weakness, would have been the first problem to fall into Duisenberg’s successor’s lap. The ECB does not have formal responsibility for the external value of the euro. But an appreciating currency would have dampened output and prices at home, and the ECB would have had to choose how to respond. Mr. Trichet, once dubbed “the ayatollah of the franc fort” (Economist, 1998) for his support of a strong French currency, was already in 2003 expected to soon earn a similar reputation for a “euro fort” (Economist, 1998 and again with the benefit of hindsight 2003). In fact, with the benefit of hindsight we could say that the euro was generally strong over the time Trichet was in office. This served the terms-of-trade position of the euro area, i.e. the purchasing power of its inhabitants and firms, quite well.

Changing policy focus of ECB from monetary to (quasi-) fiscal activities early envisaged

Already in October 2003, the Economist argued that “... though it does not threaten the credibility of the euro, fiscal policy will still pose Mr. Trichet some vexed questions. How to co-ordinate a single monetary policy with the 12 separate fiscal policies of the euro area's members? The stability pact, policed by the European Commission, was supposed to settle that question. But with the commission's fiscal rules now bent out of shape, the onus to find an answer will fall more squarely on Mr Trichet. He will no doubt use his bully pulpit at the ECB to preach the virtues of fiscal harmony. He will urge member states to see the big picture, to see how their budgetary choices affect the fiscal-monetary mix for the euro area as a whole.” We now can say that the Economist (2003) was right except the fact that the vexed questions posed by fiscal policy effectively threaten the credibility of the euro.

But Mr. Trichet was already at the start of his term in 2003 expected to do more than this. With the external value of the euro on an upward trend and “running”, some observers already forecasted at that time that the next big project for the euro area would not be monetary, but fiscal. The background: there were clear indications already at that time that euro area governments, among them both Italy and Germany, must all start to save in order to be able to bear the pension burdens of the negative demographic trend. The expectation was: “if the euro area’s governments make a credible commitment to repair their finances over the medium term, Mr. Trichet should in return offer them the reward of an accommodating monetary policy” (Economist, 2003).

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2 This is exactly the reason why they are put forward as the guiding questions of an upcoming conference organised by the German Friedrich Ebert Foundation. See FES (2011).
Mr. Trichet took part in his first interest rate decision as soon as November 6th, 2003, when the at that time 18 members of the ECB Governing Council gathered for the first time under his leadership. The Council embraced strong characters like Otmar Issing, formerly of the Bundesbank, and strong minds like Tommaso Padoa-Schioppa who has frequently been credited with vesting the euro with its “intellectual impetus” (Economist, 2003).

From consensus to majority decisions

But the ECB Governing Council was at that time also blamed to work too sluggish and in a too intransparent way. Both properties may have been unavoidable because the Council pursued the virtue of consensual voting on monetary policy issues. For this purpose, it made any effort to arrive at interest rate decisions, for example, without the necessity to hold a formal vote. "It was accused of being too slow to change rates because it tended to wait for all its members to get on board before it acted. It kept (and still keeps) the minutes of its meetings secret because it was eager to present a united front to the outside world and unwilling to let the great unwashed eavesdrop on its internal debates. In its defence, the ECB says this secrecy also shields its council members from political pressure” (Economist, 2003).

The US Fed which also conducts monetary policy by committee may serve as a counter-example: in 2003 nobody doubted that Alan Greenspan was in charge and set the agenda. The Bank of England disposes of a rate-setting committee as well. However, it does traditionally not strive for consensus. “Nine members vote and the majority rules, even when, ..., it is a majority of one” (Economist, 2003).

In 2003, Mr. Trichet had promised in response to the obligatory questions from the European Parliament to be a team player. “That went down well with the members of the parliament, a democratic institution, accustomed to coalition politics and keen to sniff out a monetary Napoleon. But the euro area’s monetary policy, if it is to respond quickly to uncertain events while sending clear signals to governments and markets, cannot afford the compromise and inertia of committee politics” (Economist, 2003). So, when Mr. Trichet took office as ECB president on November 1st, the dowry was that he was expected to display in the end the courage to act in a “presidential” but not necessarily consensual manner (Economist, 2003).

And a presidential style is exactly what Trichet to an increasing extent proved to implement later on – not least due to the fact that the Governing Council became larger in accordance with the increasing number of member countries. While the first couple of years of his term were characterized by unanimous decisions, more recent decisions are, as far as we know, only met by majority. This process started around 2007, but 2008 at the latest when Malta and Cyprus entered EMU as new members. What worried Germany that did not have a property bubble at that time was that the newcomers would tend to side with Greece, Spain, Portugal, Italy, France and Ireland should deflating property booms across the region prompt demands for a looser monetary policy. Hence, Cyprus and Malta would tip the euro balance.3

From a theoretical point of view it is interesting to see that the voting power of the Board itself will increase further after the rotation model will be implemented after the euro area will have welcomed its 19th member (Belke and Styczynska, 2006, and Belke and von Schnurbein, 2011). Whether this scenario will really become relevant for Trichet’s successor Mr. Draghi will depend on how attractive membership in the euro area will be for EMU outsiders in the future. My impression is that at least larger countries like the Czech Republic, aiming at a slow appreciation of its currency against the euro in order to prevent

3 See http://www.makro.wiwi.uni-due.de/aktuelles/einzelansicht/the-lira-ization-of-the-euro-can-no-longer-be-excluded1030/.
imported inflation, and Poland, striving for a flexible exchange rate in order to cope with external shocks, will refrain from entering in the medium run. Not to forget that both countries feel struck by the perspective to take part in the prospective huge fiscal redistribution mechanism within the euro area.

**Euro builder ending his career on a bitter note?**

Referring to the intriguing title of a recent article in the New York Times (Ewing, 2011b) it is important to refer to the undeniable fact that crises can create and destroy reputations also of central bankers. There is only little time left for Mr. Trichet to determine his own reputation. “The eurozone he will leave behind for good on October 31 is changing fast. Angela Merkel and Nicolas Sarkozy last week announced tentative steps towards a eurozone government; the ECB revealed it had spent €22bn on government bonds, more than ever before in a single week. Panicky financial markets could force further, bolder moves in the days and weeks ahead” (Atkins, 2011a).

But the outlines of how Mr. Trichet will be perceived later on in the economic history books are already delineated and looming at the horizon. “The problem for anyone concerned about the eurozone, is that there is more than one version” (Atkins, 2011a). Subsequent revisions, after all experience, could materialize as brutal and unexpected – as Alan Greenspan himself had to discover. His lax monetary policy in order to cope with the fallout of the burst of the new economy bubble was first lauded and then heavily criticized for having laid the foundations of a new bubble (Atkins, 2011a, and ECB Observer, various issues). The lesson for Trichet clearly is that it cannot be taken for granted that he will be hailed forever for having rescued the euro area from a Lehman-like desaster by unavoidable and unlimited sovereign bond purchases.

**Fighting to preserve his own legacy**

Mr. Trichet, now still ECB president for a couple of weeks, has been on the stage of crisis management before. Early in his life as Governor of the Bank of France in 1993, Mr. Trichet faced down a tidal wave of market pressure and prevented the franc from being devalued. “I can vouch for the fact that not all of his tactics were those of a choir boy, and at one point he was forced to widen the ERM trading band within which the franc was allowed to fluctuate, but he eventually emerged without having to admit defeat. The rest, and the creation of the euro, is history” (Davies, 2010). Now, at the very end of his career as ECB President, Mr Trichet is apparently fiercely fighting to save his legacy. That Mr. Trichet told the European Parliament more than once that the markets had severely underestimated the determination of the EMU authorities to preserve the single currency might serve as a proof in that respect (Davies, 2010).

**The responsible for the ECB’s good inflation record?**

At the press conference in January 2011 in Frankfurt and on many other occasions Mr. Trichet has stated that since the launch of the euro in 1999, euro area inflation had averaged 1.97 per cent – a value exactly in line with the ECB’s target. Annual data are less impressive: inflation averaged 1.6 per cent in 2010, implying that the ECB undershot its target. The majority of ECB watchers regard 1.7 per cent as the lowest rate that can be described as corresponding to the target “below but close” to 2 per cent (Atkins, 2011a, ECB Observer, various issues). De facto, the ECB has not met its target in any year since 1999. In 2009 (at 0.3 per cent) and in 1999 (at 1.1 per cent), it even undershot significantly. In 2008 with inflation reaching 3.3 per cent the opposite happened. In all the other years, inflation hovered a little above 2 per cent (ECB Observer, various issues).

But its exclusive focus on price stability was a disincentive for the ECB to become active when money and credit growth remained at elevated levels although this led to a steady
accumulation of excessive leverage and, hence, fragility of the financial sector. The fly in the ointment: this development usually displays ratchet effect behaviour, i.e. it tends to be rather persistent!

In this context, it is important to note that the ECB Governing Council ventured an assessment of its strategy and on 8 May 2003 – nearly half a year before Trichet started his terms – published the results (Carstensen and Colaveccio, 2004, citing ECB Observer, 2003). “The prominent role of M3 in the ECB strategy de facto ended with the bank’s strategy revision from May 2003 (ECB, 2003). The stock of M3 was downgraded from an information/ intermediate (target) variable of monetary policy to a mere cross-checking variable” (Belke and Polleit, 2010, p. 63; see also ECB Observer, various issues). The outcome of this benign neglect was excess money and credit growth and thus excess liquidity over quite a large sub-period of Mr. Trichet’s office terms.

Money: to watch or not to watch?

"Whether money (growth) should play a role in day-to-day monetary policy making has remained a hotly debated issue. This may come as a surprise, given that Milton Friedman’s famous dictum “inflation is always and everywhere a monetary phenomenon” is perhaps the theoretically and empirically best-supported economic proposition [if one works with long-run averages]. However, three key issues might explain why there tends to be a general reluctance on the part of policy makers [among them Mr. Trichet] to base interest rate decisions (solely) on money. First, there are considerable time-lags with which changes in the stock of money affect nominal magnitudes, prices in particular. In fact, time-lags (which tend to vary) can blur considerably the relationship between changes in the stock of money and changes in prices" (ECB Observer, No. 10).

"Second, central banks’ price stability objectives are based on keeping consumer price indices in check. Changes in asset prices[ and in the leverage of market participants such as governments, firms, commercial banks and private households ](which are influenced by money growth) still tend to be ignored as long as they do not show up in consumer prices” (ECB Observer No. 10, and Gros, 2011).

"Third, monetary data tend to exhibit “noise” from month to month, from quarter to quarter and even from year to year. For instance, non-banks’ short-term portfolio shifts can, in the short- to the medium term, distort underlying monetary dynamics. For instance, in periods of financial crisis, non-banks tend to increase their preference for liquid short-term bank deposits. In such circumstances, the stock of money aggregates may expand without necessarily indicating future inflation” (ECB Observer, No. 10).

As a result, policy makers like Mr. Trichet do not necessarily react to and sometimes even strive against any orientation at “headline” money growth (ECB Observer, various issues). The academic literature on political business cycles has often emphasized strategic considerations (“lame duck”, “to bequeath inflation and excess leverage”) in combination with the time lag phenomenon as one of the reasons of this benign neglect (Belke and Potrafke 2011).

The result in the Trichet era thus was overly expansionary monetary and credit policies: central banks, and among them also the ECB, “have pursued too expansionary a monetary policy in the last years. Excessively low (real) interest rates have stimulated credit demand. Excessive liquidity supply has inflated asset prices – such as, for instance, stocks, housing and credit products –, having provoked a misallocation of scarce resources on a grand scale. Against this backdrop, the key challenge is to draw a clear distinction between symptoms and causes of the credit crisis. To us, the symptoms listed above suggest that central banks, via pursuing an overly expansionary monetary policy for many years, have
created a “credit and money glut”. Central banks have provoked a credit boom, of which the current credit crisis is actually an economically necessary correction of bad decisions made in the past“ (ECB Observer, No. 10) – also by Trichet’s ECB.

"Surprisingly enough, for a long time goods price inflation had been widely unaffected by the strong monetary dynamics [...]". Only with a considerable lag "surplus liquidity poured into raw material, food and goods markets. Over the same time horizon, however, many countries have experienced" (in some cases two) "sharp but sequential booms in asset prices, such as real estate or share prices. Many observers interpret the sequence of increases of asset prices as the result of liquidity spill-overs to certain asset markets" (Belke, Orth and Setzer, 2010).

"From a monetary policy perspective, the different price dynamics of assets and goods prices in recent years raises the question as to whether the money-inflation nexus has substantially changed (thereby calling into question the close long-term relationship between monetary and goods price developments that was observed in the past) or whether effects from previous policy actions are still in the pipeline" (Belke, Orth and Setzer, 2010). As can be shown, the latter is definitely the case – but this time – under Trichet - excessive money creation has finally led to excess liquidity (i.e. nominally money growth exceeding nominal GDP growth, Belke and Gros, 2010), excessive credit and, as a consequence to a persistently increased leverage in the euro area since the launch of the euro - above all in financial corporations in the form an increasing debt-to-equity ratio but also in non-financial corporations, households and as seen from a rise in the debt-to-GDP ratio in the government sector itself (for more details on this central issue see Gros, 2011).

From this perspective, Trichet’s frequently communicated claim that the ECB’s balance sheet is much smaller than that of the Fed and, hence, this implies that the ECB has taken a less risky strategy than its partner bank on the other side of the Atlantic, at least seems to deserve a second look. Of course, Trichet could (and one should make allowances for him that he de facto did not) as a defence point at global liquidity, mainly of US origin but to an increasing extent also from emerging market economies, pouring in the euro area as the main culprit (Belke and Gros, 2010, and Belke and Rees, 2010).

But the yardstick to assess Trichet’s legacy properly is the answer to the question why the ECB under Mr. Trichet did not show any reaction to excess money, excess credit and excess leverage as well-suited early crisis indicators at all but, instead, reacted with an increase in the leverage of the ECB itself as measured by a steady decline in equity capital which made a capital increase necessary at the end of last year (Belke and Polleit, 2011). Simply pointing to increasing spreads as the reason for interventions in the bond markets is clearly not sufficient in this context both because the ECB was not successful in the end to bring these spreads significantly down and because it made sovereign bond yields ineffective as a market indicator of insolvency as is impressively corroborated in the case of Greece and probably also in the case of Portugal. The latter is even more problematic with an eye on the fact that it was commonly not understood (or appreciated) that the leeway for incurring public debt has significantly diminished once a country has become a member of the euro area because it cannot be financed anymore by any national monetary authority with recourse to seigniorage and the inflation tax. Trichet’s apparent benign neglect of money and credit growth over large periods of his time in office did a huge disservice in that respect.

Note that the Swiss National Bank conducts the diametrically opposite strategy and more recently focused on purchases of bonds of triple-A rated sovereigns such as Germany and (still?) France.
The man who saved the euro?

“No doubt Mr Trichet would like his legacy to be as “the man who saved the euro” – assuming Europe’s monetary union is indeed saved, which is not such a rock-hard assumption these days” (Atkins, 2011a). He was said to have impeded a fully-blown disaster in May 2010 when he persuaded the euro area heads of state to erect an allegedly credible rescue package and led the ECB Governing Council into a highly controversial bond purchasing scheme. By enhancing exactly that programme in summer 2011, the ECB has so far stopped Spanish and Italian spreads from climbing further to unprecedented heights (Belke, 2011a, and Atkins, 2011a).

Some audiences like the US one represented by Paul Krugman and others might demur he is “the man who did not go far enough” (Atkins, 2011a). They argue that the ECB has been limited in its action by legal constraints and by opposing views within the Governing Council. Exactly for this reason, the ECB has not been able to develop to a final backstop or ultimate guarantor of financial stability in the euro area – which explains why investors remain acutely nervous. But in Germany, Mr. Trichet is already labelled “the central banker who went too far” (Atkins, 2011a). These days, the Frankfurter Allgemeine Zeitung even accused him of turning the ECB into European bad bank, the EBB (Atkins, 2011a). Germans – including the Bundesbank, which has strongly fought against bond purchases – with the largest exposure of course fear that the ECB has strayed dangerously far into fiscal policy which would soften its price stability commitment. The ECB had become too loyal towards the politicians, some German newspapers complained (Atkins, 2011a).

Risks located on the ECB’s balance sheet have certainly multiplied and further large-scale recapitalisations might become necessary (Belke and Polleit, 2011). Still, I would like to follow Atkins (2011a) and would not argue that Mr Trichet is a “pushover” for politicians but that he acted in a game-theoretic scenario which did not grant him too much leeway (see chapter 3 of this Briefing Paper).

1.2. Trichet’s legacy

On dangerous grounds

In fall this year, Jean-Claude Trichet will have acted eight years as the President of the European Central Bank (ECB). He leaves his successor Mario Draghi a legacy with risks and side effects.

Everybody having had the honour of meeting Mr. Trichet personally, should admit that the efforts of recent years have been engraved in an almost frightening way in the face of Jean-Claude Trichet. The decision of the ECB to purchase Spanish and Italian government bonds, has made life not easier for the French central banker. Not only did his intentions evoke resistance within the ECB council. What is more, even the long-term consequences of this decision can not currently be calculated exactly. Trichet is likely to have desired a less spectacular finale. Hence, it is too early to finally assess Trichet’s influence as "Monsieur Euro". But the recent crisis years have taken the ECB its status as a solitary institution and have moved it closer to the US Fed, the Bank of England and the Bank of Japan (see chapter 3 in this context for discussions about the necessity of closer monetary policy coordination among the G20). There is the close alliance between the central banks and governments who had previously been observed only in Washington, London and Tokyo (Belke, Bernoth and Fichtner, 2011; Braunberger, 2011).
Without a clear strategy?

It could be argued that, in a severe crisis, any closer cooperation between monetary policy and general policy does not at all present a remarkable development and the idea of an independent central bank, after all experience, should be considered in any case as a rather fair weather concept. But at least since the decision of the ECB in May 2010 to buy Greek government bonds, the ECB moved on very dangerous grounds (Belke and Polleit, 2011). Since then Trichet did not convey a clear line, also because national governments obviously succeeded to exploit national central bank governors as representatives of national government interests. So in the recent past, almost everybody received something: the banks of some Southern member countries could submit questionable credit securities as collateral for money market operations. The Germans which were traditionally terrified by the dangers of inflation (so far) have been granted two rate hikes. And the governments of troubled countries received purchases of government bonds by the ECB (Braunberger, 2011).

But the Securities Market Programme (SMP) was not the only extraordinary measure taken by the ECB. The ECB had also adopted, on three separate occasions, changes in the eligibility of debt instruments issued or guaranteed by the governments of the most troubled countries, namely the three countries under the emergency programme. These repeated decisions negatively affected the credibility of the ECB, which had previously asserted that it would never undertake any such measure in favour of any individual country. However, the need to safeguard credibility even if unorthodox measures are applied is underscored by Tabellini (2010). Instead the ECB should have identified and acknowledged the significance of the problem earlier and accepted haircuts much earlier (Gros, 2011).

Moreover, the ECB continued to oppose any ‘private sector involvement’ (PSI) long after a decision on this had been taken by the Heads of State and Government of the Monetary Union. The ECB might even feel vindicated in this opposition. Trichet himself and his colleagues like, for instance, Vítor Constâncio do not become tired to claim that the adjustment programmes have been installed in the spirit of former similar IMF actions in order to arrive at sustainable debt and if debt burden is made sustainable, there is no need of PSI which would be even counterfactual and counterproductive. This is not tenable and enough in the context of the current EU debt crisis. But the threat to no longer accept Greek collateral in case of a Greek (selective) default did not appear appropriate at all (Belke, 2011a, and Gros, 2011).

How the close symbiosis of central banks and governments in the crisis will shape the relations between the two spheres of power also in the long run, cannot be predicted precisely right now. Maybe the impression gained by governments that the central bank can be influenced in the case of a crisis will present the most significant drawback of Trichet’s tenure (Braunberger, 2011).

Trichet’s weak points

Trichet would probably defend himself by pointing to the fact that serious mistakes stood at the beginning of this crisis and that the ECB intervened in an emergency case, because the governments did not act much more competent in combating the crisis than before in crisis prevention. The imagination to be forced to passively watching the worsening of the crisis and to accept the collapse of the monetary union would be inconceivable for the French. He

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considered EMU as an element of European reality, without alternative. In Trichet’s view, the Europe of the 21st century is not prepared for a return to scattered regionalism, but is equivalent to the commitment to Europe as a power of rank. Insofar he was not a bad choice as the winner of the Charlemagne Prize because the politics of Charlemagne was aligned on the opposite of particularism (Belke 2011; Braunberger, 2011).

Another major development in recent years in the area of monetary policy has been the ever increasing importance of asset markets (ECB Observer, various issues). It is remarkable, that central banks have never tried so bluntly to influence prices in bond markets than in recent years. Again, under Trichet’s leadership, the ECB has not refused to surrender to this tendency which has admittedly been more pronounced in Japan, the United States and the UK than in the euro area: starting with the purchases of mortgage bonds and continuing with the purchases of government bonds (ECB Observer, various issues). Again the question of what long-term consequences will emerge from the new understanding of the ECB’s role by that central bank itself must for the time being remain without clear answers. In any event, markets change according to the now-famous Lucas-critique, if they must always reckon with interventions by public agencies (Lucas, 1976). In this respect Trichet’s policy in recent years offers many points of attack. According to the Lucas critique, the ECB should have acted more coherently in the case of insolvent Greece, just in order to have credibility now when asserting that it is buying Italian and Spanish bonds in order to just fight the illiquidity problems of the respective countries (Braunberger, 2011; Gros, 2011).

The Trichet legacy at the ECB is therefore a strong reputation for consumer price stability. But in order to shed some water into the wine, it must be acknowledged that the influence and the responsibility of the ECB for a sustainable resolution of the crisis has – from the specific point of view of the central bank probably unwillingly - enormously gained importance over the last months. I cannot express it more convincingly than Gros (2011): “The legacy comprises a financial sector that is still highly leveraged and thus fragile, combined with a Governing Council that is split over the future of the SMP and more generally over the decision to buy the government bonds of the one country with a real solvency problem”.

Is the ECB’s public acceptance shrinking?

Our scepticism concerning the new role model of the ECB is amplified by the observation that trust in the ECB has fallen to unprecedented lows in the aftermath of the financial crisis. Interrupted by an only short recovery in 2009 it has decreased again at the start of the euro area debt crisis. These findings imply that European citizens do not only hold the ECB responsible for price stability in a narrow sense but also for financial stability – an area in which Trichet’s ECB did not meet the targets (Gros and Roth, 2010). But whether the ECB should really be blamed fully for this failure is a different question, mainly because one could argue that it was not within the ECB’s original reach to guarantee financial stability. Anyway, a monetary union whose central institution cannot count on the trust of its citizens will not be able to avoid political problems like dissolution processes and so on. The ECB under Trichet has already reacted and has incorporated the need to maintain trust just in its third “strategic intent” (ECB, 2010). Seen on the whole, thus, there is some reason for Trichet’s successor Mr. Draghi to observe these developments further with the adequate scrutiny.

The short-run Trichet legacy

It is true that risks for growth have become larger and inflation dangers have gone down in the meantime. How will Trichet and his colleagues decide at their next Council meeting on 08 September 2011? If a system endangering escalation of the debt crisis can be avoided
in the short run, the probability is quite high that Trichet will announce “rates on hold” after the penultimate session of the ECB Governing Council under his leadership - and will shift the increase in its key interest rate from 1.5 to 1.75 percent which was fixed until recently for the fourth quarter far into the future. Trichet's successor, Mario Draghi, will then have all possibilities from November 2011 on. If necessary, Mr. Draghi will also be able to lower interest rates again. Unlike other central banks like the Federal Reserve or the Bank of England, the ECB has with the two rate hikes in April and July 2011 some scope available and does not need to resort to alternative measures – of course apart from the highly controversial government bond purchases with which the ECB since one and a half years nourish distressed euro area countries.

1.3. Conclusion

Let me conclude chapter 1 with the quite unusual but quite fitting remark that – and this is not yet well known in the public - Mr. Trichet studied mining engineering before it pulled him into politics. This implies that he is not only endowed with excellent political and diplomatic talents but also with a formal academic background. What is more, he should be aware of the non-linear character of the current debt crisis. One member of the ECB’s scientific staff told me quite frankly in a personal conversation that Mr. Trichet has asked them to put more efforts into research on non-linear processes like hysteresis (i.e. path-dependence) effects. This is good to hear because this kind of research seems to be well-suited for the analysis of crises and deals with small shocks which can send a whole system on a new trajectory (Belke, 2003). We can, however, only hope that this pattern does not characterize the future of EMU – the doomsday scenario.
2. THE DRAGHI PRESIDENCY – BACKGROUND AND IMPORTANT CHALLENGES

2.1. Background

Agreement at June 2011 EU summit - Italian Draghi will become new ECB president

Mr. Mario Draghi shall do it: the EU summit has appointed the Italian as the new President of the ECB. Draghi will take office on November 1, 2011, in Frankfurt am Main. As diplomats reported, the Italian ECB Executive Board member Lorenzo Bini Smaghi offered previously by telephone to give up his seat in the body to clear the way for his compatriot Draghi.

A brief history of the Draghi appointment

At the EU summit there had been, prior to this decision, a fierce dispute over the appointment of Mr. Draghi. France did not accept that it would after the departure of Mr. Trichet be represented no longer in the top leadership of the ECB, but Italy would at the same time hold two seats. It would correspond to unwritten rules that the largest countries of the monetary union would be entitled to a seat on the Governing Board and France undoubtedly would be one of these countries. In this vein, the EU summit at the end of June was debating the offer by Mr. Bini Smaghi to vacate his post until the end of this year. Since the central bank is deemed to be independent in fact, politicians should clearly not be able to dictate ECB board members to vacate their posts before the end of their term. The terms of office of Board members under the ECB statute are set to eight years.\(^6\)

Without the surprising resignation of former Bundesbank president Axel Weber, Mr. Draghi (aged 63) could not have been so sure of his candidacy. At the same time the current head of Italy’s central bank is generally regarded as the ideal fit for the job - not least because he is not afraid to flatly contradict politicians. To be heir to the ECB’s top job Mr. Draghi is not to envy: after the financial crisis the cleanup is not yet finished. A sustainable solution of the European debt crisis is not yet in sight. Rising inflation rates put increasing pressure on the ECB to raise interest rates - with as yet unforeseeable consequences for the stressed euro area member countries (Badische Zeitung, 2011).

When Mr. Trichet’s eight-year term expires at the end of October, he will leave behind an institution that has grown substantially in character, stature and influence. The previous section has shown that he thus leaves behind a difficult legacy for his successor Mr. Draghi. “Mr. Draghi appears to share Mr. Trichet’s ability to negotiate cordially with European leaders — and to browbeat them when necessary. But Mr. Draghi, already an influential member of the central bank’s governing council, will also inherit an institution that has become deeply entangled with the banking system, financial markets and the political process” (Ewing, 2011a). The ECB, we derived in the previous chapter, so far has done a quite acceptable job, all things considered. But it has found itself in a very uncomfortable place without much leeway to act not of its own choosing. This place may become more uncomfortable as time goes on as will be shown later on in this chapter.\(^7\) Some experts describe the task Mr. Draghi will take over from Trichet as a "hell of a job" (Engelen, 2011, and Ewing, 2011a).

\(^6\) For detailed reports on these events see various newspaper articles cited in the references.

\(^7\) A good survey of the issues can be found in Ewing (2011a,b).
With an eye on the highly political and difficult triangle deal among Sarkozy, Berlusconi and Mr. Bini Smaghi himself to let the Italian leave the ECB’s Board, the choice of Mr. Draghi could be well interpreted as the result of a political horse-trading (Tzermias, 2011). At the same time, however, Mr. Draghi is well known among leaders of the Group of 20 nations and for years has played the same role in Italy that he has been asked to play as head of the bank — the rational technocrat restraining the spendthrift impulses of politicians (Ewing, 2011a)

The ECB gets Draghi, but at the price of lost credibility?

In many euro area quarters, the political horse-trading with respect to the search for Trichet’s successor is perceived as a unsettling issue. “Sure, Mr Bini Smaghi has not resigned immediately and could have remained in his job beyond the end of the year if he is not offered the governorship of the Banca d’Italia - the only job that many would see as of comparable standing. But the ECB was clearly swayed by political interference – there is no other reason why Mr Bini Smaghi, one of the brightest economic minds at the ECB, had to go before his term ends in mid 2013” (Atkins, 2011b). The ECB gave in spite of repeated assurances by Mr. Trichet that members of the Executive Board act independently, strictly according to the EU treaties. The strength of a central bank and the currency under its protection is undoubtedly not only dependent on the expertise, but also on the political independence of the monetary policy institution (Atkins, 2011b).

How damaging is the political horse-trading finally? “On a pragmatic view, the climbdown prevented Mr. Sarkozy’s outburst causing fresh alarm over the eurozone. A delay in appointing Mr. Draghi could have sent a disastrous signal to nervous financial markets. If Mr Bini Smaghi becomes Italy’s central bank governor, the wobble might be forgotten quickly” Atkins (2011b) argues. However, this Briefing Paper argues partly otherwise.

Draghi as the (nearly) ideal candidate

Let me just introduce this section with a pertinent introductory citation from a recent New York Times article written by Ewing (2011a): “European leaders may chafe at scoldings from the ECB, but they seem to recognize the need for a strong president at the bank. Mr. Trichet’s departure presented an opportunity to choose someone more pliant to replace him. Instead they have nominated Mr. Draghi, who brings many of the same qualities as Mr. Trichet. After years of working with Silvio Berlusconi, the Italian prime minister, Mr. Draghi appears to have the demeanor to deal with other euro area politicians with similar characters. You don’t just need a background in technical monetary policy to run the ECB. You need somebody who has as good political savvy as President Trichet”.

The newcomer will take on the ECB leadership at a time which EU Commissioner Olli Rehn recently called “the worst crisis since the Second World War”. The post is considered a key post in the euro crisis. A look at Mr. Draghi’s CV shows that he is something as the ideal candidate. He is familiar with crises. The Economist wrote his doctoral thesis at the Massachusetts Institute of Technology (MIT) under the supervision of the Nobel laureates Franco Modigliani and Robert Solow. As an economics professor, he taught at Harvard. Leaving academic life in 1984 he joined the World Bank in Washington as an executive director. At the beginning of the nineties Mr. Draghi came back to Italy, where he promoted the privatization of public enterprises and prepared the country for joining the euro in the Ministry of Finance (Volkery, 2011).

When Berlusconi took over the reins of government in 2001 in Rome, Mr. Draghi took off. For a “grace year” before entering the private sector, he first went again into academics, teaching at the Kennedy School of Government at Harvard. And then the leap to Goldman Sachs which French President Sarkozy called a black stain on the jacket of the Italian – the U.S. financial institution is alleged to have helped the EU deficit sinner Greece to gloss its
official budget figures. But Mr. Draghi has repeatedly said that he has not been entrusted with the events around Greece (Volkery, 2011). For Peer Steinbrueck, however, it is "more of an advantage than a disadvantage" for a continental European, "to know about the Anglo-American world" (Schlamp, 2011).

In 2005 he was finally appointed Governor of the Bank of Italy, at a time when the latter was rocked by scandals. Under Mr. Draghi's leadership, the bank gained in stature internationally again. His decisive action contributed significantly to the stability of the Italian banking sector. The latter refrained from investments in overly toxic financial products and thus escaped major problems during the financial crisis (Volkery, 2011). In 2006 he was appointed chairman of the Financial Stability Forum and was entrusted with the international monitoring of the financial system. He is thus currently working on how to prevent that additional financial institutions will need to be rescued with taxpayer billions - as it was the case in the financial crisis for Bear Stearns, AIG, Lloyds TSB and some others. This could just be a strategic advantage for the ECB in the coming years, as Mr. Draghi may foresee that the crisis of the monetary union may also threaten the stability of the financial system (Engelen, 2011, and Schlamp, 2011).

To take the Italian banks from the line of fire, he single-handedly announced in advance that all the tested Italian banks have passed the second Europe-stress test well. The expectation throughout Europe but particularly in Germany that the future ECB president would maintain strict neutrality vis-à-vis his home country in his new post, has been given a dampener by recent events even before he took office. The next three months amount for Mr. Draghi to an early trial period in which every of his actions in Italy will be put under scrutiny (Engelen, 2011).

At the hearings in the European Parliament Mr. Draghi has supported largely the rescue strategy pursued by the incumbent Trichet and his Governing Council, which means that even Mr. Draghi speaks out against private sector involvement (PSI). To what extent euro area member countries such as Italy or Spain can be stabilized without PSI is, carefully speaking, open to debate. At the European Parliament, he also stressed the paramount importance of the ECB’s credibility as an inflation fighter. He has emphasized the responsibility of governments to resolve their own fiscal difficulties – and stuck firmly to the ECB’s line on Greek collateral (Engelen, 2011).

Some even argue that Draghi’s nomination was a good decision for Europe in two ways. Not only is the euro endowed with a highly qualified navigator in the debt crisis. Added to that, his nomination is a testament to how far European integration has progressed – Mr. Draghi’s provenance from a "soft-currency country" was not a knock-out criterion.

**How Germany came to vote for Draghi – Draghi and his “wrong passport”**

Axel Weber has gone. And it has long been clear that there will be no suitable candidate from Germany for the ECB post. Sure, there were experimental games to install an ECB President from Northern Europe. Whatever have been endeavoured to keep Mr. Draghi outside, it would have shaken the delicate balance within the ECB leadership - the proportional representation between large and small, North and South (Dams, 2011).

The German Chancellor Angela Merkel (CDU) has presently increasing problems in the area of European policies. The coalition parties CDU and FDP encourage resistance against

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8 The British journal "Financial News" ranked him – just behind the Deutsche Bank chief of investment banking Anshu Jain - as number two on the list of the most influential people in the European financial industry. Deutsche Bank CEO Josef Ackermann is ranked only as number six, former Bundesbank President Weber and ECB-yet-foreman Trichet, his predecessor, far behind. Thus, the entire international financial establishment can be said to be behind Draghi. See Schlamp (2011).
further loans to ailing euro partners. The adoption of the future stabilization mechanism, the ESM, which will replace the current rescue package in 2013 is not certain (FTD, 2011). In this situation it was difficult for the Chancellor to put the Italian Mr. Draghi, a representative of a heavily indebted country to head the ECB (FTD, 2011). In this context it also certainly played a role that in the case of Mr. Draghi’s appointment two bankers from a southern indebted member state would lead the ECB – in fact, the Portuguese Vítor Constâncio is ECB Vice-President. What is more, in June this year the public was aware of the fact that the ECB was currently supporting banks in non-performing countries such as Greece, Ireland and Portugal with a loose monetary policy. This course - in particular the purchase of government bonds by the ECB – has been highly controversial at least in Germany (FTD, 2011). Exactly for this reason, Mr. Draghi had been arguing strongly in favour of a tightening of monetary policy in recent weeks and, by this, tries to counteract reservations against a Southern European acting as an ECB President.

Merkel, however, would have put her government into a foreign policy predicament, if she would have spoken herself out against Mr. Draghi and thus opposed the opinion of Sarkozy. So she would have risked a rift with France in one of the central points of European policy. That would have probably weighed even more serious in Paris, since Germany has recently been abstaining from voting in the UN Security Council in favour of the resolution in terms of Libya against the will of France (FTD, 2011).

After the withdrawal of Bundesbank President Axel Weber and the public confession of French President Nicolas Sarkozy to support Mr. Draghi, Angela Merkel was not really able any more to refuse the Italian. But there are good reasons to assume that France had to buy this consent off the Chancellor. Possible claims of the Chancellor are that the Euro-Plus Pact adopted in March this year must become more binding than previously agreed by EU Heads of State and some improvements to the euro rescue package, with which she also could win back the disgruntled fractions of the CDU and FDP (Hönighaus and Proissl, 2011).

**ECB succession - Signor Euro**

France, Italy and Luxembourg had immediately assured Mr. Draghi public support. And even when Angela Merkel was still winding - German Finance Minister Wolfgang Schäuble had indicated already that he thought Mr. Draghi would be suitable for the job. There is no doubt that the 63-year-old is smart, knowledgeable and worldly-wise. Therefore, the crucial question runs as follows: is it good when an Italian is leading the European Central Bank? The representative of a nation that is not famous for contractionary or at least rule-based fiscal policy and low inflation? One could claim that the passport does not matter. One could say that it is the very nature of such supranational institutions like the European Central Bank that there will always be people elected to the bodies that come from one of the Member States. But as soon as they are in office, they must feel responsible to all countries (Siedenbiedel, 2011).

**Monetary stability is in the spirit of the ECB**

This view is supported by the experience that such institutions tend to have their own spirit. Once someone works there and consults with colleagues and staff, he is also influenced by the institution (Becket effect). And the spirit of the ECB is certainly the use of monetary stability. Over the years it has kept the euro quite stable – more stable even than the Bundesbank at its time the Deutsche Mark. This has remained unchanged, as eight years ago with Jean-Claude Trichet, a Frenchman became president of the European Central Bank. Although for the French, the battle against inflation is historically not so much a matter of the heart as it is for the Germans. Mr. Trichet, however, has fought for quite a hard euro. So much that he has been insulted in his home country by being sometimes called "German" (Siedenbiedel, 2011).
Germany as a blueprint?

Mr. Draghi has now begun in the election campaign for the ECB's head claiming to be an enemy of inflation from an inflation-friendly country - very much like Trichet. In an interview with the "Frankfurter Allgemeine Zeitung" in February 2011 he presented Germany as a model for countries like Italy. And only recently Mr. Draghi urged the Italian government more strongly to go for austerity programmes. He presented himself so much as a German, that the "Bild", a German newspaper, depicted him already with a Prussian spiked helmet and offered him German citizenship (Siedenbiedel, 2011).

The top Italian banker regularly reads the riot act to his countrymen. He calls for reforms and debt reduction, increased productivity, less government bureaucracy - often in stark contrast to Treasury and Finance Minister Giulio Tremonti. His views on the European crisis are more Prussian than Mediterranean. It was "not acceptable that some states exploit the other" in a monetary union, Mr. Draghi only recently said in an interview with Frankfurter Allgemeine Zeitung (Draghi, 2011). Hence, the euro area is in need of quasi-automatic rules to force all countries to a frugal and stable fiscal policy.

And he wants to prescribe the members in the euro club further provisions to make growth-enhancing reforms compelling. Different retirement ages would lead to competitive imbalances and get everyone involved in terms of high overall costs. Germany has indeed shown how to improve its competitive strength with reforms. Mr. Draghi: "We should all follow the example of Germany" (Draghi, 2011).

Mr. Draghi made additional in-house advertising by praising the German course on currency stability as a model (Draghi, 2011). "You have to understand that price stability was the basis of German growth and now must also be a principle for the whole of Europe". In this interview, he also spoke out explicitly against common euro bonds at the present time, and advocated stricter rules to control the national budgets. Common euro bonds might instead only make sense, if Europe were not only a monetary union, but also a union with common taxes and common fiscal policy, Mr. Draghi said. He is sceptical to use euro bonds as leverage to achieve a tax union: "For me it's just as difficult, as someone would seize an elephant's tail and walk out" (Draghi, 2011).

Finally, he conveyed the impression to be a monetary falcon; the ECB considers its withdrawal from loose monetary policy, Mr. Draghi said according to Reuters on April 13 this year. Even after the rate hike the week before, the monetary stance would still be "very accommodative." On a worldwide level, he argued, there is the need to cut back on the extraordinary support which was granted by monetary and fiscal policies to support the economy.\(^9\)

All this looks quite German-centric. But is this just a roadshow in which he enacts every effort to get the job? How German the heart of the Italian really beats with respect to monetary policy issues, nobody can actually tell. Critics at least mention that Draghi has studied with Federico Caffè, a convinced Keynesian, and received his doctorate as the first Italian at MIT with Franco Modigliani, a Nobel laureate, as a supervisor who is also attributed to the Keynesian school - assessing inflation at least not as the greatest scourge of mankind (Siedenbiedel, 2011).

Institutional change of the ECB – More than mere interest rate decisions

But the above mentioned theory that the passport of the top euro-keeper does not matter, could prove to be wrong for another reason: the change that the institution of the central bank has undergone in the euro crisis (again, the Lucas critique is addressed!). The ECB is

Change of guard from Trichet to Draghi

no longer an institution that decides every now and again on higher or lower interest rates. Instead, it has to make decisions of considerable political reach and significance just for the sake of rescuing the euro. The best example is again the ECB’s decision met last year in May to buy up sovereign bonds of distressed euro member countries (Belke and Polleit, 2011). The latter could in extreme cases threaten the stability of the currency. ECB President Trichet acted very French, as he endorsed the bond purchases, and former Bundesbank president Axel Weber very German, as he fought against it. From Draghi one has heard at least no public protest (Siedenbiedel, 2011).

2.2. The main challenges for Draghi

On a general level, there are mainly three major tasks for Mr. Draghi (Wall Street Journal, 2011). First, he has to preserve the independence of the ECB in relation to politics, after the ECB - without possessing the appropriate mandate – has in recent months more and more engaged in bailouts of individual countries. It remains to be seen whether Mr. Draghi will have the conviction and the authority to stand up to Paris, Berlin and Rome, but the future of the euro could depend on it. Moreover, it will be essential for Mr. Draghi to keep an eye on the growing economic and political gap which has emerged between the EU member countries, without losing sight of credit growth and inflation. Finally, Mr. Draghi should give up the existing "surreal and dangerous" attitude of the ECB towards a possible debt cut in Greece, because the credibility of the ECB in relation to the crisis and basically the European experiment as a whole is falling rapidly.

Just to summarize: the decisive challenge for Mr. Draghi will be to give an anchor to the new role of the ECB which has undergone a significant change in the wake of the recent financial and euro area debt crisis. Why and in what politico-economic context? (Belke, 2011a).

Not too much leeway to act independently– The ECB and its political constraints

The first point I would like to make is the following. Since ECB representatives often argue that it had to engage itself in quasi-fiscal activities because politicians have not done their homework in terms of fiscal stability, it is important to look at the political economy of recent government (non-) action in the euro area. The recent proposals aimed at strengthening the euro area by the political leaders of Germany and France have received extensive criticism, even from key figures within EU institutions, for “offering too little, too late.” Why are the major players of the EU dragging their feet in coming up with a comprehensive solution to the euro area debt crisis – a problem which poses a heavy and immediate legacy for the Draghi era as well?

The answer is heavily related to how the current scenario which I will describe more deeply in the following tends to drive the markets and, hence, probably also the governments of the larger donor/guarantor countries. In early August 2011, a domino effect, leading to a significant plunge in bank assets, started to kick in because financial markets quite understandably do not wait for one country after another to be downgraded. Markets tend to anticipate the endgame, or at least one potential scenario of it, which probably consists of the unravelling of the entire EFSF/ESM structure (Gros and Mayer, 2011). And you can be sure that politicians are aware of it!

Markets were caught between three quite inconsistent constraints which cannot be alleviated by European politicians due to the given bargaining structure of the “game”. First, a sizeable increase in the borrowing capacity of the EFSF is technically and politically not possible. Second, in the short- to medium run there will be no Eurobonds because it is against the interests of the largest and (still) most solvent guarantor country. And third the
ECB is reluctant to engage in large-scale purchases of financially troubled governments’ bonds and to accept huge haircuts for over-indebted, i.e., insolvent countries such as Greece (as opposed to illiquid countries). The German government, for instance, is strongly inclined to support the ECB in this respect, because the German population was promised a financially and politically independent ECB and a strict national responsibility of Member States for their public finances in exchange for its dispense with the Deutsche Mark (Belke, 2011a).

The sophisticated structure of the “endgame” of the euro area is quite difficult to handle. Among others, there is an obvious incentive for weaker Member States to become insolvent as long as there are enough guarantors available. Moreover, as the Deauville agreement among Merkel and Sarkozy of October 2010 showed, it is the high time of package deals right now. In that case Germany gave in with respect to its target to harden the preemptive arm of the Stability and Growth Pact (SGP) and France. Caught in a minority coalition of countries with more sound finances (joint with Finland, Austria and the Netherlands), Germany is especially keen on this kind of deals because it is fearing to be finally forced into agreements such as a “true” European Economic Government by the majority of euro area countries without having dominated the design of this new type of European economic governance (Belke, 2011a).

Finally, politicians of course strive to be re-elected by their home base. In Germany, for instance, federal elections will take place in 2013, i.e. the year in which the ESM will be put in place. Remember that Merkel lost important local elections in Northrhine-Westphalia immediately after she had agreed to the first Greek rescue package (Belke, 2011a).

Seen on the whole, thus, most of which looks like the often blamed hesitant and half-hearted politicians has a clear rationale. Economists would say: euro area countries maximize their power index, i.e. their probability of being members in winning coalitions (Belke and Styczynska, 2006, and Belke and von Schnurbein, 2011). Of course, this politico-economic constellation has posed a significant challenge for another important player, the ECB. Hence, it can be seen as a great achievement from the perspective of the ECB that Mr. Trichet came out of the EU summit on 21 July 2011 with a net loss of zero, i.e. being compensated for each potential percentage point of a haircut by equivalent guarantees delivered by the European taxpayer (Belke, 2011a).

My second point starts from the observation that boosting the European Financial Stability Facility (EFSF) is regarded by many leading economists and market analysts as a necessary step to calm the markets. So why should this be not realistic also from Mr. Draghi’s point of view?

First of all, one should keep in mind that the EFSF was originally designed for a crisis in the periphery, i.e. large euro area countries provide emergency financial support solely to small countries such as Greece, Ireland, and Portugal. In particular, the EFSF simply does not and will not have enough funds to undertake the massive bond purchases required to stabilise markets (Belke, 2011a).

Additionally, the rules of the EFSF renders it vulnerable to a domino effect (Gros and Giovannini, 2011): a country that is plagued by financial difficulties and itself requests support from the EFSF is allowed to step out. According to Art. 2(7) of the EFSF Framework Agreement, it may thus no longer provide guarantees for any further debt issuance by the EFSF. Moreover, a country facing high borrowing costs (as in the case of Italy and Spain if rates stay at crisis level) will step out as guarantor and only the core euro area members would remain to back the EFSF. At this point, the debt burden on the core countries would become unbearable – due to the so-called cascade structure of the EFSF (see Belke, 2011a, and http://www.efsf.europa.eu/attachments/faq_en.pdf).
Hence, politicians and also ECB officials like Mr. Draghi are well-advised to acknowledge that there are significant dangers of applying the periphery solution to the core. This immediately makes understandable that – under current institutional circumstances - an ever larger EFSF cannot represent the solution. On the contrary, any envisaged increase to cover sums starting from EUR 2.5 trillion (Buiter, 2011) to an incredible EUR 4 trillion (Gros and Giovannini, 2011) could accelerate the domino effect because it either leads to step-outs of an increasing number of guarantors or leads to ever increasing refinancing costs of the EFSF if those countries stay in with an eye of the reputation loss they would experience if they would leave (Belke, 2011a).

That the French government has reduced its emphasis on the increase of the EFSF does also make much sense even from the French point of view itself. Sarkozy had to recognize that financial markets have understood the domino risk and have actually started to push up French borrowing costs. Just rumours of a boost to the EFSF have made France the EMU core country most in danger of losing its AAA rating. But if France really gets rid of its AAA status and is then forced to step out of the EFSF, there would only be Germany (and some of its smaller neighbours like Austria, the Netherlands and Finland which can be called its strategic “allies“ in the current politico-economic game) remaining to carry the whole burden. This would not only be politically unacceptable, thus evoking growing nationalist tendencies, but also economically impossible – in terms of GDP Italy is eight times Greece and the Italian government debt alone is equivalent to the entire GDP of Germany (Belke, 2011a).

Finally, I have frequently argued elsewhere that a boost to the EFSF is equivalent to introduce a variant of “euro bonds“ because the member countries jointly guarantee for each other (note that the term „euro bonds“ is often used in the public debate in a way not specific enough). This is in strong contrast to the rescue programmes for the periphery which are characterized by a unilateral lower scale flow of guarantees and funds. However, any “euro bond“ approach would make a change in the EU treaties necessary. Finally, it would probably not be compatible with the German constitution which is at least relevant for the German government and, thus, have an impact on Germany’s behavior as a player in the current euro game (Belke, 2011a).

My third point starts from the observation that Greece has unmanageable levels of debt, which everyone seems to recognize except the EU leadership. Indeed, no plan offered so far appears to adequately address the Greek debt issue. So, an important challenge for Mr. Draghi is to answer on behalf of the ECB under what conditions can Greece avoid default and remain in the eurozone.

We should really be concerned that under the current projections and after the Summit of 21 July 2011 Greek debt looks set to increase in the short-term and will remain above 100% of GDP for years to come. Hence, I see the necessity of another adjustment being made in the future (Belke, 2011a).

"Although parts of the agreements of the recent Summit point in the right direction, the extent of the concrete measures decided is disappointing. They do not have the potential to put an end to the debt crisis. Instead, the risk of contagion of other countries will increase. This is because the much too low haircut immediately sends the message to the market participants that an even more significant restructuring if not a more gigantic transfer of euro area countries to Greece will be necessary and take place in the future. Presumably, we will see an even more substantial debt restructuring after 2013 when the EFSF will be substituted by the ESM and the German elections will have taken place", (Belke, 2011a). This view is supported in technical terms by the fact that the existence of the ESM will make restructuring of privately hold government bonds much easier.
The ECB is also under the lead of Mr. Draghi urged to take part in the process of defining conditions for a sustainable solution in the context of the whole euro area. This process could look as follows but is still a task quite open for future action. The latter, however, will be of enormous concern for the future role of the ECB.

Let us start from the usual observation that (not only) the Greek banks are the weakest link. They usually create negative feedback loops and accelerate the transmission of the domino effect described above. This is because many banks keep large amounts of government debt in their books and their credit rating usually shrinks in parallel with that of their own sovereign (Belke, 2011a). This has exactly been the reason for Mr. Trichet to be so keen on decoupling the euro area banks from their sovereign (see chapter 2 of this Briefing Paper).

It is now apparent that capital markets are anticipating the potential for a doomsday scenario, with the economy falling abruptly into recession as the interbank market breaks down and public debt problems are expected to grow. Unfortunately, as Gros and Mayer (2011) argue these expectations will materialize unless the breakdown of the interbank market is addressed immediately. Thus, just to circumvent the worst thinkable scenarios, one option would be to follow Gros and Mayer (2011) in that the euro area is – whether one is ready to accept it or not - in need of a large-scale infusion of liquidity. Given that the existing cascade structure of the EFSF is part of the problem, the solution cannot be a massive increase in its size (see my remarks above). Rather, in a case of emergency, according to Gros and Mayer (2011), the EFSF should be granted access to re-financing by the ECB as a lender of last resort. The EFSF would thus be finally transformed into a European Monetary Fund (EMF).

With an eye on the structure of the politico-economic euro game, my guess would be that any solution via the EFSF would in the end be preferable to Germany as compared to any Commission-led solution because this country has increasing doubts in the non-political character of the EU Commission with its alleged bias towards the Southern, e.g. Portuguese and Italian view.

If also the ECB under Mr. Draghi would be prepared to follow the approach proposed by Gros and Mayer (2011), Germany with its rule-based and price-stability oriented Bundesbank tradition would have to swallow the bitter pill that this change in character of the ECB is the price for strongly pushing through the only way to get away from the mess: governments of highly indebted euro area countries should continue to tackle the markets’ crisis of confidence at the roots by pursuing the extremely difficult task of improving competitiveness and growth (Belke, 2011a).

Admittedly, bringing EMU sustainably back on track will only be successful if government debt and deficits are reduced substantially – optimally by national debt brakes democratically imposed by national parliaments. The recent financial and economic crisis has proven again that any concept of permanent deficit-spending and excessive debt will inevitably lead to the impossibility of debt rolling. A long-term oriented programme of debt reduction is a conditio sine qua non. However, debt reduction takes time not only in Greece. In order to avoid failure of EMU, it should thus be accompanied by a crisis management mechanism like the one described above which should not yet rely on euro bonds as correctly and repeatedly stated also by Mr. Draghi. A key condition for the introduction of euro bonds in a narrow definition is that public debt has first to be reduced to a sustainable level. But this condition is neither realized in the euro area as it stands nor is it credibly on the official agenda, at least for the time being. Instead, it has been watered down in Deauville in October 2010 (Belke, 2011a).
Seen on the whole, thus, I am not quite sure that the Gros and Mayer (2011) proposal will be an “equilibrium solution” in the politico-economic game just described because it would be against the short-term interests of the German government. However, it brings up the painful subjects that (1) credible commitments by all euro area governments to stop permanent deficit spending forever and to deliberately introduce waterproof debt brakes are probably not more than a fiction, and (2) if one would reject this proposal because it is very close to direct monetary financing of public debt, the only obvious alternatives to this proposal would be to acknowledge the end of the fiat money standard\textsuperscript{10} and to head for fierce currency competition (ECB Observer, several issues) which, however, could contradict the necessity to go for more monetary policy coordination among the G20 (as argued later on in this briefing paper).

One ultimate (purely academic?) solution would be to re-nationalize and de-politicize and economize the process of money creation in the Hayekian tradition (for a comparison of Friedman’s constant money growth plan with Hayek’s Competition of currency concept see Belke and Polleit, 2010, pp. 352ff.). But in order to be realistic, at least, this would imply for Mr. Draghi to set the ECB on track to compete for the assessment as the most stability-oriented currency area in the world in order to attract the confidence of international investors from China, Russia and oil-exporting countries currently on the brink of turning away from the US as a safe haven due to its obviously unsustainable macroeconomic policy mix (Belke and Polleit, 2011). This would immediately imply for Mr. Draghi to push for an acceleration of the exit from expansionary unconventional monetary policies even as a go-it-alone strategy and to cut the ECB’s balance sheets down as fast as possible.

**Monetary policy challenges in the Draghi era**

According to many experts, Mr. Draghi urgently needs to turn to a repair of the ECB’s balance sheet. The ECB has weakened its capital base by the purchase and the collateralisation of toxic paper from the heavily indebted countries (Belke and Polleit, 2011). Further challenges are in the shorter run: How should interest rate policy look like in the next months in Europe? And more generally: What is the right monetary exit strategy for the ECB? How should the ECB handle diverging economic developments in the euro area in the future? Note that any final assessment of convergence of, for instance, current account balances will be able to meet not earlier than after having run through a complete credit cycle, i.e. after 10 years. The pre-crisis dogma of a complete business cycle lasting 4 to 6 years is gone now. Which goal(s) should monetary policy follow in Europe (price stability, growth/employment and/or financial market stability)? Which indicators and which instruments should be chosen? Are there trade-offs between these goals (price stability, growth/employment, financial market stability)? How should/could the ECB and other financial regulatory/supervisory authorities work together more effectively to prevent financial crisis in the future? And often stressed by Mr. Trichet himself: How will it be possible to decouple banks from their sovereign? Should the ECB finance the deficit of the state budget more directly in the future? Should central banks work together more effectively in the future, e.g. to influence/stabilize exchange rates and to prevent speculative capital flows?\textsuperscript{11} In the following section we will draw a little bit more on the final aspect.

\textsuperscript{10} Anyway, it could be argued not only by monetary purists that also all alternatives such as public sector involvement (PSI) would imply exactly the same: using the printing press to finance public debt. PSI in the end means that the private sector is then bailed out in one way or the other by governments which then are bailed out by the ECB or directly by the central bank.

\textsuperscript{11} Whether the Gros and Mayer (2011) proposal itself has an inflationary bias is still open to debate. The authors argue that EFSF money demand simply crowds out money demand by the private sector.

A couple of these questions are put forward as the guiding questions of an upcoming conference organised by the German Friedrich Ebert Foundation. See FES (2011).
International policy challenges stemming from global liquidity

The outbreak of the global economic and financial crisis in 2007-08 led to a speedy and coordinated response for the provision of global liquidity, in particular by major central banks supplying significant amounts of liquidity through different channels, including currency swaps and non-standard measures. Four years after the start of the crisis, several weaknesses in the functioning of the global monetary system remain to be addressed. Much controversy surrounds the issue of global liquidity in the international context. There are concerns that ample global liquidity conditions lead to distortions in asset prices and cross-border capital flows, which contribute to the emergence of bubbles and protectionist responses. Moreover, there is substantial disagreement and debate as to the drivers of global liquidity. While the monetary policy stance of some reserve currency issuers is criticised by emerging economies as contributing to an excessive build up in global liquidity, massive foreign exchange intervention, fear of floating and capital controls put in place by several emerging economies may have a profound effect on the magnitude and allocation of global liquidity (Belke and Rees, 2010; Belke, Orth and Setzer; 2010, and Belke, Bernoth and Fichtner, 2011).

Selected issues are: What are the underlying origins of global liquidity on the demand side, and on the supply side? What is the relative importance of monetary policy and exchange rate policies? What are the effects, and the underlying channels, of global liquidity on the real and financial sides across economies? How may externalities and spillovers of policies contribute to the generation of global liquidity? Should global policy coordination be designed to deal with this and, if so, how can it be done? (Belke and Rees, 2010, Belke, Orth and Setzer, 2010, and Belke, Bernoth and Fichtner, 2011).

While the first three questions pose a big challenge for economic science the last one certainly represents an important point on the agenda of Mr. Draghi.

Belke and Rees (2010) "have investigated whether there is increasing uncertainty for monetary policy in the wake of globalization and whether central banks have become less effective in influencing national liquidity conditions. In brief, our answer to both questions is a clear “yes”. Hence, we feel legitimized to derive at least four policy conclusions" relevant for the Draghi era "emerging from our analysis. First, global liquidity conveys additional information about monetary conditions not summarized by national money and short-term interest rates. Second, global liquidity restricts national monetary policy in its ability to influence nominal and real variables, caused by, for example, the effect of global liquidity on short-term interest rates. As a consequence, the influence of central banks on domestic money supply is weakening. Third, national monetary policy is faced with an increasing degree of uncertainty and might feel forced to act according to the so-called Brainard conservatism principle."12

"Fourth, the old question of optimal monetary policy among interdependent economies powerfully reappears on the surface. In the following, we elaborate a bit more on the third and the fourth policy conclusion" (Belke and Rees, 2010).

"Our third policy conclusion is that national monetary policy" as, for instance, also the ECB's "is faced with an increasing degree of uncertainty. Needless to say, monetary policy always operates in an environment of uncertainty. Sometimes, for instance, it is not unambiguously clear for central banks how to interpret new incoming macroeconomic data. Moreover, there are uncertainties about the concise monetary transmission mechanism. However, our empirical results indicate that the fog of uncertainty has indeed become denser due to structural changes in the transmission process between global and national variables. Among other common forces, this seems to be also true for global liquidity,
which has an increasingly stronger effect on monetary aggregates in some but not all countries. This “Knightian uncertainty” or model uncertainty may have significant implications for the behavior of central banks” such as the ECB in the future (Belke and Rees, 2010).

"According to the Brainard conservatism principle, uncertainties about major model parameters can change the incentives facing central bankers, thereby leading them to use their policy instruments less vigorously. The reason is that uncertainties about the elasticity between global and national money is amplified into the economy the more monetary policy reacts to this relation. Since the Brainard conservatism introduces a motive for caution in optimal central bank behaviour, financial globalization and its corresponding structural changes may have been important reasons for central bankers like Mr. Trichet not fighting against strong rises in monetary and credit aggregates in the last few years. In contrast, Borio and Filardo (2007) explain excessive monetary policy accommodation not by rising uncertainties but by favourable supply side developments triggered by globalization. This in turn dampened inflationary pressure and allowed the reduction of short-term interest rates to exceptionally low levels. If structural breaks and the higher potential for making mistakes make up for the underlying reasons for too prudent central banks behaviour, it is not clear whether this will change in the years to come. Both financial markets and the global economy may undergo even more profound modifications after the unprecedented financial crisis." (Belke and Rees, 2010).

Besides the fact that after the crisis pre-crisis levels of potential output and the like – being blown up by the bubble - cannot serve as a benchmark for monetary policy anymore, this poses a decisive burden not to be neglected for Draghi.

"Our fourth policy conclusion concerns the question of the optimal design of monetary policy among interdependent economies". (Belke and Rees, 2010). Mr. Draghi will certainly be confronted with, especially so in the framework of the G20 (Belke, Bernoth and Fichtner, 2011). "Should open “spillover-driven” economies adopt rules designed to fit specific features of more open and more closed economies? This is old wine in new bottles and is closely related to the popular debates about inward-looking versus outward-looking monetary policy and commitment versus discretion, respectively." The ECB will have to fix its views on these vital points.

"The Chicago School saw a flexible exchange rate as a way of insulating domestic developments from foreign economic disturbances, including foreign monetary policy. There is no need, they argued, for central banks to coordinate their monetary policies. All that is needed is flexible exchange rates." This is the usual answer you get from central bankers from, for instance, the Bundesbank. But doesn't "the existence of global liquidity mean that we need coordination or", equivalently, something like "a “world central bank”? International coordination might be needed to keep global liquidity shocks as low as possible, since structural changes between global and national liquidity cannot be influenced by central banks. One reason is that monetary policy competition between central banks "(which might be beneficial by itself if it is related to stability orientation as means to attract Chinese or Russian investors’ trust) "might cause a free-rider problem without any coordination. If a national central bank, let’s say the Bank of Japan, is inclined to conduct a lax monetary policy, liquidity spillovers occur and foreign central banks have to bear parts of the burden. Another reason is that there may be multiplier effects that occur when several countries all turn their monetary policy in the same direction" as was so often the case in the recent financial crisis in the framework of unconventional monetary

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12 See Brainard (1967).
policies. "The crucial issue is how best to prevent further excessive, synchronized shifts in the world money stock (Belke and Rees, 2010, and Belke, Bernoth and Fichtner, 2011).

"However, [Mr. Draghi will also have to take into account that] policy coordination would bring greater predictability, but at the risk of all countries simultaneously choosing the wrong set of policies. International policy coordination would merely elevate to the global level the shortcomings that are now apparent at the domestic level." (Belke and Rees, 2010).

While Belke and Rees (2010) "have come up with some additional empirical evidence supporting the view that monetary policy has become less effective as a consequence of globalization, the question remains unsolved whether central banks like the ECB need to adapt their monetary policy strategies in order to cope with the challenges of globalization." Also this task is left to be solved by Mr. Draghi and his colleagues.

**Challenges in the reform of the international monetary system**

Among the various issues being discussed in the context of reforming the International Monetary System, the move towards a multi-polar currency system and the debate on the role played by the US dollar are as topical as never before since the collapse of the Bretton Woods system. Several leaders of emerging economies are currently questioning the current uni-polar system as they link the crisis to the dominant role of the US dollar and to the "exorbitant privilege" that the United States derives from this role, as well as to the ensuing negative global externalities. Clearly, this represents also a challenge for the euro area member states and, most significantly, also the Draghi term in office. Not at least because Draghi and the ECB would potentially have to strategically rethink the role of the exchange rate within the ECB’s monetary policy strategy – given that other countries tend to open so-called currency wars (Belke, Bernoth and Fichtner, 2011).

Several observers and policy-makers like Eichengreen (2011) have argued in favour of the emergence of a multi-polar currency system, in which the Chinese renminbi and the euro, for example, would emerge as truly global currencies alongside the US dollar, or see scope for an enhanced role of Special Drawing Rights (SDRs). In their view, although the smooth transition to such a multi-polar currency system without too much of exchange rate and capital flow variability might pose a challenge, it could have several benefits, among them efficiency gains, higher policy discipline across the globe and significant improvements in economic and financial stability, as major real and financial imbalances in the global economy would be reduced and risks would be diversified even more (Belke, Bernoth and Fichtner, 2011).

Another challenge for the Draghi era is – as elaborated in chapter 2 of this Briefing Paper - associated with elevated debt levels in advanced economies and the use of restructuring measures as a possible option to address them. Reviewing the reasons of why past proposals for a sovereign debt restructuring mechanism have failed, as well as global approaches to dealing with adjustment programmes and sovereign debt, and looking at why the IMF doctrine does not insist on debt restructuring as a rule in its adjustment programmes might be of particular interest in this context. This is all the more valid as this Briefing Paper critically asks why the ECB and especially its President, Mr. Trichet, is so outspoken against PSI. Mr. Draghi will have quickly to become familiar with a world in which monetary policy is heavily involved in quasi-fiscal activities.

Draghi must develop an ECB view on the desirability of a shift (to what extent?) towards a multi-polar currency system. The ECB should strive to gain clarity about the determinants of such a possible shift and whether it should be a market-driven or a policy-driven process. Finally, he should convincingly explain over which horizon it could occur (Belke, Bernoth and Fichtner, 2011).
What is more, Mr. Draghi will have to develop his vision about what role Special Drawing Rights (SDRs) should play in the international monetary system. How and, when should currencies be added to the SDR basket? Most important, the ECB under his lead has to infer what impact would an increased volume have on the ECB because it is the final guarantor behind SDRs. It should develop measures to prevent that money in circulation will be blown up in a way that excessive liquidity is created in a way which is not under the control of the ECB. This is an important issue which has already been addressed by Member of the ECB Board Jürgen Stark several times and should be taken up by Mr. Draghi in any case. The final task in this context is to propose how a disorderly transition towards a multi-polar currency system, with excessive swings in exchange rates, can be prevented. How can it be ensured that the euro does not bear an excessively larger share of the adjustment while at the same time the ECB avoids (in the long run futile) interventions on the forex market to weaken the external value of the euro (ECB Observer, various issues, and Belke, Bernoth and Fichtner, 2011)? Why have past proposals for a sovereign debt restructuring mechanism failed? Mr. Draghi should be prepared to have a say within the G20-framework in the selection of the global approaches to dealing with adjustment programmes and sovereign debt.

Seen on the whole, thus, the challenges for Mr. Draghi might even be more global ones than those for Mr. Trichet already were.
3. CONCLUSIONS

The aim of this briefing paper was twofold. First, it provided a review of the Trichet presidency and its main legacy. Special emphasis was laid on politico-economic considerations. What is more, it especially assessed the difference that the President has made through his own person. Second, it also delivered a preview of the Draghi presidency and evaluated the challenges the new President will have to deal with. Again, the ECB and its political constraints in the current euro area debt crisis were focused upon.

One of the important messages is that the effects from Trichet’s previous policy actions are still in the pipeline. Most important, excessive money creation has finally led to excess liquidity, excessive credit and to a persistently increased leverage in the euro area. Another observation is that Mr. Trichet abrogated the market-based interest rate mechanism for sovereign debt throughout the euro area. The costs and benefits of this venture are evaluated against the backdrop of the fact that the potential scope for public debt is much lower for a country within a monetary union because it should not and cannot resort to seigniorage and the inflation tax to finance it.

Since some consequences of Mr. Trichet’s monetary policy choices will manifest themselves only with a lag, the main legacies of the Trichet era also correspond to the main challenges for Mario Draghi. Among them is the potential dramatic worsening of the euro area debt crisis (hopefully not in parallel with the US debt crisis) since up to now no sustainable institutional solution is found. On top of that Mr. Draghi will be confronted to a larger extent than his predecessor with challenges concerning international liquidity spillovers and the reform of the international monetary system.

Although Mr. Trichet has only two months remaining on the job, that time could be crucial (Ewing, 2011b). He has a point in not discussing his plans for retirement and appearing as vigorously engaged as ever.
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European Monetary Policy under Jean-Claude Trichet

Stefan Collignon

BRIEFING NOTE 9

Abstract
The change of the ECB’s president is a moment to take stock. Since January 1999, the ECB has gone through three major phases: foundation, consolidation and financial crisis. Through all this period it has achieved its primary and secondary objectives with remarkable precision. We estimate a reaction function and find that under Trichet, increased credibility and a more stable macroeconomic environment allowed monetary policy to shift focus in favour of employment and financial stability. Handling the financial crisis was Trichet’s master piece, although Member States have not made it easier for the bank. We conclude by saying:

Bravo et merci, Monsieur Trichet! And Buona fortuna, Presidente Draghi!
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EXECUTIVE SUMMARY

On 1 November 2003, Jean-Claude Trichet took over as President of the European Central Bank (ECB) from Wim Duisenberg. Eight years later on 1 November 2011, he will now hand over to Mario Draghi. This is a good moment to take stock and review the performance of the ECB, since it started operating on 1 January 1999, and to assess the perspectives for the future. After a short overview of the monetary policy environment, I will evaluate the Bank's achievements with respect to inflation, growth and employment. I will then show how monetary policy under Trichet was different from the Duisenberg Era, and I will discuss the ECB’s role in the crisis after 2008. I will conclude on some future perspectives.
1. OVERVIEW

Since European Monetary Union started on 1 January 1999, the ECB has gone through three major phases: foundation, consolidation and financial crisis. Wim Duisenberg presided over the first, Jean-Claude Trichet over the other two. However, one has to keep in mind that the composition of the ECB’s directory has also changed, as Figure 1 reminds us.

Figure 1

Source: ECB

1.1. Foundations

When the ECB started its operations in 1999, it was handicapped by large uncertainties. The new bank had no track record. No one knew whether people and financial markets would accept the new currency. Because monetary policy operates largely through communication and signals sent to financial markets, the ECB needed to build up a reputation that would allow it to conduct policies as effectively as any other central bank. Many observers judged the ECB against the standards set by the Bundesbank. The ECB and its President had to gain credibility as tough inflation fighters who were independent from European governments. On a technical level, there was significant heterogeneity in the functioning of national banking systems and uncertainty about how the combined monetary aggregates in the euro area would behave. Thus, it was not clear, how actors in different markets would respond to a given signal from the ECB.

The macroeconomic environment was also changing rapidly. It was hit by a series of shocks. Some economists had expected that the new currency would appreciate against the USD, while in fact it did actually weaken in the first two years. This was often seen as a lack of trust in the new currency. A weaker euro made imports more expensive, which added pressure on prices, especially from raw material imports. The oil price tripled in the first 20 months of the euro, raising fears that it could threaten price stability as it did in the 1970s. In 2000, the so-called dot.com bubble burst and monetary policy worldwide became accommodating. In this context, the ECB took a hard line to maintain its "conservative"
reputation\textsuperscript{1}. While this strategy seemed to have worked and achieved its purpose, the bank was coming under increasing criticism for stifling economic growth, especially when its policy was compared with the Fed under Chairman Greenspan’s leadership. President Duisenberg was also frequently considered as clumsy in his communication; he was seen more often as a spokesman for the Bundesbank than as a leader in his own right and authority. Nevertheless, the introduction of euro bank notes had been a technical success, even if, due to framing problems, the impression of price rises due to the changeover exceeded reality (Sturm et al. 2009; Jemec, 2010). By the time Jean Claude Trichet took over office, the ECB was well established and had gained esteem and credibility. The ECB was increasingly seen as a central bank like any other and this perception was instrumental for making it actually so.

1.2. Consolidation
The first four years of Trichet’s presidency were blessed with a fairly stable macroeconomic environment. Inflation was under control, unemployment on the way down. Oil price inflation did not spill over into “second round” wage increases as in the 1970s. On the foreign exchange markets, the euro had started to appreciate and the volatility was contained. See Figure 2 and 3. The communication management improved. As governor of the Banque de France Trichet had already established a personal reputation as a "conservative" Central banker and this reinforced his credibility at the ECB.

**Figure 2**

*Weekly OPEC Countries Spot Price for Crude Oil*

<table>
<thead>
<tr>
<th>Year</th>
<th>Duisenberg</th>
<th>Trichet</th>
<th>Lehman</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>50</td>
<td>100</td>
<td>150</td>
</tr>
<tr>
<td>2001</td>
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<tr>
<td>2007</td>
<td>35</td>
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</tr>
<tr>
<td>2008</td>
<td>40</td>
<td>150</td>
<td>300</td>
</tr>
<tr>
<td>2009</td>
<td>45</td>
<td>175</td>
<td>350</td>
</tr>
<tr>
<td>2010</td>
<td>50</td>
<td>200</td>
<td>400</td>
</tr>
<tr>
<td>2011</td>
<td>55</td>
<td>225</td>
<td>450</td>
</tr>
</tbody>
</table>

Source: US Energy Information Administration and WTO

\textsuperscript{1} In an influential article, Rogoff (1985) had proposed the delegation of monetary policy to a central banker who is more averse to inflation than the government, in the sense that he places a greater weight on the loss from inflation than the government does. While such a "weight-conservative" central banker will, in equilibrium, produce a lower inflation bias than the government, his stabilization of the real economy will be suboptimally low from the government's point of view. See also Herrendorf and Lockwood, 1997.
Most importantly, the new stable macroeconomic environment allowed the bank to marginally shift its policy focus. Monetary policy became more growth-oriented without losing its strong anti-inflation stance. This became an important asset in the second half of Trichet’s tenure, when the financial crisis overshadowed everything and the ECB had to introduce new and non-standard monetary policies.
1.3. Crisis management

In the second half of Trichet’s tenure, the economic environment deteriorated dramatically. Inflation started to accelerate after 2005, and the ECB tightened its policy. In 2007, dangers in the US-credit markets became apparent; they exploded with the Lehman collapse in September 2008. Euro area GDP fell by 5.25 percent, unemployment shot up and public debt to GDP ratios increased everywhere. The handling of the crisis was Trichet’s master piece. In line with all major central banks, the ECB slashed interest rates to levels close to zero and it provided unlimited liquidity to stabilize financial markets. The ECB was able to prevent a meltdown of the European Banking system and cooperates with other major central banks in order to avoid a global depression.

Yet, the crisis is not over. In 2009, after a change in government, the Greek debt crisis has destabilized financial markets massively. In May 2010, after the European Council had agreed to set up the European Financial Stability Facility (EFSF), the ECB responded by buying sovereign debt in the secondary market. While this is a banal open market operation for most central banks in the world, it was innovative in Europe because the ECB used to provide liquidity to banks through repo operations rather than outright purchases. This policy shift gave the ECB an additional tool for preventing disruption in financial markets and stabilizing the European banking system. Since 2010 it has made use of this procedure repeatedly, most recently to stabilize the bond markets for Spanish and Italian government debt. However, the operations have also made the ECB more vulnerable. Sovereign defaults could have serious consequences for the ECB’s asset structure and own funds. Most importantly, however, the ECB has become involved in a power struggle with national governments, while some governments, especially in Germany, Slovakia and Finland, have resisted providing funds to overcome the liquidity crisis. The ECB under Trichet’s leadership was able to ensure a minimum of European coherence, which national governments failed to do. Jean-Claude Trichet’s speech in Aachen, where he called for a European Treasury and Finance Minister will remain his legacy.
2. ASSESSING THE ECB´S PERFORMANCE

The objectives for European monetary policy have been stipulated by all Treaties since Maastricht and are now part of the Lisbon Treaties. They are stated as asymmetric objectives.

According to Article 127(1) TFEU: “The primary objective of the European System of Central Banks shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union”.

In addition Article 127(5) TFEU states: “The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.”

These are the priority goals for the ECB. However, the overall economic objectives of the Union set in Article 3 of the TEU broaden the brief. Article 3(1) TEU states: “The Union's aim is to promote peace, its values and the well-being of its peoples. (...)” and in Paragraph 3 it is written "The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment”. In other words, provided price stability is assured, the ECB must support economic growth and employment and it must ensure the stability of the financial system. Hence it is not correct, as frequently claimed, that the ECB should exclusively focus on price stability. Under Trichet, the ECB took the Treaty more seriously with respect to all these objects.

2.1. The ECB’s primary objective: mission accomplished

Assessing the performance of the ECB must necessarily start with inflation, given that price stability is the primary objective of its monetary policy. Figure 4 shows the evolution of the inflation rate.

2 Emphasis added.
The policy benchmark is the Harmonised Index of Consumer Prices (HICP), which, according to the ECB, should stay below 2% over the medium term. Table 1 shows that, over the full 150 months since Monetary Union started, the mean inflation rate was exactly 2%. For the Trichet period it was 0.2 percentage points higher, for Duisenberg equally 0.2 point lower. However, one cannot draw the conclusion that Trichet was less successful. During his tenure, the euro area went through much more dramatic shocks than under Duisenberg. This is clear from the huge swings in the inflation rate, visible in Figure 4, with a doubling of the inflation rate in the 12 months from July 2007 to July 2008 and then a dramatic fall after the Lehman collapse. This explosion and subsequent drop was due to prices in food and mainly energy as is clearly visible in Figure 2. The core inflation rate, which does not contain these items, has been much more stable with 1.55% for the whole 150 months and a lower rate with a negative differential of nearly 1 percentage point for Trichet when compared with Duisenberg. Quite a remarkable achievement.

We can also look at inflation expectations, as measured by OAT inflation indexed bonds. We find that inflation expectations are generally higher for the future. The 10 year forecast is on average 12 base points (bp) higher than the average of the last 150 months and the 15 year forecast increases by another 2 bp. The mean difference between Trichet and Duisenberg is 23 bp, which is small given the importance of price shocks that have occurred during the Trichet period.

Table 1 also shows estimates for the distribution of inflation rates. Not surprisingly, given the huge shocks in 2008 and 2009, the standard deviation from the mean is higher for the HICP during Trichet’s years, but interestingly, it is lower for the core rate. Inflation expectations are more stable than actual performances. This is an indication that inflation expectation management by the ECB has been successful and improved under Trichet.

However, the question has frequently been raised, whether the ECB’s inflation objective takes 2% as an average target or as a top ceiling. If it were a target, deviations from the
target should have a normal distribution; if it were a ceiling, we should expect to observe more points below than above the 2% line. The Jarque-Bera test rejects the null hypothesis of a normal distribution\(^3\) for the HICP inflation rate and for expected inflation, but not necessarily for the core inflation. This would indicate that the ECB’s actual target is closer to 1.5% than to 2%. But where is it? The skewness measure tells us on which side of the mean the observed inflation data are more frequent. A normal distribution has a skewness value of zero; a negative value implies that the distribution has a long left tail and the opposite if it is positive. We find that the skewness measure is always negative. Thus, we can conclude that there are significantly more months with less than the mean inflation rate than higher inflation. In other words, the 2% overall achievement is conditioned on a few high outliers, without which the average inflation rate would have been lower.

However, given the energy price shocks, this is not true for the core inflation rates. Here, the skewness indicates not only more values above the mean (which is what we would expect if the core inflation had a normal distribution), but also that there are more values than below the mean. Hence, we would conclude that the ECB’s effective inflation target is probably close to the median value of the core inflation. Interestingly, the median is lower for Trichet than for Duisenberg. Thus, inflation expectation has fallen and confidence has increased under Trichet. Duisenberg’s environment was less transparent than Trichet’s. This is also supported by an analysis of the distribution of monthly inflation rates. The measure for Kurtosis indicates the peakedness or flatness of a distribution. A normal distribution has Kurtosis value of 3; if it is lower, the distribution is flat. We observe a significant increase of kurtosis during the Trichet years, which indicate that the uncertainty around monetary policy has diminished despite the higher observed shocks.

\(^3\) In other words, the probability of a normal distribution of inflation data around the mean is very close to zero (for the HICP it is 1.17%).
Table 1. Descriptive Statistics for Inflation

<table>
<thead>
<tr>
<th>Inflation:</th>
<th>HICP</th>
<th>CORE</th>
<th>OATi -10Y</th>
<th>OATi -15Y</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Period: 1.1.1999-30.6.2011</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>2.00</td>
<td>1.55</td>
<td>2.12</td>
<td>2.14</td>
</tr>
<tr>
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<td>1.58</td>
<td>2.14</td>
<td>2.21</td>
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<tr>
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<td>2.56</td>
<td>2.46</td>
<td>2.64</td>
</tr>
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<td>Minimum</td>
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<td>0.76</td>
<td>1.63</td>
<td>1.31</td>
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<tr>
<td>Std. Dev.</td>
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</tr>
<tr>
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<td>-0.646389</td>
<td>-1.038265</td>
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<td>2.327778</td>
<td>2.958903</td>
<td>4.834029</td>
</tr>
<tr>
<td>Jarque-Bera</td>
<td>26.00255</td>
<td>3.898992</td>
<td>4.740059</td>
<td>15.35128</td>
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<tr>
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<td>0.142346</td>
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<td>0.000464</td>
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<td>48</td>
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<tr>
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<td></td>
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<td>2.21</td>
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Source: own calculations
The overall image that emerges from these data is:

1. The ECB has achieved its primary objective of keeping price stability with impressive precision, despite an increasingly difficult economic environment during the later Trichet years.
2. The credibility and reliability of monetary policy has increased in the 8 Trichet years, compared to the 5 Duisenberg years.

2.2. The second Treaty objective: supporting the real economy

Next we look at the other objectives of monetary policy. If the ECB has maintained price stability, it is obliged under the Treaty to support the other economic objectives of the European Union, in particular economic growth and high employment. How has it fared in this respect?

**Figure 5**

![Euro Area GDP](image)

Figure 5 shows the time series for nominal GDP of the euro area. It also indicates the trend development based on the first decade of Monetary Union prior to the Lehman crisis. By taking a long term view back to the 1990s, we observe, first of all, that the crisis in the European Monetary System in 1992/93 caused output losses, which were not recuperated by higher growth in the following years. This is interesting, as it invalidates all those who believe an exit from the euro in the present crisis could solve the problems of Southern Europe. By contrast, we find, secondly, that with the start of European Monetary Union economic growth improves. No doubt this reflects the greater certainty for investment and the lower interest rates in the euro area and was especially important for the South. The rise in investment in 1999/2000 was also driven by the so-called dot.com bubble, i.e. by a global asset price inflation for new technological investment (see Figure 6). But when this
bubble bursts with the crash of the Nasdaq in August 2000, it had serious consequences for firms’ and banks’ balance sheets and economic growth worldwide. This earlier financial crisis was, of course, not as toxic as the Lehman crisis, but it was prolonged by the uncertainties resulting in the US economy after 9/11, which further reinforced the global slowdown of growth, although it did not cause a recession in Europe.

**Figure 6**

**NASDAQ Index and Trend Deviation**

Hodrick-Prescott Filter (lambda=14400)

The period of contraction in the IT-sector took nearly 3 years to be cleaned out. Compared to the time it usually takes after property bubbles, this was short. However, after the events of 9/11 in 2001, financial markets feared a recession and most central banks slashed interest rates. See Figure 7. The loosening of monetary policy was most pronounced in the United States, where interest rates fell to 1% in 2003. The UK did not lower interest rates to fall below 3.5%, while the euro area stopped at 2%. Only after the Lehman crisis did the ECB allow interest rates below 2%, but at that time the inflation rate had already become negative. In other words, the ECB has always sought to keep expected real policy rates positive. This policy stands in sharp contrast to the United States, where real rates were permanently negative from mid 2002 to 2005. The three years of negative interest rates fuelled the American asset bubble, which started to destabilize financial markets in late 2007 and finally burst with the Lehman bankruptcy. During this period, the ECB was frequently attacked by economists for being too restrictive. However, the truth is that the ECB under Trichet pursued a more responsible course than the Fed under Greenspan. The only period, during which the charge of over-tightness might have been justified, was for the 12 months of 2002 under Duisenberg, as I will show in the next chapter. By contrast, the fall of the 3 month interest rate below the official (main

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4 In Japan and Germany, it took over ten years until markets normalized after the real estate bubble burst. It is likely that it will takes as long in the USA, Ireland and Spain.
refinancing operations) rate in 2009/10 indicates that the ECB provided excess liquidity to banks to a degree that was not necessary in the USA or the UK.\(^5\)

**Figure 7**

Monetary policy short term rates

Source: Bloomberg

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\(^5\) For a more detailed explanation see, European Central Bank, Monthly Bulletin 7.2011: 55-69
What were the consequences of this policy for unemployment? Figure 8 shows the monthly unemployment rate for the euro area. In the first decade of the euro, approximately 15 million new jobs were created net; most of them in the South, especially in Spain (3 million) (CER, 2011). However, 5 million jobs were lost again in the financial crisis. Nevertheless, the dynamic job creation has contributed to a fall of the unemployment rate. This came as a surprise. In the 1980s and 90, when member states had their national currencies, Europe used to be attacked for its structural rigidities in the labour market, which were thought to generate a ratcheting effect: an economic shock, like a sudden increase in oil prices, would push unemployment up, but in subsequent periods it would come down less than before, so that unemployment rates were continuously rising and creating long term joblessness. Since Monetary Union began, this ratcheting effect seems to have been reverted, at least until the Lehman crisis broke.

In 2002, when monetary policy was tight, unemployment started to rise, but we have seen that the ECB then lowered interests and kept them relatively low which stabilized unemployment again. Given that price stability was maintained over time, we must interpret this as a sign that the ECB responded to developments in the labour market. Thus, the actual policies of the ECB were in reality more flexible than the sometimes dogmatic martial public discourses given by the bank. However, the question is legitimate whether there this more accommodating policy stance was related to the change in leadership from President Duisenberg and Trichet. To find evidence for answering this question, we estimate a monetary policy reaction function for the ECB and test if we can observe any structural break at the time Trichet took over.

**Figure 8**

Unemployment Rate Euro Area

Source: Eurostat
3. HOW THEY DID IT: THE ECB’S POLICY REACTION FUNCTION UNDER DUISENBERG AND TRICHET

It is nowadays widely accepted in economics that monetary policy should adjust the nominal interest rate in response to divergences of actual inflation rates from target inflation rates and of actual Gross Domestic Product (GDP) from potential GDP. The idea goes back to a famous paper by John Taylor (1993) and since then a rich literature has developed on different formulations of the Taylor rule. We use this methodology to assess whether there as been a change in the ECB’s policy reaction under Duisenberg compared to Trichet. The Annex to this paper gives the technicalities of the econometric estimate. Here we will summarize the results and insights.

The starting point is the standard specification of the Taylor rule:

$$r_t = r^* + k(\pi_t - \pi^*) + \beta x_t + \varepsilon_t$$

Where $r^*$ and $\pi^*$ are the equilibrium values for the nominal interest rate and the inflation target and $x_t$ is a measure for the output gap; $k$ is the reaction of the interest rate to inflation changes and $\varepsilon_t$ are shocks. A value of $k>1$ indicates stabilizing monetary policy as the increase in the nominal interest rate is higher than that of inflation, resulting in a rise of the real interest rate. On the contrary, $k<1$ means that the central bank is accommodating inflation movements. In line with the literature, a smoothing factor of the interest adjustment can be put into the model and the details are explained in the Annex.

The econometric evidence can be summarized as follows:

- If we neglect interest rate smoothing, monetary policy from 1998 to 2008 was accommodating;
- If we introduce a smoothing parameter, monetary policy was stabilising during Duisenberg’s presidency but became accommodating with Trichet.
- A level shift suggests a break in the equilibrium values for inflation and interest rates, implying a more favourable macroeconomic environment for Trichet.
- The results from the forward looking specification are similar to those of backward looking results, indicating that the ECB has achieved a high degree of credibility as an inflation fighter, even if it has become slightly more accommodating under Trichet.

The overall picture is that the ECB initially took a very tough policy stance to establish its reputation as an independent central bank that is fully committed to maintaining price stability. Once this was achieved by President Duisenberg, the bank under the leadership of President Trichet could start to focus on the other objectives under the Treaty of the European Union.

How much of a break was the shift from one president to the next? We can assess this by comparing the actual interest rate with what it would have been, had the alternative policy rule been applied. Figure 9 therefore draws the actual EONIA money market rate against what this rate should have been under Duisenberg, had the ECB responded as it did under Trichet, and inversely, what the EONIA would have been, had the Duisenberg regime continued. The deviations are small, but not insignificant. Table 2 shows that on average the EONIA rate would have been 22 bp lower in the first 5 years of EMU; but had the Duisenberg regime continued, interest rates would only have been 12 bp higher than what

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7 I acknowledge Piero Esposito for his contribution.
they actually were under Trichet. The error distribution indicates that during the Trichet years, this new policy rule was applied even during the turbulent years after the Lehman crisis. During the Duisenberg years, there were some distorting irregularities particularly in reaction to the post-9/11 period in 2002, when the Duisenberg policy appeared excessively tight. Given that monetary policy impacts the real economy with significant lags, it might be reasonable to conclude that the 2002 regime contributed to the relatively slow growth (see Figure 5) and rising unemployment under Duisenberg, while the low rate policy during Trichet’s first two years helped to accelerate growth and to lower unemployment. In this respect it is also interesting that the Duisenberg rule would have already tightened monetary policy in 2010, while the actual ECB policy has kept interest rate increases low. The increases of key rates in April and July 2011 simply reflect the monetary policy rule that has guided the ECB since Jean-Claude Trichet had been its president.\(^8\)

**Figure 9**

Monetary policy rates

EONIA against counterfactual

Source: ECB and own calculations

\(^8\) Figure 7 shows that the key rates are closely matched by the short term market rates and Figure 9 shows that they are more accommodating than the Duisenberg rule.
### Table 2. Deviation of Duisenberg and Trichet rule from actual

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Source: own calculations
4. CRISIS MANAGEMENT AND NON-STANDARD MONETARY POLICY

4.1. The banking crisis

Our analysis has revealed so far that under Duisenberg and under Trichet the ECB has responded to threats to economic growth by reducing interest rates. This has happened after the dot.com bubble burst and when the world economy was negatively affected by 9/11; it happened, of course, again after the Lehman crisis, when rates were slashed from 4.25 to 1 percent. However, the global financial crisis, which Jean-Claude Trichet faced, was infinitely more dangerous than the series of shocks with which Duisenberg was confronted, because the crisis hit the world economy at its inner core and threatened a meltdown of the global banking system. Banks lost trust in each other and had a high preference for liquidity. This liquidity had to be provided by central banks in large quantities. This fact required unusual policy measures. When money markets froze, only the ECB was able to preserve the stability of the financial system by acting as the lender of last resort in the euro area.\(^9\)

Loss of trust was particularly dangerous because of the relatively important heterogeneity in the euro area’s banking and financial structures. There is a populist image of banks as greedy monsters that suck the wealth out of the “real” economy. Nothing could be further from the truth. Even if there may always have been crooks who seek a shortcut to wealth, the system could not work and reproduce itself over time if its constitutive principle were “grab and run”. Without the financial sector, there would be no “hard working real economy” and we would still live in the Stone Age. Since early days of the Italian Renaissance, the purpose of banks has always been to make and facilitate payments on behalf of their clients, and in the course of doing so they have developed the capacity to make loans and grant credit. Banks function as intermediaries that bring together those who are in the possession of excess liquidity and those who need to borrow. The counterpart to credit is debt, which is a promise of future payment, and the two are held together by trust. Financial assets are simply certified forms of promises. If debtors do not honour their promises, creditors’ wealth is impaired and trust disappears. As intermediaries, it is the job of banks to assess and minimize risk of loss. Modern financial markets have therefore specialised agents to deal with risk through all kinds of products, including derivatives, but in the end the system only works because there is trust. However, the integration of European financial markets has a history of, at best, 25 years, while national banking systems have grown over centuries. As a consequence, trust in non-national financial institutions within the euro area has been fragile during the crisis. Banks would no longer lend to other banks in the money market. Instead they relied increasingly on the ECB for borrowing and depositing their excess liquidity. Thus, only the institutional safeguards and the non-standard policy measures by the ECB were able to hold the system together.\(^10\)

Over the last 200 years it has become clear, that the stability of the financial system requires a lender of last resort that ensures that solvent debtors can make the payments they have promised to make. For if creditors, including those who have deposited their

\(^9\) Kindleberger 2005 has called the concept of lender of last resort “the hallmark in the development of the ‘art of central banking’, which has developed over the last 200 years.”

\(^10\) This argument underscores the importance of a single currency in a single market. The economic distortions which would have occurred without the institutional backup of monetary union would have been dramatic, given the small size of national markets and national currencies in Europe. The overvaluation of the Swiss franc is only a small example of such developments, because uncompensated shocks in the European single market would have cumulated and reinforced negative externalities.
Cash with banks, lose trust and the confidence that they will get their money back, they will rush to withdraw their cash or liquefy their assets and this can cause a cascade of liquidity problems which could turn into solvency problems. This is called the systemic risk in financial systems. The function of a lender of last resort is to stand ready to halt a run out of real assets or illiquid financial assets into money, by supplying as much money as may be necessary to forestall the run. It must provide an elastic supply of base money (Kindleberger, 2005).  

In such financial crises, low interest rates become a powerless policy tool. The academic discussion has often blamed monetary impotence on the fact that nominal interest rates cannot be lowered below zero. However, the ECB has emphasized that the aim of non-standard measures is to maintain the transmission mechanism of monetary policy in otherwise dysfunctional financial markets. In other words, without the non-standard measures the central bank could no longer do its job in the present environment. The ECB could not pursue its primary objective, i.e. price stability, unless it ensures and preserves the stability of the financial system. As Kindleberger (2005:226) pointed out, historically “the development of the lender of last resort evolved from the practice of the market rather than from the mind of economists.” In Europe’s monetary Union this is no different.

The first step in the crisis was the provision of liquidity to the banking system that was required to prevent a bank run after the Lehman bankruptcy. A special tool was the Covered Bond Purchase Program (CBPP), under which nearly EUR 100 billion were pumped into the banking system (see Table 3). Under the CBPP, the Eurosystem made outright purchases of covered bonds in the primary and secondary market. In recent months, the ECB has started to carefully withdraw some of these non-standard operations, but the sovereign debt crisis has become an additional risk factor for the banking system.

4.2. The sovereign debt crisis

The different non-standard interventions of the ECB were highly effective in the money market during 2009 and the ECB has now started to exit at least some of them. However, when the sovereign debt crisis developed in late 2009, the European Central Bank faced a new dilemma. On the one hand, there was the principle that in European Monetary Union, fiscal policy remained under national responsibility. Bailing out Member States could then create a moral hazard and undermine fiscal discipline. Why would a member state consolidate its public finances, if it could count on getting finance from other Member States that markets would deny? On the other hand, there was the need to avoid a self-

11 It is sometimes argued that such “unlimited” supply of money could cause inflation. However, in a liquidity crisis this is unlikely to happen, because the high liquidity preference only increases demand for base money, while the broad money aggregate, which affects prices it likely to stagnate. This is precisely what we have observed in the euro area over the recent crisis. For evidence see S. Collignon 2010, How to avoid currency wars; IP/A/ECON/FWC/2009_040/C10, 17 November 2010. Download from: http://www.stefancollignon.de/PDF/How%20to%20avoid%20currency%20war_Nov10%20(3).pdf
13 For a detailed analysis see Beirne et alt. 2011.
14 According to Article 125 TFEU, “The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.” This article is often called the “no-bail out clause” in the Treaty. However, it is clear from the text that giving credit cannot be the same as being liable, for credit given are an asset and not a liability. A bailout according Article 125 TFEU would imply that one Member State’s liability becomes another Member State’s liability.
15 Moral hazard is a situation in which a party insulated from risk behaves differently from how it would behave if it were fully exposed to the risk. Moral hazard arises because an individual or institution does not take the full consequences and responsibilities of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to hold some responsibility for the consequences of those actions. See: http://en.wikipedia.org/wiki/Moral_hazard
fulfilling vicious circle, whereby lack of liquidity would turn into insolvency. This is the well-known problem of collective action or fallacy of composition: in a panic, welfare augmenting individual actions can become detrimental to general welfare.

Thus, the logic of the sovereign debt crisis is similar to a banking crisis: distrust between nations and their governments prevents them from dealing with liquidity issues. Furthermore, because sovereign bonds represent an important share in private banks’ portfolios, the drop in bond prices will destabilize their balance sheets and impair banks’ capacity to lend. A major recession would follow. This is in fact, what has happened to Greek, Irish, Spanish, and Portuguese and recently Italian government bonds; the painful impact on growth is only too obvious. For these reasons, a lender of last resort is necessary that provides sufficient liquidity in the sovereign bond market to essentially solvent states, for otherwise a run to liquefy bond holdings can occur when investors lose trust (De Grauwe, 2011).

In fact, this is one reason, why the so-called principle of market discipline, whereby markets force governments to restrain borrowing, has not worked. The problem resembles the prisoner’s dilemma. The central bank should lend freely to halt the panic, but leaves governments to their own devices to reduce the likelihood of future panics. But governments do not have incentives to do so if they know they will get bailed out by the central bank. This is a dilemma, where today always wins over tomorrow (Kindleberger, 2005:228), or as in the European case, where the partial interests of national governments always win over the general interest of all Europeans.

In their famous book about monetary policy and the American depression, Milton Friedman and Anna Schwartz wrote: “The detailed story of every banking crisis ... show how much depends on the presence of one or more outstanding individuals willing to assume responsibility and leadership. ... Economic collapse often has the characteristics of a cumulative process. Let it go beyond a certain point, and it will tend for a time to gain strength from its own development... Because no great strength would be required to hold back the rock that starts the landslide, it does not follow that the landslide will not be of major proportions.” First in the European banking crisis and then especially during the sovereign debt crisis, Jean-Claude Trichet provided that leadership against the resistance of some of the most powerful chiefs of government. He has ensured that the ECB was willing to venture unbeaten paths.

The dilemma between welfare-detrimental moral hazard and welfare-increasing liquidity bail outs is old and has no easy answer. Historically, policy makers have often dealt with it by creating a flou artistique by setting up rules of which they knew that there were times when they could not be adhered to with safety. European policy makers have also tried this lane although, in the European case, such ambiguity is counterproductive. For in traditional nation states, a unified government was able to act in an emergency and get legitimacy from Parliament to regulate markets. As anyone knows, this is not the case in the European Union and under these conditions ambiguity does not prevent moral hazard;

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16 For a clear, although one-sided, description of the moral hazard logic, see Bundesbank, Monatsbericht August 2011. For an equally clear outline of the lender of last resort problematic in the euro area for banks and sovereign debtors, see de Grauwe 2011.

17 The fallacy of composition arises when one infers that something is true of the whole from the fact that it is true of some part of the whole. See: http://en.wikipedia.org/wiki/Fallacy_of_composition.

18 I have argued that applying the rules of the Treaty (excessive deficit procedure) are sufficient to ensure that member states remain solvent, including Greece. See Collignon 2011 for the theoretical foundation and my last Briefing Paper for the European Parliament: Debt Restructuring is no Free Lunch; (http://www.stefancollignon.de/PDF/Debt%20Restructuring_Collignon_Mod_June%202011.pdf).

19 Milton Friedman and Anna Schwartz, 1963:418-9 (quoted on Kindleberger, 2005)

20 This was the insight by Thomas Joplin, Case for Parliamentary Inquiry into the Circumstances of the Panic, in a Letter to Thomas Gisborne, Esq., MP; London: James Ridgeway & Sons, n.d.|after 1832 (quoted by Kindleberger, 2005:227,N.13)
instead, it encourages and therefore fuels financial panics. Europe’s economic governance is not able to “hold back the stone” from starting a landslide.

The ECB has tried to solve this dilemma by pushing member states to commit to fiscal discipline prior to starting its Securities Markets Program (SMP). In May 2010, the euro area stood at the brink of collapse. It was avoided in the last minute by an agreement whereby the Member States set up the European Financial Stability Facility (EFSF) and the ECB would buy Greek (and later other) government bonds outright, thereby providing the urgently required liquidity. Since then the ECB has done similar operations in other government bond markets.

In principle, this was a good deal. It saved the euro. It avoided the Hellenic Republic turning from being illiquid into insolvent. Two-thirds of the Greek liquidity needs resulted from refinancing maturing debt. By turning the EFSF into a future European Stabilization Mechanism (ESM), the Union has potentially a new policy tool. However, the SMP was also criticized. Many commentators, especially in Germany, Finland or Slovakia, thought that it meant that taxpayers had to pay “for the sins committed by other countries”. Yet, even if we ignore the religious connotation, this is not correct. As the concept of a lender of last resort indicates, the funds given to Member States in distress are credits. In other words, lending Member States have claims against Greece. This means that lenders have exchanged their short term liquid assets (cash) for long term less liquid assets (namely claims against another government). In principle, there is no change in the net asset position of lenders. Hence taxpayers are not “losing money”. In fact, they will become richer, because the credit will be remunerated by interest. To make it clear: not German or Finnish tax payers are paying for Greece, but Greek taxpayers are paying Germans and Finns. However, this would change if a Member State would default or if its debt would be restructured, for then the money is lost, indeed.

For the European Central Bank, the commitment by Member States to provide loans to Greece, Ireland and Portugal and the implementation of a consolidation program in these countries was the basis on which it could justify to intervene in the market and buy sovereign bonds with minimal risk, because it could be seen as an insurance against the risk of moral hazard. However, the conditions, under which Member States were lending to distraught governments, were so draconian that economic growth has not yet returned. This has aggravated the liquidity situation. More liquidity was needed. However, under populist pressures from public opinion, governments have hesitated to go to the end of the logic they had already embarked upon. Instead, a debate started about debt restructuring and private sector involvement in loss sharing. Yet, this government withdrawal of the lender of last resort function is a self-defeating policy, which has severely aggravated the operating conditions for monetary policy

It is important to understand that Europe’s debt crisis is first of all a liquidity crisis. The insolvency of Greece or, as a matter of fact of any other Member State, is neither inevitable nor automatic. Provided governments play by the rules of the Treaty and the Excessive Deficit Procedure, public debt in Europe is sustainable. It is the coordination failure among nation state governments that has exacerbated the European debt crisis and pushed a sovereign debtor like Greece over the cliff. Precisely as described by Friedman and Schwartz, holding back the rock could avoid the landslide. This is what the ECB under Trichet attempted to do. Unfortunately, Member States threw more rocks by making irresponsible statements and lacking clarity as to whether they would stick to their commitments and provide the necessary liquidity. This behaviour has become a threat to the independence of the ECB.

21 See FN. 18
Part of the problem is a power struggle over who should be responsible for the lender of last resort function. In the UK of the 19th century, the banking community quickly had the Bank of England assume this function, although Parliament and the government monitored the process. In France, Prussia or the early United States, governments took over and used tax revenue for bank bailouts. In a way, it did not matter who acted as the lender of last resort as long as central banks were considered to be part of the government. Their operating losses are always a reduction in public revenue. However, in the euro area, the credibility of the ECB stands and falls with its independence. The resistance by Member States to act swiftly and collectively as a lender of last resort has undermined the ECB’s material independence. Technically, the ECB is best suited to provide liquidity by buying up government bonds, although, as Bagehot has taught, the collateral must be sound. The problem with the European debt crisis is that the wavering political commitment to go through the full process of the liquidity bailout until the crisis is over, leads to panic sales which undermine the quality of the collateral and the assets purchased by the European Central Bank.

In fact, the ECB has been trapped by EU-Member States. As Table 3 shows, non-standard liquidity measures under the Covert Bond Purchase Programme (CBPP), which was primarily aimed to banks, reflects approximately a quarter of the ECB’s own funds, but the value of assets held under the Securities Market Programme (SMP), which covers sovereign bond purchases in the crisis countries, amounts to about one third of the bank’s net worth. Both are less than the value of traditional assets for Main Refinancing Operations (MRO) and Long Term Refinancing Operations (LTRO). With 1.5% of GDP these non-standard interventions are small amounts compared to the United States, where they amount to over 15%. Nevertheless, in terms of exposure towards the ECB’s own funds, the risk is not negligible. Some commentators have called for partial debt forgiveness on Hellenic debt, but it is clear from Table 3 that this could entail substantial losses for the ECB. The European Council on 21 July 2011 did not go as far as that, but it has forced the private banking sector to “participate voluntarily” in Greek debt restructuring and this had consequences for private banks’ balance sheets. The European Council has, therefore, put the ECB into an uncomfortable position. It may turn out that this will become the most problematic inheritance that Jean-Claude Trichet will leave for his successor Mario Draghi.

**Table 3. Securities in the ECB Balance sheet**

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</tr>
<tr>
<td>Net Worth (NW)</td>
<td><strong>193.8</strong></td>
<td><strong>294.7</strong></td>
<td><strong>387.4</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Source:</strong> ECB</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The dogmatic and one-sided approach for dealing with the debt crisis, whereby everything is framed in terms of moral hazard and fiscal discipline and no consideration is given to collective action problems and liquidity issues in the market, has become a threat to the
survival of the euro. It poses the problem of the political governance of the euro area with new acuteness and this issue is far bigger than anything the ECB could do. Maybe de Grauwe (2011) is right when he says: “the EFSF and the future ESM have a governance structure that makes them ill-suited for crisis management. Each country maintains a veto power. As a result, the decisions of the EFSF and the future ESM will continuously be called into question by local political concerns (“true Finns” in Finland, Geert Wilders in the Netherlands, and so on).” It is therefore entirely coherent, when Jean-Claude Trichet, “on a personal basis, as a European citizen”, has called for a European Treasury: “In this Union of tomorrow, or of the day after tomorrow, would it be too bold, in the economic field, with a single market, a single currency and a single central bank, to envisage a ministry of finance of the Union? Not necessarily a ministry of finance that administers a large federal budget. But a ministry of finance that would exert direct responsibilities in at least three domains: first, the surveillance of both fiscal policies and competitiveness policies, as well as the direct responsibilities mentioned earlier as regards countries in a “second stage” inside the euro area; second, all the typical responsibilities of the executive branches as regards the union’s integrated financial sector, so as to accompany the full integration of financial services; and third, the representation of the union confederation in international financial institutions.”22 To push forward in this direction will be one of the tasks of his successors, first of all for Mario Draghi.

5. THE TASKS AHEAD FOR MARIO DRAGHI

Forecasting what Mario Draghi will or should do over the next eight years is of course impossible. If the ECB loses its power struggle with Member State governments over the provision of liquidity to distressed debtors, it is possible that the euro will not survive and Mario Draghi would simply be the last administrator of a failed enterprise. However, we must assume that common sense will prevail. We can then see the major challenges for ECB President Draghi.

The first is solving the debt crisis. This is without any doubt the most delicate task. The ECB must continue to steer a path between austerity policies that kill growth and debt bailouts that invite moral hazard. This is essentially a political task to which Mario Draghi with his personal background of experiences in the private sector, the Italian Treasury, central banking and international Institutions, including as Chairman of the Financial Stability Board is uniquely well qualified.

The second is terminating non-standard monetary policy operations as the situation in European financial markets normalizes. An important distinction may have to be made between the liquidity situation in money market and in bond markets, which will remain distorted by sovereign debt for a considerable period of time.

The third is the speed of raising interest rates back to levels above 2%, i.e. to levels where expected interest rates are positive in real terms. The present level of 1.5 percent is not sustainable over the medium run and probably not even compatible with the present level of core inflation. If one can learn one thing from the Greenspan experience in the mid 2000s, it is that negative real policy rates fuel financial bubbles. It is, however, possible to combine rising interest rates with non-standard monetary policy operations at least for some time.

The fourth challenge is the evolution of the global economy. The risks of a global recession are increasing, as the United States struggles with a fractioned political system and structural weaknesses. Japan still has to overcome the Tsunami shock. China is emerging as the new global economic player, but it is handicapped by rising domestic inflation which bears serious risks for political stability at home.23

Finally, the global economy will profoundly change over the next eight years. Aging populations will require new social and fiscal policies. The growth centres in the world will shift to Asia and later to Africa. During its first decade, European Monetary Union has benefitted from the Great Moderation, which made achieving the ECB’s primary objective relatively easy. The integration of China into the global economy added a quarter of the world’s labour force and therefore kept a lid on wage pressures worldwide. However, there are signs that China’s unlimited supply of labour is coming to an end. This will transform the conditions for maintaining price stability and conducting monetary policy over the next decade.24

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23 The political and social unrest in 1989, which culminated in the famous Tiananmen incidence were to a large degree caused by inflation and sinking purchasing power.

24 In a recent statement (Monthly Bulletin 7/2011: 12-14) the ECB argues that “China is expected to remain a low-cost country for a prolonged period”. However, I have argued in a previous briefing paper for the European Parliament that it is not entirely clear that China is a low-cost country when unit labour costs are compared with the Euro Area. See:

http://www.stefancollignon.de/PDF/How%20to%20avoid%20currency%20war_Nov10%20%283%29.pdf
6. CONCLUSION

President Jean-Claude Trichet has steered the European Central Bank through a difficult period. He has consolidated the achievements by Wim Duisenberg in setting up the new institution, and he was able to build on the improved reputation when the Global Financial Crisis posed a major threat to the world economy and to the European Union. Let us conclude by saying:

Bravo et merci, Monsieur Trichet!

and

Buona fortuna, Presidente Draghi!
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- CER (Centro Europa Ricerche), 2011. Report on Europe; Rome
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ANNEX: ESTIMATING THE ECB’S POLICY REACTION FUNCTION

THEORETICAL MODEL AND EMPIRICAL SPECIFICATION

The starting point is the standard specification of the Taylor rule:

\[ r_t = r^* + k(\pi_t - \pi^*) + \beta x_t + \epsilon_t \]  \hspace{1cm} (1)

Where \( r^* \) and \( \pi^* \) are the equilibriums values for the nominal interest rate and the inflation rate; \( k \) is the reaction of the interest rate to inflation changes and \( x \) is a measure for the output gap. \( k > 1 \) indicates stabilizing monetary policy as the increase in the nominal interest rate is higher than that of inflation, resulting in a positive reaction of the real interest rate. On the contrary, \( k < 1 \) means that the central bank is accommodating inflation movements. A partial adjustment mechanism can be introduced as it follows:

\[ r_t = \rho r_{t-1} + (1 - \rho)(r^* + k(\pi_t - \pi^*) + \beta x_t) + \epsilon_t \]  \hspace{1cm} (2)

this specification implies that the interest rate adjusts to its past value and to the inflation and output variables by weighting the two components with a parameter \( \rho \).

Rearranging equation (2) we obtain:

\[ r_t = (1 - \rho)\alpha + \rho r_{t-1} + (1 - \rho)k\pi_t + (1 - \rho)\beta x_t + \epsilon_t \]  \hspace{1cm} (3)

where \( \alpha = r^* - kn^* \). The final equation is then:

\[ r_t = a + \rho r_{t-1} + b\pi_t + cx_t + \epsilon_t \]  \hspace{1cm} (4)

Where \( a = (1 - \rho)\alpha \); \( b = (1 - \rho)k \); \( c = (1 - \rho)\beta \). This specification assumes all variables are contemporaneous. Sauer and Sturm (2007) found that for the ECB a forward looking specification fits better the data. In order to transform equation (4) into a forward looking specification there are a number of alternatives. First, leads of historical or real time data can be introduced, as in Clarida et. Al. (1998), and the equation is estimated via GMM:

\[ r_t = a + \rho r_{t-1} + bE[\pi_{t+\alpha} | \Omega_t] + cE[x_t | \Omega_t] + \epsilon_t \]  \hspace{1cm} (5)

With \( \Omega_t \) being the information set available to the central bank. This is equivalent to assuming rational expectations, as the orthogonality condition imposed by the GMM procedure assures asymptotically correct standard errors. The alternative is to use expectation data and run a standard OLS regression. Our choice is to use a combination of the two models. We use expectation data for the output gap variable while for inflation we alternatively try historical contemporaneous data, as in equation (4), and inflation in \( t+3 \) as in equation (5). In the latter case we estimate the model with GMM. The structural break is modelled as a regime shift for the constant term \( a \) and for the slope parameter of inflation \( k \). The final mixed and forward looking specifications are the following:

\[ r_t = a_1 + TR + \rho r_{t-1} + b_1\pi_t + b_2TR(\pi_t) + cx_t + \epsilon_t \hspace{1cm} (6a) \]

\[ r_t = a_1 + TR + \rho r_{t-1} + b_1E[\pi_{t+\alpha} | \Omega_t] + b_2TR(E[\pi_{t+\alpha} | \Omega_t]) + cx_t + \epsilon_t \hspace{1cm} (6b) \]

where TR is a dummy variable which takes the value 1 from November 2003 onward.
DATA AND RESULTS

For the nominal short term interest rate we use the Euro Overnight Index Average (EONIA), calculated as monthly average of daily data. As measure of inflation we use the year on year difference of the monthly Harmonised Index of Consumer Prices (HICP) calculated by Eurostat. Turning to the output gap measure, we do not use the classical contemporaneous variable calculated applying the Hodrik Prescott filter to the monthly industrial production data. This is because this variable is not stationary, so that applying the filter would potentially result in the creation of artificial cycles. We use instead three measures of expectations on the evolution of the economy provided by the European Commission. The first measure is the EMU Economic Sentiments indicator (EUESEMU), the second is the EMU Business Climate Indicator (EUBCI) and the third is the EMU Manufacturing Confidence Indicator (EUICEMU).

Most of the empirical works on the Taylor rule do not take into account the potential non stationarity of the series. In particular, while the interest rate and the output gap are typically stationary, inflation can be approximated by an integrated process if mean shifts are not explicitly taken into account (Russell, 2011). This means that once the mean shift is considered, the t statistics of the supposed I(1) regressor will not be oversized due to spurious regression (Stewart, 2010).

<table>
<thead>
<tr>
<th>Table A1</th>
<th>Unit root tests</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EONIA</strong></td>
<td><strong>INFLATION</strong></td>
</tr>
<tr>
<td>ADF</td>
<td>-2.63*</td>
</tr>
<tr>
<td>ERS DFGLS</td>
<td>-2.14**</td>
</tr>
<tr>
<td>Phillips Perron</td>
<td>-1.66</td>
</tr>
<tr>
<td>KPSS*</td>
<td>0.25</td>
</tr>
<tr>
<td>ERS optimal</td>
<td>1.84***</td>
</tr>
<tr>
<td>Ng Perron</td>
<td>12.49**</td>
</tr>
<tr>
<td>Zivot Andrews</td>
<td>-2.77 (2003m4)</td>
</tr>
</tbody>
</table>

* the null hypothesis is that series are stationary. ADF=augmented Dickey Fuller; ERS DFGSP=Elliot, Rotemberg and Stock Dickey-Fuller-GLS; KPSS=Kwiatkowski, Phillips, Schmidt, Shin; ERS optimal=Elliot, Rotemberg and Stock optimal test.

In Table A1 we report the results of the unit root tests. The interest rate is stationary in five out of six cases, while inflation has a unit in all cases. As to the performance indicators, the Industrial Production Index is non stationary as anticipated, implying that its use after applying the HP filter may lead to meaningless results. Among the expectation indicators, EUBCI and EUICEMU are stationary in four cases out of five while EUESEMU has a unit root in three cases, is stationary in one case, while in the remaining two cases it is stationary at 10%. This means that this variable can be unit root or near unit root, causing problems in the estimates. Accordingly, we consider the results with EUBCI and EUICEMU more reliable. In order to check whether a structural break took place when Trichet became president, we test for unit root with a single endogenous break point by using the Zivot and Andrews test (last row of Table A1). The result is in line with our expectations, the series is found to be stationary once the break is accounted and the break date is April 2003, half a year before Trichet came in charge. In any case, it must be noted that the Zivot and Andrews test has been often criticised for anticipating the break date. This means that the real break date can be very close or coincident with change of presidency, giving first evidence in favour of a change of monetary policy when Trichet took office.
result is that for all the specifications there is a significant level shift, which implies a change in the equilibrium value for inflation. The change in k is not significant in the specification without smoothing parameter while it is strongly significant in the others. Further, in the first specification we find a k<1 indicating that monetary policy from 1998 to 2008 was accommodating. This result is not confirmed when a smoothing parameter is introduced. The latter is always extremely significant and with a coefficient above 0.9, indicating that inflation and output gap contribute to the change in EONIA by less than 10%. It means policy responds only slowly. In the mixed specification monetary policy is stabilising during Duisenberg’s presidency but becomes accommodating with Trichet. The reaction coefficient k ranges from 0.99 to 1.56. Further, the level shift suggests that a break in the equilibrium values for inflation and interest rates took place, with the Trichet dummy always being significant. The results from the forward looking specification are similar, with slightly higher constant terms and slightly lower k and the basic conclusion that monetary policy changed from stabilising to accommodating keeps valid. In both cases the higher k is estimated when EUESEMU is used, probably due to its (near) unit root process, which makes this result less reliable.
### Table A2 Taylor rule estimates

<table>
<thead>
<tr>
<th>Dependent variable: EONIA</th>
<th>no smoothing (OLS)</th>
<th>with smoothing (OLS)</th>
<th>with future inflation (GMM)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>euesemu</td>
<td>eubci</td>
<td>euicemu</td>
</tr>
<tr>
<td>eonia t-1</td>
<td>0.904***</td>
<td>0.922***</td>
<td>0.914***</td>
</tr>
<tr>
<td>output</td>
<td>0.091***</td>
<td>0.815***</td>
<td>0.089***</td>
</tr>
<tr>
<td>inflation</td>
<td>0.886***</td>
<td>0.623**</td>
<td>0.597**</td>
</tr>
<tr>
<td>inflation*trichet</td>
<td>-0.068</td>
<td>0.076</td>
<td>0.054</td>
</tr>
<tr>
<td>inflation t+3</td>
<td>-1.171***</td>
<td>-1.417***</td>
<td>-1.394***</td>
</tr>
<tr>
<td>inflation t+3*trichet</td>
<td>-0.130***</td>
<td>-0.041</td>
<td>-0.064**</td>
</tr>
<tr>
<td>trichet</td>
<td>1.996***</td>
<td>2.364***</td>
<td>2.977***</td>
</tr>
<tr>
<td>constant</td>
<td>0.632</td>
<td>0.571</td>
<td>0.597</td>
</tr>
<tr>
<td>R²</td>
<td>126</td>
<td>126</td>
<td>126</td>
</tr>
<tr>
<td>Hansen J</td>
<td>6.779</td>
<td>7.442</td>
<td>8.008</td>
</tr>
<tr>
<td>Under. Id.</td>
<td>27.799***</td>
<td>9.023*</td>
<td></td>
</tr>
<tr>
<td>Weak id.</td>
<td>11.3***</td>
<td>4.3***</td>
<td></td>
</tr>
<tr>
<td>F endog. regr.</td>
<td>99.9***</td>
<td>22.8***</td>
<td>37.6***</td>
</tr>
<tr>
<td>Chi² endog. regr.</td>
<td>2.00</td>
<td>2.36</td>
<td>2.98</td>
</tr>
<tr>
<td>Implied α</td>
<td>0.82</td>
<td>0.95</td>
<td>1.58</td>
</tr>
<tr>
<td>Implied k</td>
<td>0.89</td>
<td>0.62</td>
<td>0.60</td>
</tr>
<tr>
<td>Source: own calculations</td>
<td>Standard errors in brackets; * significant at 10% level, ** significant at 5% level; *** significant at 1% level. Estimating period January 1998-June 2008</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Role
Policy departments are research units that provide specialised advice to committees, inter-parliamentary delegations and other parliamentary bodies.

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