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POLICY DEPARTMENT A
ECONOMIC AND SCIENTIFIC POLICY

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Monetary Dialogue 2009-2014: Looking Backward, Looking Forward

Monetary Dialogue March 2014

COMPILATION OF NOTES

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POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Monetary Dialogue 2009-2014: Looking backward, looking forward

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Abstract

With the European Parliament's 7th legislative (2004-2009) term coming to an end, the notes of this compilation reflect on the working of the Monetary Dialogue exercise. The notes assess the actual activity of information exchange between the European Parliament and the ECB, review the past five years of monetary dialogues and make policy recommendations on how to possibly improve the Monetary Dialogue in the current context of the ECB's evolving role. The notes by key monetary experts have been requested by the Committee on Economic and Monetary Affairs (ECON) as an input for the March 2014 session of the Monetary Dialogue between the Members of ECON and the President of the ECB.

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INTRODUCTION

The European Parliament Resolution on democratic accountability in the third phase of EMU of 4 May 1998[1] *'Calls [therefore] for the organisation of a dialogue between the European Parliament and the future ECB on monetary and economic affairs, the framework for which dialogue should be confirmed through a mutual agreement'*. The Treaty on European Union also contains provisions regarding the issues of transparency and accountability of the ECB vis-a-vis the European Parliament.[2] Based on these requirements it was agreed that the President of the ECB would appear four times a year before the ECON Committee (Economic and Monetary Affair Committee).

With the European Parliament's 7th legislative term coming to an end, it seems appropriate to reflect on the working of the Monetary Dialogue exercise, to review the past five years of monetary dialogues as well as to look forward for potential improvements.

It is widely acknowledged that the (conventional) monetary policy of managing *short-term interest* rates shall not be subject to political business cycles, so as to preserve central banks' independence as a welfare-enhancing quality. However, the financial crisis has challenged the conventional monetary policy strategy of major central banks. For instance, the adoption of the practice of forward guidance on interest rates has changed the ECB reaction function with relevant implications in terms of appropriate communication (e.g. information coverage, timing) and transparency requirements (e.g. confidentiality versus accountability vis-a-vis the European Parliament).

In this compilation, selected monetary policy experts reflect on the working of the Monetary Dialogue exercise, assess the actual activity of information exchange between the European Parliament and the ECB and make policy recommendations on how to possibly improve the Monetary Dialogue in the current context of the ECB's evolving role. The main conclusions and policy options are summarised below.

The notes have been requested by the Committee on Economic and Monetary Affairs (ECON) of the European Parliament as an input for the March 2014 session of the Monetary Dialogue between the Members of the ECON Committee and the President of the ECB.

Gregory Claeys *et al.* (Bruegel). The ECB is less accountable or transparent than the Bank of England or the US Fed: the European Parliament cannot sanction the ECB if it fails to fulfil its mandate; the European Parliament's has only a consultative role in the appointment of ECB executive board members; the ECB does not publish the minutes and the votes of the Governing Council meetings. The MEPs should formally review ECB's performance relative to its primary objective and secondary objective of supporting the goals of the EU. To do that more effectively, the chairman of the ECON committee should play a greater role and ask the same series of very specific questions about the ECB's fulfilment of its mandates to the President of the ECB at the beginning of each hearing's Q&A session. It appears that Monetary Dialogues are much less reported in the press than ECB monthly press conferences. Given that the accountability of the ECB to the European Parliament is only based on the information exchange with the ECB and not on the enforcement of its mandate, reporting of the event in the media should be important for the European Parliament. A publicised and well-functioning live stream, and a quickly available transcript of the hearing would enhance the transparency of this exercise and increase its visibility. A discussion about the future course of monetary policy before the European Parliament should be encouraged for reasons of accountability and transparency and because the discussions might make the policy more effective. If the ECB decides to implement a quantitative easing policy, the purchase of government bonds in

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:51998IP0110:EN:HTML

[2] According to Article 284(3) of TFEU (Treaty of the Functioning of the European Union), *'the President of the ECB and the other members of the Executive Board may, at the request of the European Parliament or on their own initiative, be heard by the competent Committees of the European Parliament'*.

different euro-area countries would have some distributional consequences. The Monetary Dialogue would be an ideal platform for the European Parliament to evaluate any such programme under the ECB's remit. Regardless of how effectively the European Parliament holds the ECB accountable for its function as banking supervisor, concerns about whether decisions taken as supervisor affect monetary policy should be part of the remit of the Monetary Dialogue.

Charles Wyplosz (Graduate Institute of International and Development Studies). The Monetary Dialogue involves quarterly testimony by the President of the ECB to the Economic and Monetary Affairs Committee of the European Parliament (ECON). Given its size, the ECON Committee is a small parliament in itself. As a result, the Monetary Dialogue sees the President of the ECB addressing a large crowd. The very idea that the ECB is brought to account is absent from the start. The obvious solution would be that the President of the ECB only meets a subcommittee. An alternative would be a limited number of questions by a limited number of Committee members. The choice would be made on the basis of a text, submitted ahead of time by the President of the ECB, possibly an extended version of his oral presentation. The ECB is a technical institution whose decisions are based on extensive preparatory work by a large and highly qualified staff. MEPs, on the other hand, are not expected to have the same technical level. This situation can create an asymmetry that is detrimental to the quality and intensity of the dialogue. ECON relies on briefing notes produced by external experts. This is insufficient, however. MEPs rarely confront the President of the ECB on technical matters. There should be a tighter link between ECON members who intend to contribute to the Monetary Dialogue and the experts. One possibility would be to reduce the role of briefing notes, possibly to suppress them, and enhance direct contacts between MEPs and the experts. One could envision face-to-face meetings between ECON Committee members and the experts to carefully prepare questions. Another possibility would be for the ECON Committee members who will intervene during the Monetary Dialogue to seek written advice from the experts. This could be achieved by assembling a wider pool of experts who could be asked to intervene only on issues that correspond more closely to their area of knowledge. Another striking feature of the Monetary Dialogue is that the President of the ECB stands on a high podium and looks down upon Committee members. The difference with the US congressional hearings is stark: there, a limited number of Committee members sit on a high podium and look down at the Chairperson of the Fed who sits in front of a large table, facing the podium. These are 'hearings', not a dialogue. The physical layout makes it clear that the Chairperson of the Fed is brought to account by the relevant Committee, which represents the authority of an elected body.

Karl Whelan (University College Dublin). First, it would be preferable to have a smaller number of MEPs asking questions, in any given session. By cutting down on the number of questions, the nature of the interaction at the committee could be substantially improved. Second, the dialogue could benefit from themed sub-sessions. For example, the ECB President could be informed that a first group of MEPs will be asking questions on a particular topic and that the sub-session on this topic will run for 45 minutes. The Chair of the committee could take soundings from other committee members, economic advisers and ECB officials on which topics would be appropriate for sessions of this kind. In some cases, it may be helpful for the committee to solicit a briefing paper from experts on a particular topic with this paper containing a number of questions for the ECB. Such a paper could be provided to the ECB president prior to the meeting and could be used as a focus point for discussions at the meeting. Third, the usefulness of the meetings to the European public would be improved if the selected questions focused mainly on topics that relate directly to the ECB's powers (excluding matters such as French fiscal policy, Italian pension systems or the performance of the Irish economy). Fourth, the briefing papers provided by the panel represent a good investment by the committee. Perhaps the committee and its staff could consider ways to allow the briefings to achieve a higher public profile. Finally, the committee would get a greater benefit from its panel of experts if it involved them in designing more focused sessions with the ECB president.

Anne Sibert (Birkbeck, University of London). Since the current crisis began in late 2007 central bank policy rates have been reduced to near zero and unconventional monetary policy measures have been put in place; central bank balance sheets ballooned and their maturity structure lengthened. The latest unconventional monetary policy to be adopted by the Fed, the ECB and other central banks is forward guidance. The quarterly Monetary Dialogue should be used as a forum to question the ECB about its intentions with regard to forward guidance. Has the central bank changed its objectives? Has it changed its view of the world? Has it changed its view of the transmission mechanism? What is the theory behind what they are trying to accomplish? Is there any empirical evidence that this unconventional monetary policy is likely to work? If the forward guidance is effective, will the central bank have any incentive to follow through on the policy actions implied by forward guidance? From its beginning the ECON committee has used the quarterly Monetary Dialogue to pressure the ECB to be more transparent. There are signs that the new regime may be more receptive to this than its predecessors. It is to be hoped that the committee will be able to successfully use this opportunity to promote a more accountable ECB.

Stefan Collignon (Scuola Superiore Sant'Anna and London School of Economics). The Monetary Dialogue is one of the few bridges to link monetary policy with other policy considerations and it contributes importantly to the legitimacy of the ECB. The ECB is one of the most independent central banks in the world and it has, therefore, a particular responsibility for ensuring transparency and accountability in the conduct of its policies. In the public debate about monetary policy, the European Parliament was hardly as audible as it deserves. While the Monetary Dialogue has often served to clarify the policy stances of the ECB, the Parliament has never taken a well-defined policy stance for Europe or developed a debate about clear-cut policy alternatives. Although questions posed by MEPs are often pertinent, they remain enmeshed in the day-to-day management of the political machine of which the agenda is set by the Council and the Commission. As a consequence, the Monetary Dialogue has served primarily as one of several communication instruments for the ECB. One of the major failures during the legislature was the fact that the European Parliament has not questioned the major policy blunder when the ECB raised interest rates prematurely in 2011. However, the quality of exchanges has significantly improved since Mario Draghi became President of the ECB. Econometric evidence reported in this note does not show a stabilizing effect from the Monetary Dialogue during the Euro crisis. With the exception of Italy, yield spreads amplified in all crisis countries in the days after the Monetary Dialogue (or fell less if the general tendency was to reduce them). Volatility increased slightly in Spain and very marginally in Italy. However in Greece, market volatility falls while spreads increase, which means markets are more certain about the risks for Greece as a consequence of the information obtained from the Dialogue. The note also reports the opinions of MEPs about the dialogue: Less than two thirds of the members of the ECON Committee have asked questions to the ECB President; in general, the frequency of interventions by MEPs represents the strength of their parliamentary group in the Parliament overall, although ALDE outperforms other groups and S&D underperform; crisis countries have more than average questions and non-Euro members have also participated actively; most MEPs are aware that the Monetary Dialogue did not improve the crisis management during the crisis, but they consider it useful for themselves and for the citizens they represent; in general, pro-European parties on the centre-right have a good opinion about the Monetary Dialogue, left of centre and anti-European MEPs are more critical; MEPs feel well prepared for the exchanges with the ECB, but they feel less informed how parliamentary control is done in other major economies.

Ansgar Belke (University of Duisburg-Essen). The briefing paper first discusses the arguments in favour of more ECB transparency. It then compares the effectiveness of publishing the minutes with reference to the new ECB voting model. The briefing also describes why a lack of ECB transparency may actually improve the design of the Monetary Dialogue. For this end, the current framework for the Monetary Dialogue and its potential changes are discussed in terms of the ECB's new "forward guidance" communication strategy, the transparency of data revisions and the choice of the underlying macroeconomic model. The briefing paper also elaborates on how accountable shall the ECB towards the EP. The need for increasing ECB's transparency and accountability stems from its new supervisory roles. Given their importance, they are emphasised separately. The paper finally discusses issues related to the limits to transparency and communication. As a whole, the arguments presented give overwhelming support for the Monetary Dialogue's efforts to enhance ECB transparency. In theory, however, it is not clear how far this process should go as the "optimum degree of the ECB's secrecy" is different from zero. This poses an operational problem for the Monetary Dialogue, yet to be solved. This view is supported also from a policy cycle perspective. Full accountability to and "democratic control" through the EP may conflict with the central bank's policy and instrument independence. Policy independence may be endangered as soon as groups of different political or ideological orientation in the EP pressure for the adoption of specific macroeconomic models or even specific monetary policy measures. Instrument independence may be hampered by the fact that policy tools such as the ECB's sovereign bond purchases may be effective only when they are not anticipated. Because the Monetary Dialogue would lose its social value if ECB's independence is threatened, monetary experts shall warn as early as possible about the danger of such negative feedback. While recognising that current times are far from 'normal', the Monetary Dialogue is even more important "now" than in "normal" times. Still, changes are needed regarding both design and focus range of the Monetary Dialogue to make it more effective. In this context, the (new) supervisory role of the ECB should also be carefully scrutinized. Overall, the real challenge is to find out the optimal degree of transparency and accountability within the current institutional framework for the Monetary Dialogue.

Sylvester C.W. Eijffinger (Tilburg University). The ECB could and should improve with respect to its procedural and policy disclosure. The procedural disclosure can be improved by releasing minutes and voting records. The policy disclosure could be improved by providing more explicit and detailed forward guidance. The proposal calls for more concrete and explicit communication about the path of policy and the envisioned evolution of interest rates.

Guillermo De La Dehesa (Centre for Economic Policy Research). First, the publication of the 'minutes' of the Governing Council meetings would increase the transparency of the ECB and also significantly reduce the likelihood of leaks. But the timing of publication of the minutes has to be calibrated very carefully. The reason is that the ECB President holds a press conference the same day the monetary policy decisions are taken. That press conference is highly scrutinized by media and financial markets. Therefore, should the minutes be published too late, they might turn to be at odds with market sentiment. Should they be published too early, markets' reaction may depend on the number of members who voted against, possibly negatively affecting the arguments to be spelled out in the press conference. In addition to the timing, the length, extent and information content of the minutes matters. If they are too short and with little detail, they won't add much to the press conference. If they are too long, they might end up generating confusion. Second, the Monetary Dialogue shall contribute to the effectiveness of a common monetary policy in the euro, thus reducing current financial market fragmentation. A quantum leap in this direction would be the approval of the Banking Recovery and Resolution Directive (BRRD) of the Single

Resolution Mechanism (SRM). This would increase the confidence in the euro area financial system. Third, the Monetary Dialogue shall contribute to an orderly separation of ECB two main tasks: monetary policy and banking supervision. The separation might not be as desirable as often claimed, however. The reason is that the systemic (in)stability of a financial system during a financial crisis represents the biggest threat and the key issue to be addressed by a central bank. The functional separation between the two tasks may also prove difficult to achieve as, for instance, the Supervisory Board will be composed of representatives from the same institutions, which also dominate the Governing Council. Fourth, the Monetary Dialogue shall contribute to achieve a viable trade-off among the distinctive demands coming from Member States facing different economic situations, partly as a result of financial fragmentation (saving/deficit countries; high/low inflation countries). Fifth, the Monetary Dialogue shall contribute to improve the transmission mechanism of monetary policy, e.g. by promoting the use of marketable credit instruments (ABS/CBS), backed up by the European Investment Bank. Sixth, the Monetary Dialogue could also prove useful for the delivery of a clear message on the ECB 'forward guidance' policy. Finally, the Monetary Dialogue may prove useful for confidence building. It is important to recognise that, even if the trust of European citizens in the euro area, the ECB and the EU has been falling during the crisis, the EP and the ECB are still among the most trusted institutions of the EU according to both the Euro-barometer as well as other sources. The quarterly dialogue of the ECB President with the ECON Committee of the EP could be a very effective way to enhance transparency of monetary policy and promote better accountability of the ECB towards its democratically elected body.

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Options for the Monetary Dialogue under an evolving monetary policy

Gregory CLAEYS,
Mark HALLERBERG
Olga TSCHEKASSIN

IN-DEPTH ANALYSIS

Abstract

According to the Treaties, the European Central Bank (ECB) is accountable to the European Parliament. In practice, this accountability takes mainly the form of a quarterly Monetary Dialogue between the President of the ECB and the European Parliament ECON committee. This brief assesses this Dialogue. We describe the accountability practices of the ECB, compare them to those of other major central banks and provide an assessment of the dialogue in the last five years. We believe that the Monetary Dialogue could be improved and we make recommendations on this. We also consider what role the Dialogue could play in the current context of the ECB's evolving role. We discuss in particular forward guidance and quantitative easing (QE). We review the main features and the way in which those policies have been implemented by other central banks. We then suggest the appropriate role for the Monetary Dialogue in relation to each of those policies. We conclude with some observations on the function of the Monetary Dialogue after the establishment of a banking union in Europe.

CONTENTS

EXECUTIVE SUMMARY

- First, we describe the legal and actual procedure of the Monetary Dialogue, but also more generally the relationships between the European Central Bank (ECB) and the European Parliament. We judge the procedure of the Monetary Dialogue in a positive light overall: the fixed schedule and predetermined course of events of the quarterly meetings allows the ECB and the Parliament to have a general discussion on economic policy. The ECB complies with all its obligations under the Treaties and appears to cooperate fully with the Parliament during the Dialogue.
- Second, we compare the practices of the ECB with the procedures of the Bank of England and the Federal Reserve (Fed). The structure of the Monetary Dialogue is quite similar to its equivalents in the UK and the US in terms of hearings and reports. However, because of some key differences, the ECB is less accountable or transparent than the Bank of England or the Fed: the European Parliament cannot sanction the ECB if it fails to fulfil its mandate, the European Parliament's has only a consultative role in the appointment of ECB executive board members, and the ECB does not publish the minutes and the votes of the Governing Council meetings.
- Third, we assess the dialogue in the last five years. The introductory statements made by the ECB President appear to never reveal important news or new policy measures, which tends to make the event less interesting for the media and the general public. However, the President is invited to give a view on some topics decided in advance by the ECON committee. External monetary experts also write briefings on those topics in preparation for the hearing. We think that it could lead to a very fruitful discussion if members of the Parliament (MEPs) would focus on those topics, but this does not often happen. We also think that the MEPs should put some emphasis on the successes or failures of the ECB in fulfilling its mandate: they should formally review its performance relative to its primary objective and secondary objective of supporting the goals of the EU. To do that more effectively we recommend that the chairman of the ECON committee plays a greater role and asks the same series of very specific questions about the ECB's fulfilment of its mandates to the President of the ECB at the beginning of each hearing's Q&A session.
- Fourth, we assess the visibility of the Monetary Dialogue in the media. It appears that Monetary Dialogues are much less reported in the press than ECB monthly press conferences. Given that the accountability of the ECB to the European Parliament is only based on the information exchange with the ECB and not on the enforcement of its mandate, reporting of the event in the media should be important for the European Parliament. A publicised and well-functioning live stream, and a quickly available transcript of the hearing would enhance the transparency of this exercise and increase its visibility.
- Fifth, we consider what role the Dialogue could play in the current context of the evolving role of the ECB. We discuss in particular forward guidance and quantitative easing (QE). We review the main features and the way those policies have been implemented by other central banks, and we suggest the appropriate role for the Monetary Dialogue in relation to each of those policies. On forward guidance, we believe that a discussion about the future course of monetary policy before the European Parliament, and the inevitable political discussions that come with the testimony both within Parliament and in the press as part of the Monetary Dialogue, may contribute to more effective forward guidance. Such discussions should therefore be encouraged for reasons of accountability and transparency and because the discussions might make the policy more effective.

- Sixth, if the ECB decides to implement a quantitative easing policy, the purchase of government bonds in different euro-area countries would have some distributional consequences. The Monetary Dialogue would be an ideal platform for the European Parliament to evaluate any such programme under the ECB's remit.
- Finally, we conclude with some observations on the function of the Monetary Dialogue after the establishment of a banking union in Europe. Regardless of how effectively the European Parliament holds the ECB accountable for its function as banking supervisor, concerns about whether decisions taken as supervisor affect monetary policy should be part of the remit of the Monetary Dialogue.

INTRODUCTION

In the wake of widespread inflation in developed countries in the 1970s, and subsequent seminal research by Kydland and Prescott (1977) and Barro and Gordon (1983), one solution put forward to prevent political interference in monetary policy and its effects on inflation was to delegate its management to individuals who were insulated from the government and averse to inflation (Rogoff, 1985). Since then, operational independence has become an integral part of modern central banking.

However, because non-elected officials manage money and monetary policy, independent central banks should be accountable to an elected body. To whom they are accountable is different in different countries: some are accountable directly to the government, to the parliament or to both. According to the EU Treaty and the Statute of the European System of Central Banks (ESCB), in the euro area, the European Central Bank (ECB) is accountable to the only directly elected European Union (EU) institution, the European Parliament.

What accountability means in this context is not really spelled out, but according to Schedler (1999) accountability should be two-dimensional. Accountable central banks should be obliged to inform representatives of the people about their policy decisions and they should be able to justify them. Parliaments (or governments depending on the case) should be able to impose sanctions on central banks in case they fail to fulfil their mandates.

However, the ECB's situation is peculiar compared to other independent central banks. It is one of the most independent central banks in the world: it has full operational independence, financial independence and it even has target independence. The treaty establishes price stability as the EB's primary objective, but it does not give a precise definition of what is meant by price stability. The ECB Governing Council has therefore announced it intends to maintain inflation rates below, but close to, 2 % over the medium term. Given this degree of independence, one should expect a high level of accountability. But the ECB only satisfies one part of Schedler's definition of accountability. It is true that the ECB explains regularly its actions to the European Parliament, but there is no way for the Parliament to take action if the ECB fails to fulfil its mandate. This is different to the situation facing the Fed, for example. A simple majority in Congress plus a presidential signature can change the Fed's statutes. The Monetary Dialogue is therefore essential to provide democratic oversight of the ECB. Because it is the only real instrument to make the ECB accountable for its policy, it should be a key meeting of the ECB and, in our opinion, it should become more visible, especially in the current context of the evolving role of the ECB with the recent introduction of forward guidance, the Outright Monetary Transactions (OMT) Programme and the Single Supervisory Mechanism (SSM).

In this brief, we first assess the exchange of information between the European Parliament and the ECB (especially during the last five years) and compare it to other central bank practices around the world. We propose ways in which the Monetary Dialogue can be improved, and how its role in the ECB's communication strategy can be enhanced. It is important to note that we mainly restrict the discussion to recommendations to improve the Monetary Dialogue that could be easily and immediately implementable and that do not require a revision of the European Treaties. Given that a Treaty change would require EU Member State unanimity, the probability of such a revision on this topic would be very low. Finally, we consider what role the Monetary Dialogue could play in the context of an evolving monetary policy with an emphasis on forward guidance, quantitative easing (QE) and bank supervision.

1. ACTUAL ACTIVITY OF THE MONETARY DIALOGUE

In the following section we analyse the relationship between the European Parliament and the European Central Bank. We describe the legal and actual procedure of the dialogue, compare the accountability practices of the ECB to those of the Bank of England and the Fed and provide an assessment of the dialogue in the last five years.

1.1. Relationship between the European Parliament and the ECB

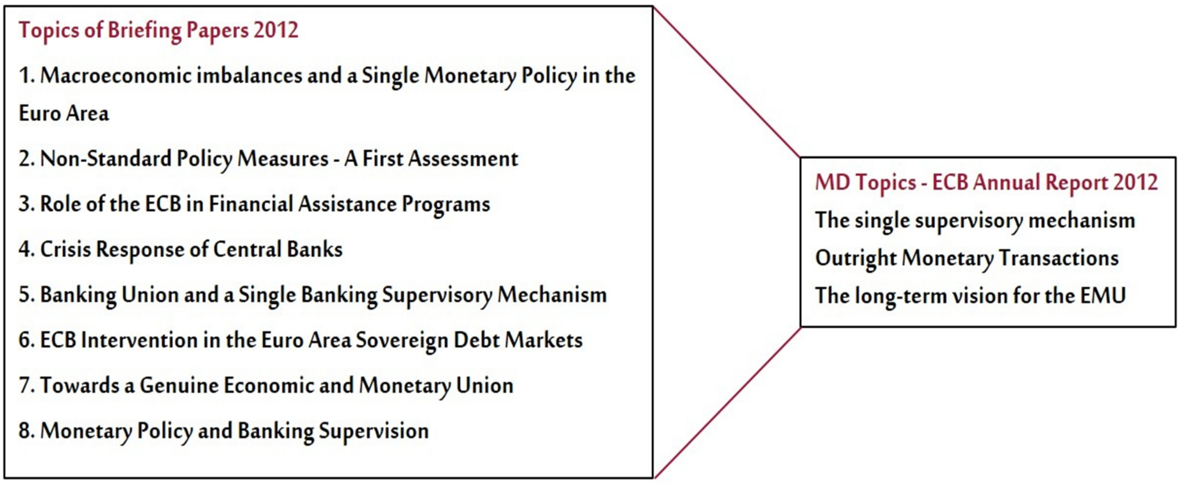
The Legal Basis for the Monetary Dialogue is laid down in the Treaty on the Functioning of the European Union (TFEU) Article 284.3. The framework is given in Article 232, which gives the European Parliament the right to adopt its own Rules of Procedure. The Rules of Procedure, in turn, give a framework for the meetings between the European Parliament and the ECB.

Rule 113 regulates "Statements by the European Central bank”. According to 113.3, the ECB President shall appear at least four times a year before the responsible committee. These meetings are informally called the Monetary Dialogue and are held with the Committee of Economic and Monetary Affairs (ECON). Before every meeting, the Parliament asks a monetary expert panel to submit briefing papers on one or two specific topics. These papers are published on the Parliament website shortly before the quarterly meetings. It is common practice that the ECB President incorporates the respective topics into his introductory statement to the Committee. After his statement, the ECB President has to answer questions from committee members. The committee chair leads the debate, which usually lasts about two hours including the introductory statement. On the Parliament’s request, members of the ECB Executive Board can be invited to additional meetings. Unlike the four meetings with ECON, these meetings may or may not be confidential. After the public meetings, a report is prepared in the official languages and an audio recording of the meetings should be available on the European Parliament website.

Additionally, the ECB President shall present once a year the Annual Report to the European Parliament plenary, followed by a general debate, according to Article 284.3 TFEU. Even though it is not legally regulated, it is common practice that the ECB Vice-President presents the Annual Report to ECON on the day of its publication. This usually takes place around April and leaves the Parliament some months to draft a resolution that provides its opinion on the Annual Report, before the President appears before the plenary. In his introductory statement to plenary, the President addresses critical points raised in the resolution.

Since 2011, the ECB’s Annual Report has contained a section on external communication and accountability that describes the ECB’s accountability to the European Parliament. It takes into account the dialogue held between the ECB and the European Parliament and characterises the main discussion topics. It refers, however, only to a short selection of topics discussed during the year. As Figure 1 shows, the Monetary Dialogue usually includes about eight topics each year, while the ECB’s Annual Report comes back to only three of them. We think that the inclusion of this chapter is a positive development for the dialogue as a whole. A higher degree of completeness in order to inform the public about the meetings would be, however, desirable.

Figure 1: Briefing Papers' topics vs. Annual Report's topics in 2012



Source: Bruegel, ECB Annual Report 2012, European Parliament Website: http://www.europarl.europa.eu/committees/en/econ/publications.html?id=ECON00005#menuzone

In addition to the debate during the meetings, any MEP can submit questions for written answer to the ECON Chair, who shall forward them to the ECB, as stated in Rule 118 of the Rules of Procedure. A record of written questions and answers shall be available in the Official Journal of the European Union. Questions not answered within the deadline can be included in the next Monetary Dialogue meeting at the request of the questioner.

The European Parliament also has a role in the appointment of ECB Board Members, though this is not part of the Monetary Dialogue. According to Rule 109 of the Rules of Procedure and Article 283.2 of the TFEU, any candidate nominated by the Council as President, Vice-President and Executive Board Member shall appear before ECON to make a statement and answer questions. The Committee in turn makes a recommendation to the Parliament on the approval of the candidate. The Parliament has only a consultative role in relation to the European Council, which approves the appointment. In case the Parliament does not agree with the Council's nomination, its President can ask the Council to nominate another candidate, but the Council can still decide to maintain the appointment of its nominee.

Overall, we judge the procedure of the Monetary Dialogue positively: the fixed schedule and predetermined course of events of the quarterly meetings allows both the ECB and the Parliament to build expectations about how information is exchanged between the two bodies. Nevertheless, we believe that some elements could be improved and this is what we focus on in section 1.3.

1.2. Practices of other major central banks

In this section, we compare the practices of the ECB with the procedures of the Bank of England and the Fed.

Similar to the Monetary Dialogue held between the European Parliament and the ECB, the Bank of England holds a dialogue between the Members of the Monetary Policy Committee (MPC) and Financial Policy Committee (FPC) and the House of Commons' Treasury Select Committee. These hearings take place on a regular basis. Bank officials also hold occasional meetings with the House of Lords Economic Affairs Committee. Unlike the Bank of England but similarly to the President of the ECB, there is a fixed schedule of meetings for the

Chairman of the Fed. He appears, however, only twice a year before the US Congress: once in front of the Committee on Banking and Financial Services of the House of Representatives, and once in front of the Committee on Banking, Housing, and Urban Affairs of the Senate. Additionally, he or other Fed officials have to appear before either of the Committees on request. In addition, an Annual Report prepared by the Fed Board of Governors describing the Fed's activities is submitted to the Congress.

While the European Parliament takes at least an advisory role in the appointment of ECB Executive Board Members before an appointment is made, the UK Parliament plays no role in the procedure. Members of the MPC are appointed by the Crown, after the prime minister and the Chancellor of the Exchequer have been consulted. Hearings of new MPC Members by the House of Commons' Treasury Select Committee are held only after the appointment has been made to assess the independence and the competence of the new appointee. In contrast, the US Senate has more power. Any appointment to the Fed Board of Governors made by the President of the United States has to be confirmed by the US Senate before it becomes effective.

In terms of reporting, we note that both the Bank of England and the Fed are more transparent than the ECB. Both the Bank of England and the Fed publish minutes after meetings of the MPC and the Federal Open Market Committee (FOMC). The ECB is the only bank among the three that does not publish minutes. The ECB is afraid that, if votes or discussions were public, there could be political pressure on members of the Governing Council in their countries of origin — especially if there is a conflict between a country's immediate economic interest and that of the euro area as a whole — and that this would reduce the independence of Governing Council members. However, the ECB could find a solution to that problem by publishing minutes that would not reveal individual votes or names in the discussion. Most importantly, the ECB differs from the Fed and the Bank of England because it cannot be sanctioned by the European Parliament if it fails to fulfil its mandate. By contrast, in the US for instance, a simple majority of Congress plus a presidential signature can amend the Federal Reserve Act and change the bank's statutes. There is no such possibility in the euro area. Table 1 summarises the main differences in the transparency and accountability of the three central banks.

Table 1: Comparison of the ECB, the Bank of England and the Fed

	ECB	Bank of England	FED Reserve Board
Legal Basis	TEU, TFEU, Statute of the ESCB; International law, can only be changed with unanimity of all EU countries	1998 Bank of England Act	Federal Reserve Act, can be altered by Congress
Appointment of Board Members	President, the Vice-President and the other members of the Executive Board shall be appointed by the European Council, on a recommendation from the Council after it has consulted the European Parliament and the Governing Council.	The Court is appointed by the Crown on the advice of the Prime Minister and the Chancellor of the Exchequer. Treasury Committee holds appointment hearings for new Monetary Policy Committee (MPC) and Financial Policy Committee (FPC) members.	President of the United States appoints the members of the Board of Governors. Appointment has to be confirmed by the US senate.

Accountability to	European Parliament	House of Commons' Treasury Select Committee and government	US Congress
Testimony frequency	President of the ECB appears four times a year before the ECON. On Parliament's request, the President, Vice-President and other Members of the Executive Board shall be invited to attend additional meetings	Members of the MPC and FPC give evidence on a regular basis at hearings	Chairman of the Board shall appear before the Congress at semi-annual hearings.
Reports	President presents Annual Report before the plenary. Vice-President presents it to EOCN. ECB replies in writing to written questions put by Members of the Parliament.	MPC members produce an annual report ahead of Treasury Committee hearings. After each meeting of the Monetary Policy Committee, the Bank publishes minutes of the meeting.	With each semi-annual hearing submit a written report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking and Financial Services of the House of Representatives
Sanctions	On application by the Governing Council or the Executive Board, the Court of Justice may compulsorily retire a member of the Executive Board.	An Member of the Court can be removed by the Oversight Committee with the consent of the Chancellor of the Exchequer	Board Members can be removed for cause by the President.

Source: TEU, TFEU, Statutes of the ESCB, EP Rules of Procedure, Protocol No.4 on the Statue of the European System of Central Banks and of the European Central Bank, 1998 Bank of England Act, Federal Reserve Act.

1.3. Assessment of the last five years of the Monetary Dialogue

In this section, we focus mainly on the quarterly hearing of the ECB President that takes place in front of the European Parliament Economic and Monetary Affairs (ECON) committee, and on the plenary parliamentary sessions to which the president is invited. In both cases, the procedure is similar: the ECB president reads a statement and this is followed by a Q&A session between him and MEPs.

Concerning the introductory statement by the ECB president, our careful study of the speeches given in the last five years reveals that the first part is always quite similar to the economic and monetary analysis given in the ECB monthly press conference preceding the hearing. Therefore, no important news or new policy measures are ever revealed during the hearings. In a way, it makes sense that the ECB Governing Council makes announcements of new policies immediately after decisions are taken, ie during the press conference following the meeting, and it is also reassuring that its views on the economic situation expressed in front of the European Parliament are consistent with those expressed during the previous months, but this repetition at the hearing also gives the impression that the ECB considers that its own press conferences make the hearing redundant. By contrast, the Fed often uses the semi-annual testimonies of its chairman to make important public announcements about its policy. For instance, current Fed Chair Janet Yellen used her testimony in front of congress on 11 February to clarify the Fed's forward guidance strategy and announce that it may "be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6.5 %, especially if projected inflation continues to run below the 2 % goal".

The second parts of the ECB introductory speeches are in general much more interesting, in our view, because they deal with topics on which the ECB president is invited to give his views. Topics are chosen by the ECON committee and a background on the topics is provided by the briefing papers prepared by monetary experts before each meeting. However, we regret that MEPs do not focus at all on those topics in their questions following the ECB president's statement, as this would give a focal point to the discussion.

Indeed, the Q&A session following the ECB president's introductory statement is unstructured with questions covering a wide range of topics, supposedly reflecting the monetary and economic concerns of European citizens. Of course, it is a good thing that MEPs are free to ask whatever question they want to the ECB president. Moreover, it seems that the Monetary Dialogue between the ECB and the Parliament has matured over time. The parliamentary discussion has shifted from the central bank's ability to maintain price stability and discomfort with the level of transparency of its decision making process, to more general discussions about economic policy.

However, again, we think that the dialogue would gain from focusing on some particular topics. More precisely, we have serious doubts about the extent to which the Monetary Dialogue actually amounts to an effective assessment of the performance of the ECB. We believe that committee members should focus on the successes or failures of the ECB as it works to fulfil its mandate: they should review its performance towards its primary objective, and also towards its secondary objective of supporting the goals of the EU (ie growth and high employment). Even though the European Parliament's instruments to discipline the ECB are non-existent, a more careful assessment of the ECB's performance could give more weight to the monetary dialogue.

One option would be for the ECON committee chairman to play a more prominent role and ask the same series of very specific questions at the beginning of each hearing's Q&A session about the ECB's fulfilment of its mandate. One question, if observed (or even predicted) inflation is too low or too high compared to the target, could be: "why have you missed your inflation target since our last meeting?", in the same way that in the UK the Governor of the Bank of England is required to send an open letter to the Chancellor every time inflation moves away from the target by more than 1 %age point in either direction, to explain why the Bank of England failed to achieve its mandate. In the opposite case, when the inflation target is met, the Chairman could also ask the ECB president why the ECB is not doing everything it can to fulfil its secondary objective and support EU policy objectives, if the ECON committee considers there are shortcomings in this respect.

Finally, we assess the visibility of the Monetary Dialogue in the media. Given that the accountability of the ECB to the European Parliament is only based on the information exchange with the ECB and not on any enforcement powers, reporting of the event in the media should be important for the European Parliament. However, as Figure 2 clearly shows, it seems that the Dialogues are much less reported in the press than the ECB monthly press conference. Figure 2 also confirms our idea that MEPs should focus on one particular topic at each hearing. The monetary dialogue of October 2012, during which some MEPs were determined to talk about gender inequality, seems to have been the most cited dialogue in the media in the last five years. We do not say that coverage in the media should be the objective of this democratic exercise, but that it would help to put the ECB under democratic scrutiny.

The fact that the dialogue appears to be less important to the media or ECB watchers than the ECB monthly press conferences could even give the wrong impression that the ECB is more accountable to the financial markets than to the European Parliament. We also think that other elements would increase the media visibility and enhance the transparency of the Monetary Dialogue: a publicised and well-functioning live stream of the event (comparable to that available for ECB press conferences) is paramount, as are rapidly available transcripts of the hearings (for some reason the transcripts of the December 2013 and December 2012 hearings are missing on the dedicated webpage, and it is impossible to find the transcripts from before 2009). We encourage the European Parliament to highlight this event, because as long as the event is not sufficiently publicised, the ECB will be reluctant to make important announcements during the Monetary Dialogue, and reciprocally the event will not be visible if the ECB does not make important announcements, so the Monetary Dialogue could remain stuck in this bad equilibrium.

Figure 2: ECB Online Press Mentions

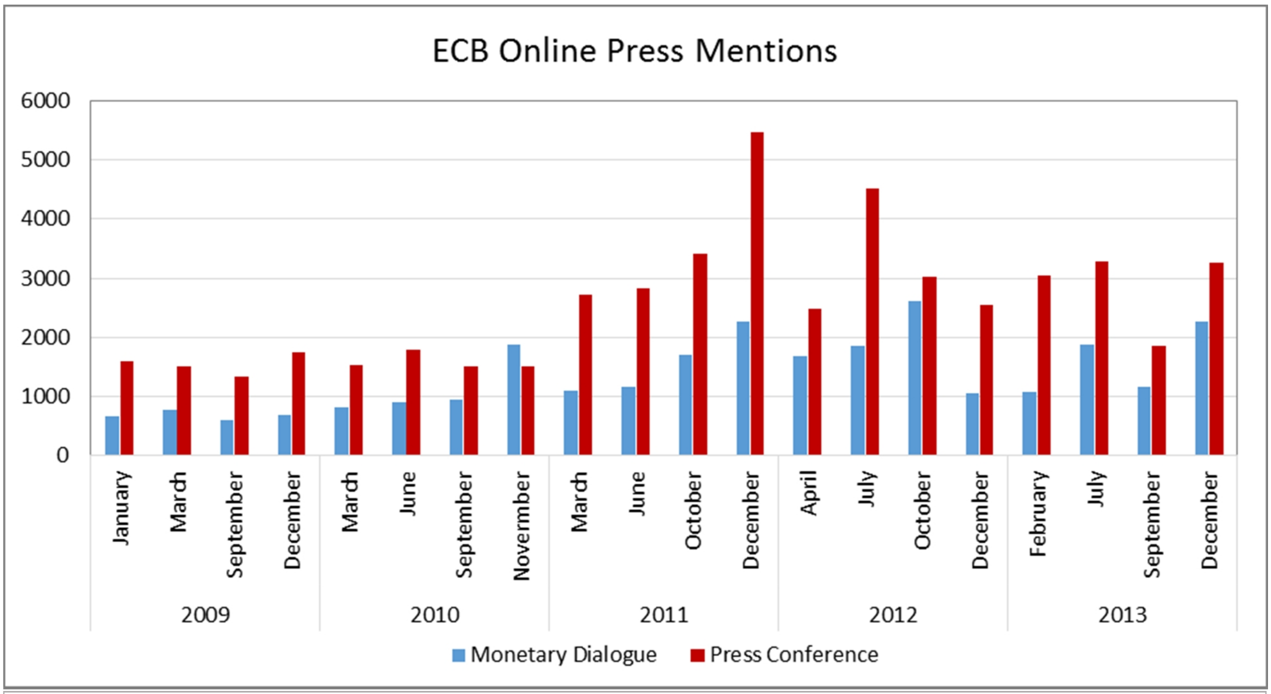


Figure 1: *The figure shows the Mentioning of "ECB", "EZB" or "BCE" in English, German and French speaking online press on the day of and a day after the Monetary Dialogue or Press Conference in the respective month. The number can be inflated since not every mention is checked for its relevance. The upward bias is, however, the same for both time series and the absolute number of the mentions is not of interest. The numbers are generated using the online platform Factiva.*

Source: Bruegel, Factiva.

2. FUTURE ECB POLICY OPTIONS AND THE ROLE OF THE MONETARY DIALOGUE

This section reviews possible future policy choices the European Central Bank might face. A clear challenge for the euro area is deflation. The price level is below 1 %, and a drop below zero could damage the European economy. Moreover, the ECB's most prominent conventional monetary tool, namely the interest rate, is already near zero, which means that the ECB has limited scope to use this instrument to address low inflation. Should the European Central Bank looks to what other banks have done, it will find two types of policies. The first is forward guidance. The second is quantitative easing. We review the main features of each and then suggest the appropriate role for the Monetary Dialogue in the context of the two types of policy. We conclude with some observations on the function of the Monetary Dialogue after banking union.

2.1. The role of the Monetary Dialogue in the forward guidance strategy of the ECB

"Forward guidance" refers to a monetary strategy meant to guide consumers, markets and politicians about the mid-term actions of a central bank. The version that the Fed and the Bank of England introduced respectively in December 2012 and August 2013 has two components. The first indicates that a possible increase in short-term interest rates will not happen before a specific macro-economic target is met. This was initially an unemployment rate of 6.5 % in the United States and 7 % in the United Kingdom.[1] The goal of the policy was to influence not just short-term but also long-term interest rates. If markets are more confident that short-term interest rates will remain the same, long-term interest rates will fall towards the short-term rates. This should then encourage the purchase of capital goods as well as housing. It should be noted that both institutions made clear that they would maintain this policy only while it did not mean that they would significantly overshot their inflation targets. As the banks note in their explanations, it is also a policy that they have introduced when interest rates were already very low and when there was little scope for further interest rate cuts[2].

In February 2014, both banks modified their frameworks as official unemployment rates fell close to the pre-announced targets. The Fed decided to widen its definition of what it counts on the job market to include other indicators, such as the long-term unemployed, but it basically kept a form of unemployment target in place. In the Bank of England's case, Governor Mark Carney announced that the Bank would increase the number of indicators it would use to assess when it would be appropriate to raise rates, including several indicators not related directly to employment, such as productivity, hours worked and household consumption. Neither bank ended its forward guidance programme.

The second component of forward guidance is an active communication strategy about the targets. The banks want to influence market, and consumer, expectations about future monetary policy. There is a growing literature on how central-bank pronouncements can

[1] Note that the Federal Reserve Bank first introduced the concept of "forward guidance" in August 2003 when it feared that deflation was a risk and again in December 2008 at the height of the global financial crisis. In these early cases, there was a calendar date set rather than a specific macro-economic target the Federal Reserve Bank expected to reach before changing short-term interest rates. See Plosser, Charles, 2013, "Speech: Forward Guidance," downloaded at http://www.philadelphiafed.org/publications/speeches/plosser/2013/02-12-13_siepr.cfm on 16 February 2014.

[2] See Federal Reserve Bank 2014, "How does forward guidance about the Federal Reserve's target for the federal funds rate support the economic recovery?" downloaded at http://www.federalreserve.gov/faqs/money_19277.htm on 15 February 2014 and Bank of England 2013, "Monetary Policy Trade-offs and Forward Guidance." For both banks, the statistical overshoot would be a rate more than .5 % above each bank's explicit target of 2 %. For the theoretical justification for why this policy is especially effective under very low interest rates, see Eggertson and Woodford (2003).

affect expectations, which in turn affect individual behaviour[3]. For example, if consumers expect that prices will drop next year, they might wait to make purchases this year. This type of deflationary scenario in Japan meant prices and economic output dropped even more than if households had expected stable or increasing prices.

These central banks have several platforms via which to announce, and to reinforce, their forward guidance policies. Former Fed Chairman Ben Bernanke first announced the most recent version of forward guidance in a press conference following a meeting of the FOMC. This is where the legislature might play a role. Current Fed Chair Janet Yellen announced the change in the US version of forward guidance in testimony before the US Congress.

There is a further relevant point. The ECB is not the only institution that sets out future expectations on the health of the economy or the level of inflation. Some recent research suggests that increases in political contestation lead to more precise discussions among politicians about the economic future (Baerg, 2013), and this in turn provides a better hook for households on which to set their expectations. Discussion of the future course of monetary policy in front of the European Parliament, and the inevitable political discussions that come with the testimony both within Parliament and in the press as part of the Monetary Dialogue, represent a move towards greater contestation and might contribute to more effective forward guidance. In this case, such discussions should be encouraged for reasons of accountability and transparency and because those discussions might make the policy more effective.

2.2. The role of the Monetary Dialogue if the ECB were to decide to implement a quantitative easing policy

Quantitative easing means that the central bank purchases assets from financial institutions. It gives money to the seller of the assets, which boosts the money supply. There is a series of expected effects. QE provides a signal to households that monetary policy will remain expansionary in the future and that interest rates will remain low, which is the same function that forward guidance is meant to provide. QE has a similar goal to forward guidance, namely to push down long-term interest rates, but the central bank takes immediate action through its purchases. This action makes the asset class more expensive, and owners of assets are then expected to rebalance their portfolios, meaning that they purchase other assets. To the extent that commercial banks are the sellers of the bonds, they have more money on their balance sheets they can loan to customers, which may address a credit squeeze faced by businesses[4].

The US programme began in November 2008 and is on-going. The Fed has purchased mortgage-backed securities in addition to the purchase of US Treasury bonds. It asserts that QE has contributed directly to the economic recovery and to lower mortgage rates. In total, it has expanded its balance sheet almost $3 trillion since 2007[5]. The Fed has announced a "tapering" of its programme, and it first reduced its purchases from $85 billion to $75 billion per month in December 2013.

The Bank of England began its QE in January 2009 at the height of the global financial crisis and it purchased £200 billion worth of mostly medium- and long-term government debt by January 2010. It made further purchases in 2011 and 2012, which took the total amount to £375 billion. It is no longer actively buying government bonds.

The Bank of Japan introduced what it calls quantitative and qualitative easing (QQE) in April 2013. The main purpose of the policy is to maintain price stability, which in practice means

3 E.g. Blinder *et al* (2008).

4 A good summary appears in Joyce *et al* (2011).

5 *Economist*, 14 January 2014.

raising inflation towards its target of 2 %, and it is done by trying to double the country's monetary base. Like the Fed, it purchases its government's bonds, and this is its main tool, with purchases of about 50 trillion yen per year as of 2013. It also buys exchange-traded funds (1 trillion yen) and Japan real estate investment trusts (50 billion yen)[6].

Each of these programmes therefore purchases government bonds. The ECB has announced a so-far unused policy to do the same, namely Outright Monetary Transactions (OMT). The programme allows the ECB to purchase essentially unlimited amounts of government bonds of Member States that are already subject to a European Stability Mechanism programme, as long as the Member States in question respect the conditions of the ESM programme. The ECB contends that this policy could be necessary on monetary policy grounds, namely to safeguard "an appropriate monetary policy transmission and the singleness of the monetary policy"[7]. Yet OMT is not strictly conceived as a direct monetary tool meant to push down interest rates across the euro area (Mody, 2014)[8].

For the ECB, a quantitative easing programme would probably mean the purchase of bonds of euro-area countries. The purchase of such assets would have distributional consequences. Governments gain by paying less interest on their debt, while households lose by earning less interest on their savings[9]. Any government intervention in the economy that leads to profits for some groups in society should be subject to parliamentary oversight, with parliament holding the central bank directly accountable for such decisions. This is common practice where other central banks have initiated quantitative easing — the Fed has to defend its QE programme before Congress, while the UK Parliament created a Select Committee to take evidence on the Bank of England's programme[10]. Should the ECB adopt this policy, the Monetary Dialogue would be an ideal platform for the European Parliament to evaluate any such programme under the ECB's remit.

2.3. Should the Monetary Dialogue evolve to take into account the new role of the ECB as financial supervisor?

The Single Supervisory Mechanism (SSM) foresees the European Central Bank as the supervisor of "significant" banks in the euro area. National supervisors will be most important for the remaining banks, although the ECB will cooperate with national authorities and can take responsibility for any bank in the euro area if it so chooses.

A concern is that the ECB's monetary policy objectives could conflict with its banking supervision responsibilities. An increase in interest rates, for example, could be useful to maintain the ECB's inflation target, but it also might put pressure on the balance sheets of banks that have significant levels of short-term debt. It could also lead to an increase in non-performing loans if customers who took out short-term loans cannot afford higher interest rates. The central bank decision to address price stability would also affect bank profitability and (perhaps) financial stability. There is evidence in the literature that those

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6 See the explanation on the Bank of Japan website, http://www.boj.or.jp/en/mopo/outline/qqe.htm/ , accessed 15 February 2014; and Bank of Japan 2013, "Introduction of the Quantitative and Qualitative Monetary Easing." April 4.

7 European Central Bank, 2012. "6 September 2012 - Technical features of Outright Monetary Transactions." Available at http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html

8 There is an on-going court case against OMT that began in the German Constitutional Court and is now pending at the European Central Bank. Whether OMT constitutes "monetary policy" is one of the issues in contention.

9 In a recent report on the distributional consequences of quantitative easing from 2007 to 2012, the McKinsey Global Institute (2013) estimates that governments collectively saved $1.6 trillion, non-financial corporations saved $710 billion, while private household savers lost $610 billion. Our point is not that these figures are necessarily correct, but that they are large and should be subject to parliamentary review.

10 Further information on the testimony is available at: http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news/committee-to-take-evidence-on-qe/

countries in which the monetary authority and banking supervisor are united in one institution have higher inflation rates than those in which these authorities are separate (eg Copelovitch and Singer, 2008).

Some steps have been taken to avoid this conflict. According to the regulation that establishes the supervisor, the ECB's Governing Council appoints four individuals to the Supervisory Board, all of whom should not perform duties directly related to monetary policy[11]. There are also arguments that there are important synergies between the two roles. Darvas and Merler (2013) suggest that liquidity assistance that only a central bank can provide is crucial to a banking supervisor. They also suggest that the ECB drop co-decision on various types of financial assistance programmes because such policies might represent a true conflict of interest.

Given that the decision has been taken that the ECB will add banking supervision to its pre-existing mandate to set monetary policy, how could, and should, the role of the Monetary Dialogue change to ensure democratic accountability? We have some concerns about the democratic accountability of the ECB as a supervisor under banking union. Who will hold the supervisor to account? The European Parliament does have the right to approve the Chair and Vice-Chair of the SSM Supervisory Board, but the ECB selects the candidates[12]. There is an agreement between the European Parliament and the ECB that the Chair of the Supervisory Board will appear twice a year before the relevant European Parliament committee. The ECB will also submit an annual report to Parliament on its activities as a Supervisor, and the Chair is expected to present the report in an open hearing. There are also provisions for making specific hearings confidential[13]. Regardless of how well the European Parliament holds the ECB accountable for its function as banking supervisor, one would expect that concerns about whether decisions taken as supervisor affect monetary policy to be part of the remit of the Monetary Dialogue.

Possible Policy	Role of Monetary Dialogue in increasing accountability and effectiveness
Forward Guidance	Evaluate and publicise the targets the ECB sets, which will increase the effectiveness of the policy
Quantitative Easing	Evaluate the distributive implications of central bank purchases of assets
Banking Union	Evaluate how decisions the ECB takes as a banking supervisor affect monetary policy

[11] See Article 26(5) of Regulation 024/2013.

[12] See Howarth and Quaglia (2013) on the role of the European Parliament in the SSM.

[13] The text of the agreement can be found at: http://www.europarl.europa.eu/document/activities/cont/201311/20131107ATT74064/20131107ATT74064EN.pdf. Accessed 15 February 2014. For concerns about whether this procedure will be transparent enough about the state of the banking system, see Gandrud and Hallerberg (2014).

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DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

The Monetary Dialogue

Charles WYPLOSZ

IN-DEPTH ANALYSIS

Abstract

Central banks must be independent from political influence. As a non-elected bureaucracy with considerable powers, fundamental democratic principles require that they be brought to account of their actions with elected representatives of the citizens. The EU Treaties have entrusted the European Parliament to exercise this essential task. At the formal level, this is happening. In practice, however, accountability is limited. One reason is that the Parliament has no leverage on the ECB. Changing this situation would require a new treaty, which is unlikely to happen any time soon. Improving accountability, therefore, can only be achieved through the practical details of the Monetary Dialogue. At present, both the physical layout and the contents of the dialogue contribute to an asymmetric encounter. This asymmetry is reinforced by the technical nature of the ECB actions. Suggestions to improve the Monetary Dialogue include a different layout, more structured interventions by a limited pre-set number of MEPs and better use of the experts.

CONTENTS

EXECUTIVE SUMMARY

A central bank is a bureaucratic institution with considerable power. In a democracy, such an institution must be accountable to elected bodies. In the euro area, it is accountable to the European Parliament but this accountability is incomplete, in part because the Parliament has no power on the ECB.

The relationship between the ECB and the European Parliament is formally determined by the EU Treaties. Any improvement would therefore require a new treaty, which is most unlikely, at least for the foreseeable future. Changes, therefore, must rely on *de facto* practice. While this offers limited room, some improvements are possible. They depend almost entirely on the Parliament.

Both principles and practice unambiguously back the view that central banks must be independent from politics. Independence, however, is not an absolute concept. There are various degrees of independence because money plays many roles and can serve many means. Central banks should be free to carry their mission without *ex ante* interference but with strict *ex post* accountability. Through their elected representatives, citizens must be able to continuously monitor and criticise their central bank. In addition, mistakes in the face of solidly argued criticism must have consequences.

The Monetary Dialogue involves quarterly testimony by the President of the ECB to the Economic and Monetary Affairs Committee of the European Parliament (ECON). The practice, however, is not fully satisfactory. The President of the ECB presents carefully scripted preliminary remarks, followed by Q&A that cover a bewildering range of issues.

Given its size, the ECON Committee is a small parliament in itself. As a result, the Monetary Dialogue sees the President of the ECB address a large crowd. The very idea that the ECB is brought to account is absent from the start.

The obvious solution would be that the President of the ECB only meets a subcommittee. An alternative would be a limited number of questions by a limited number of Committee members. The choice would be made on the basis of a text, submitted ahead of time by the President of the ECB, possibly an extended version of his oral presentation.

The ECB is a technical institution whose decisions are based on extensive preparatory work by a large and highly qualified staff. MEPs, on the other hand, are not expected to have the same technical level. This situation can create an asymmetry that is detrimental to the quality and intensity of the dialogue. This aspect has long been recognised by the ECON Committee. It has hired a staff of significant size, which includes members with the required competence. It also relies on Briefing Notes produced by external experts; the present Note is part of the series. This is insufficient, however.

MEPs rarely confront the President of the ECB on technical matters, which lie at the heart of the ECB work. They prefer instead to delve into general, sometimes even political questions, which significantly reduce the precision of the accounting procedure. In addition, the Briefing Notes prepared by the experts concentrate on two, sometimes three issues, which may or may not be related to the questions that will be discussed by the President of the ECB. The experts are regularly invited to pre-meetings but ECON Committee members poorly attend these meetings. Various improvements are possible.

A striking feature of the Monetary Dialogue is that the President of the ECB stands on a high podium and looks down upon Committee members. Another feature of the Monetary Dialogue is the wide array of questions put forward by the ECON Committee members.

INTRODUCTION

A central bank is a bureaucratic institution with considerable power since its decisions have important implications for the citizens. In a democracy, such an institution must be accountable to elected bodies. In some countries, for example in the US, the central bank is accountable to the Congress. In others, such as in the UK, it is accountable to the Chancellor of the Exchequer. In the euro area, it is accountable to the European Parliament. This accountability, however, is incomplete because the Parliament has no power on the ECB: it cannot change its statutes as in the US, or assign objectives as in the UK. At the end of the day, therefore, the ECB can disagree with the Parliament without any consequence. The situation contributes to the well-known democratic deficit of Europe.

The relationship between the ECB and the European Parliament is formally determined by the EU Treaties. Any improvement would therefore require a new treaty, which is most unlikely, at least for the foreseeable future. Changes, therefore, must rely on *de facto* practice. While this offers limited room, some improvements are possible. They depend almost entirely on the Parliament.

The limited, and ultimately unsatisfying, exercise of democratic control over the ECB has been known since the start.[1] The fact that the Monetary Dialogue has remained virtually unchanged is a clear warning that improvements are difficult to design and implement. The situation has probably worsened since early adjustments have not been made, which has led to a tradition that is now deeply entrenched. Furthermore, the role played by central banks during the financial crisis has brought them closer to fiscal policies, which has raised their political profile; accountability has become even more important.

This note reviews the reason why central banks must be independent (Section 2) and why accountability is the counterpart to independence (Section 3). Section 4 examines the relevant lessons from the financial and sovereign debt crises. The current practice of ECB accountability is critically reviewed in Section 5. Some suggestions to improve the process are advanced in Section 7. The last section concludes.

[1] My comments written after attending a dialogue in September 2001 are presented in the Appendix.

1. CENTRAL BANK INDEPENDANCE

Both principles and practice unambiguously back the view that central banks must be independent from politics. In all continents and in every period, central bank submission to political power has led to bad outcomes, often to crises. The possibility of using the printing press, the legal right to create money, has proved to be an irresistible temptation to politicians under financial pressure, which is bound to happen now and then. The result has been inflation and financial crises, with dramatic implications for citizens and private enterprise. Even before the advent of paper money and the creation of central banks, the sovereign has resorted to inflationary finance in many ways: the debasement of metallic monies, borrowing under threat from private lenders leading to the latter's collapse, issuance of promissory notes that go unpaid and thus ruin subscribers. The evidence is so overwhelming that any discussion of this universal principle is unwarranted.

Independence, however, is not an absolute concept. There are various degrees of independence. Those who consider that a central bank is too independent may be right, but this does not justify the rejection of the principle. Rather it calls for a nuanced and carefully circumscribed discussion of the implementation of the principle. The financial and sovereign debt crises have made such a discussion even more important.

The reason why independence is not a black-or-white issue is that money plays many roles and can serve many means. As a store of value and a unit of value, the purchasing power of money must be stable and foreseen to remain stable. It follows that a central bank must be able to deliver price stability at all times. To achieve price stability, the central bank must have sole effective authority on how much money it creates. Price stability, however, is an elusive concept: is it 0% inflation, or 1%, or 3%? Should it always be exactly 2% or can it vary over time within bounds? Because it is impossible, in practice, to keep the inflation rate absolutely stable, some flexibility is unavoidable. Flexibility, of course, can be abused.

The answer is that a central bank should aim at some low inflation rate within reasonable bounds. Crucially, the central bank should be able to decide on occasional fluctuations of the inflation rate on the basis of some valid reasons such as economic shocks, financial turmoil or, more generally events outside its control. The one reason that is invalid is to help a financially strapped government. That means a rigorous separation between monetary and fiscal affairs. Since intentions are impossible to detect, the separation between monetary and fiscal affairs can easily become a matter of judgment. In addition, the financial collapse of a government is such a momentous event, with disastrous consequences, that even this requirement cannot be absolute.

In addition, money is used for financial transactions, nationally and internationally. It is a well-established fact that financial markets are inherently unstable. This instability, in turn, does not just create economic havoc, it also undermines monetary policy. As a consequence, any central bank must concern itself with banks and financial markets. As it does so, however, a central bank can affect overall wealth and its distribution among citizens. Naturally, this prospect leads to intensive lobbying by various interest groups. Independence from these groups – and politicians that may be captured – is essential. On the other hand, wealth distribution is a deeply political issue that can only be decided by elected governments and their parliaments. Even if the central bank is likely to best serve the common good, it cannot operate without any constraint.

2. CENTRAL BANK TRANSPARENCY

The current view is that central banks should be formally independent, with a clear price stability mandate, but they should be able to exercise discretion if and when needed. They should be free to carry their mission without *ex ante* interference but with strict *ex post* accountability. Even so, because the effects of monetary policy occur several quarters after actions, some contemporaneous control is required. The solution is transparency. Those who have a stake in monetary policy decisions, the citizens through their elected representatives, must be able to detect the central bank intentions in real time. Furthermore, like any one, central banks can make mistakes or simply misread the facts. The citizens must therefore be able to continuously monitor and criticise their central bank. In addition, mistakes in the face of solidly argued criticism must have consequences.

This is where accountability comes into play. In the euro area, the European Parliament is tasked with making the ECB accountable for its past actions (*ex post* accountability). It should also be able to discuss openly potential misjudgements mistakes, with the reasonable presumption that its doubts will be taken on board by the ECB. This requires a high degree of transparency. The ECB must be candid about what it is trying to achieve, and how, and it should be willing to acknowledge shortcomings in its views as they happen and shape its policies accordingly.

This, in turn, requires that the Monetary Dialogue be a debate among equals. The ECB must be forthright in divulging its intentions and the European Parliament should have the means to argue on the basis of an in-depth analysis of the situation and of the ECB views. The Dialogue should also have a demonstrated influence on ECB actions when criticism is valid and well demonstrated. Such influence should not be seen as a loss of independence, much less a loss of face, but as an indication that the ECB listens to valid criticism and suggestions, much as it occasionally does in response to views aired by banks and the financial markets.

3. LESSONS FROM THE CRISIS

The financial and sovereign debt crises have made it clear that the role of central banks is considerably wider and more complex than anticipated in the European Treaties. Until then, the official view, strongly supported by the ECB, was that the function of a central bank is to deliver price stability. There was no mention of financial stability. This view has now been discarded, at long last, but all the implications have not been drawn yet.

A first missing element is that no central bank can get rid of the responsibility of being lender in last resort to banks and systemically important financial institutions. The creation of the Single Supervision Mechanism, with a major role for the ECB, is an important step towards realism. The complexity of the Mechanism, though, and the role that national supervisors can still play, show that more remains to be done. The likely shape of the Single Resolution Mechanism is even more disturbing. The debate about resources to be used to restructure ailing banks indicates that the ECB's role as lending in last resort is not yet accepted.

A second missing element is that central banks cannot simply detach themselves from public finances. The reason why the sovereign debt crisis has been circumscribed to the euro area is that elsewhere the financial markets casually take it for granted that each central bank is ready to act as lender of last resort to its government (De Grauwe, 2011). In the euro area, this notion is often considered as perfectly inacceptable in part because it threatens the independence of the ECB.[2] This is true, but a lesson from the crisis is that 'no' cannot be the only answer. The proper answer involves institutional arrangements that allow the ECB to act as lender of last resort to governments, if needed, while fully protecting its independence in a way that guarantees price stability. Existing federations offer examples of such arrangements (Wyplosz, 2013).

The fact that these lessons have not been fully taken on board is a source of grave concern. The ECB has only slowly recognised publicly this concern, most probably because it feels vulnerable to adverse political reactions. While understandable and quite possibly realistic, this timidity *de facto* exposes a loss of independence. A proper accounting process should have exposed the situation and provided the ECB with the backup that was needed to make better progress on these issues. This would have required a clear understanding of the issue among governments and parliaments.

[2] Another reason is that such interventions might result in transfers across countries.

4. THE STATE OF PLAY

The Monetary Dialogue involves quarterly testimony by the President of the ECB to the ECON Committee of the European Parliament. Occasionally, the Committee invites other Members of the ECB Executive Board, and they dutifully accept these invitations. Formally, therefore, the ECB is brought to accountability, the counterpart to independence.

The practice, however, is less satisfactory. The President of the ECB appears before the ECON Committee with carefully scripted preliminary remarks, designed to shape the discussion. During the following Q&A part, he fields questions from any member of the Committee. The questions cover a bewildering range of issues and speakers can only ask one follow-up question. The result is an unstructured and often superficial exchange of views.

The ECB rightfully insists that it also makes itself accountable through the press conference that follows its monthly monetary policy meeting. This meeting is indeed the one with most visibility and transparency. The press conference also begins with a careful preliminary presentation, so careful that the press has developed skills to detect the use of code words. The Q&A part is occasionally challenging and this is where, sometimes, new information is gathered. It must be noted that the current President has reduced the formatted preliminary presentation and shown some more willingness to engage the media than its predecessors. The fact that the press conference has become a very visible event, in contrast to the Monetary Dialogue, should lead the European Parliament to review the way it discharges this essential responsibility.

Another source of concern is that several national parliaments also invite their national governors to hearings. More recently, the ECB President has also felt the need to appear in front of some national parliaments. There is nothing wrong with this evolution but it is another signal that the Monetary Dialogue is not *the* key accountability exercise initially foreseen in the Maastricht Treaty. With one currency and one central bank, accountability can only be centralised in the European Parliament. National parliaments and national central banks do not have any formal power and should not attempt, or even be seen as attempting to exercise power.

5. DESIREABLE CHANGES

In the best of worlds, the Monetary Dialogue would be a process through which the European Parliament scrutinises in detail the ECB's past actions, critically follows on-going policies and has the ability to influence decisions when there is a glaring discrepancy with its mission. The latest requirement would need some authority that the Parliament does not have. In the US, for instance, the Congress never misses an opportunity to remind the Federal Reserve that it can change its statutes. In the UK, the Chancellor of the Exchequer can do the same and, anyway, he decides what the inflation target should be. In the euro area, the Parliament has no authority whatsoever over the ECB, which is arguably the most independent central bank in the world. A good case could be put forward that the ECB is excessively independent but any change would require a new treaty, which is not a realistic possibility at this time. The implication is that the Parliament can only rely on internal changes to improve the situation.

5.1 The Economic and Monetary Affairs Committee

Given its size, the ECON Committee is a small parliament in itself. As befits a parliament, its members represent the whole spectrum of nationalities and political parties. All of them are allowed to attend and take part in the Monetary Dialogue. This means that it is not a dialogue at all: the President of the ECB addresses a large crowd. The very idea that the ECB is brought to account is absent from the start.

The obvious solution would be that the President of the ECB only meets a subcommittee, with the other ECON members allowed to attend – possibly in reserved seats separate from those for the public at large – but not to intervene. Such an arrangement should be an internal matter for the Parliament to settle and should not require any new treaty.

An alternative would be to agree *ex ante* on a limited number of questions by a limited number of Committee members. The choice would be made on the basis of a text, submitted ahead of time by the President of the ECB, possibly an extended version of his oral presentation.

5.2 Preparation of monetary dialogues

The ECB is a technical institution. Its decisions are based on extensive preparatory work by a large and highly qualified staff. During the Monetary Dialogue, the ECB draws on this work, as well as on a large amount of data, some of which are produced by the central bank staff. MEPs, on the other hand, are not expected to have the same technical level. This situation can create an asymmetry that is detrimental to the quality and intensity of the dialogue. This aspect has long been recognised by the ECON Committee. It has hired a staff of significant size, which includes members with the required competence. It also relies on Briefing Notes produced by external experts; the present Note is part of the series. This is insufficient, however.

To start with, individual MEPs are perfectly entitled to develop their own views, which may not coincide with the technical advice provided by the ECON staff. They may ask their own assistants to provide analytical support but it seems – I hope that I am not wrong – that few of them have a technical background comparable to the staff of the ECB. Of course, the ECON Committee deals with a wide range of issues, so its staff cannot be entirely specialised in monetary matters. In the same vein, the parliamentary assistants must deal with various issues. The natural outcome is that MEPs rarely confront the President of the ECB on technical matters, which lie at the heart of the ECB work. They prefer instead to delve into general, sometimes even political questions, which significantly reduce the precision of the accounting procedure.

Second, the Briefing Notes presented by the experts concentrate on two, sometimes three issues, which may or may not be related to the questions that will be discussed by the President of the ECB. Over the many years that I have been preparing such notes, I have witnessed increasing precision – and quality – of the questions put to us. At the same time, I have rarely seen that these notes have been actually used during the Q&A period.

Finally, the experts are regularly invited to a pre-meeting of the Monetary Dialogue where they present their Briefing Notes. These meetings are well attended but most of the participants are ECON staff members and parliamentary assistants. Few ECON Committee members attend these meetings, and they tend to be the same from one meeting to another. It seems that an overwhelming majority of the ECON Committee never attend any meeting, and yet they will be active during the Q&A session.

This all seems to be insufficient use of the resources of the Committee. The aim should be to provide Committee members with the kind of technical support that the President of the ECB receives from his staff. There should be a tighter link between ECON members who intend to contribute to the Monetary Dialogue and the experts. One possibility would be to reduce the role of Briefing Notes, possibly to suppress them, and enhance direct contacts between MEPs and the experts. One could envision face-to-face meetings between ECON Committee members and the experts to carefully prepare questions. Another possibility would be for the ECON Committee members who will intervene during the Monetary Dialogue to seek written advice from the experts. This could be achieved by assembling a wider pool of experts who could be asked to intervene only on issues that correspond more closely to their area of knowledge.

5.3 Conduct of monetary dialogues

A striking feature of the Monetary Dialogue is that the President of the ECB stands on a high podium, alongside a few ECON Committee members. He looks down upon the other members who ask for the floor pretty much like journalists during a press conference. Many interventions are full of praise and respect. The difference with the US congressional hearings is stark: there, a limited number of Committee members sit on a high podium and look down at the Chairperson of the Fed who sits in front of a large table, facing the podium. These are 'hearings', not a dialogue. The physical layout makes it clear that the Chairperson of the Fed is brought to account by the relevant Committee, which represents the authority of an elected body.

Another feature of the Monetary Dialogue is the wide array of questions put forward by the ECON Committee members. In many instances, these questions are repetitive. In other instances, they deal with national issues, which lie outside the remit of the ECB. The impact on the quality of the discussion cannot be overestimated. Naturally, freedom of speech must be an integral part of the work of the European Parliament. Yet, the Monetary Dialogue is the only accountability tool imposed on the all-powerful ECB. Freedom of speech must take into account this constitutional requirement. In that sense, the European Parliament has not yet found a way of delivering fully its duty.

Finally, as in the US, the Committee might ask various experts, including former central bank officials, to immediately comment briefly on the statement of the President of the ECB. This could provide Committee members with on-the-spot technical advice and leads that can feed the Q&A discussion.

CONCLUSIONS

The European Parliament is the only institution that has the right to bring the ECB to account. This is a duty of considerable importance. It is also a potential source of redistribution of power away from the bureaucracy toward elected representatives of citizens. The Monetary Dialogue does not have the teeth that it could, and should have. It may be normal that we have not yet found a good balance of powers; after all the euro is barely 15 years old, a very short period when viewed in the relevant historical perspective. The time should come to rethink the procedure. There is nothing in the EU Treaties that prevents the changes suggested above, and more.

The use of experts can also be enhanced in numerous ways, some of which are suggested above. Experts are expensive resources, and they should be able to provide technical advice on issues that directly feed into the Dialogue. Most of them, in fact probably all of them, deeply wish to enhance the quality of the Monetary Dialogue. My own experience, which spans three Parliaments, has been rewarding in a limited way: the hope, which was renewed every quarter, that my notes will serve a useful purpose; I also have appreciated the generally interesting questions put forward by the ECON staff. The pre-session meetings have often been disappointing, due to the limited presence of MEPs and, sometimes, to superficial exchanges. The greatest frustration has been the quasi absence of any link between my work as an expert and the content of the Monetary Dialogue.

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APPENDIX

THE MONETARY DIALOGUE OF 12 SEPTEMBER 2001: DEBRIEFING NOTES

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1. The setting

The title and the physical layout already suggest the limits of the exercise. A "dialogue" is much less than reporting. The Chairman of the ECB speaks from a podium, physically dominating the ECON members. He takes questions much like in a press conference. It is a dialogue, but not among equals.

The setting partly reflects the ambiguity in the Treaty's Article 113 which calls for one annual presentation of the ECB's Annual Report while allowing the EUP to call for more hearings. Thus the Chairman is not bound to report to the EUP, only to present a publicly available document and to respond to requests for more appearances with an unspecified agenda.

From the outside, the Monetary Dialogue resembles a gentleman's agreement whereby the Chairman will appear four times a year in front of ECON, but not for reporting. This is less than the Treaty allows for: the EUP may very well request hearings and run them in a more US-style form of hearings. This, however, would require a change in ECON's own approach. The sheer fact that the whole Committee is involved creates a deep asymmetry: one person facing tens of others who, furthermore, are politically divided. A more symmetric arrangement would call for a small-size sub-committee to run the hearings.

2. Public interest

It is clear that there is little public interest in the Monetary Dialogue, with minimal press coverage. There are several reasons for that:

- The Chairman of the ECB does not use the Monetary Dialogue to present new information. Instead, he holds his own monthly press conference and keeps most of the scoops for the occasion. These monthly press conferences are not frequent central bank practice and, coming immediately after Governing Council meetings, they appear to create considerable pressure to promptly summarize a decision that may have been controversial. It is not unconceivable that another Chairman will adopt a different approach. The EUP is keenly interested in this possible evolution.
- It is in the interest of the ECB to keep the Monetary Dialogue as a low profile event since it is the only public obligation to which it is bound.
- Monetary policy is not an exciting topic for the media, except in special circumstances (the attacks in the US provided for some drama, but the Dialogue occurred a bit too soon to allow for serious questioning). There is typically little new that happens every three months, so there is no drama.
- The Chairman does not appear to be in difficulty. He simply repeats familiar earlier statements.

3. General observations

The ECB Chairman has little to offer and may reasonably be expected to be criticized. Given his early record of *gaffes*, the best strategy for him is to re-state as forcefully as possible the ECB's position on each issue. He may occasionally deliver some new information, and he did on 12 September (readiness to support the dollar following the terrorist attacks, early signals of end of slowdown), but that is more courtesy than accountability.

The questions put to the Chairman are of four kinds:

- Factual questions on recent events/decisions
- General questions on the ECB's approach
- Critical interventions designed to prompt a defence
- Local interest questions

The last two categories clearly do not work. Criticism is rarely new, so the Chairman has answers at the ready. There would be a need to follow-up with increasingly tighter criticism, which is not possible under present rules (only one follow-up question, no grouping by theme) and is undermined by the physical layout. Local interest questions are out of place, they only offer the Chairman a chance to diplomatically state that he cares about this or that country.

Factual questions are crucial but they need to be well thought through. The ECB spends considerable time and effort (with a large staff as backup) preparing its decisions, so any question put to the Chairman must be based on the premise that there is a good answer. In fact, there are many acceptable ways of dealing with any monetary policy issue, so the questions should always outline the alternatives and seek the reasons why the alternatives have not been adopted.

General questions are important but should not become ritual, because they invite ritual answers. The ECB has been sharply criticized for its monetary policy framework, in fact it is criticized daily in the media. But it is entitled to define its strategy so that new criticism should only be brought up as new events illustrate the problems generated by the strategy. Put differently, such questions ought to be put in a very precise frame.

One structural weakness of the Chairman is that he is bound to be occasionally proven wrong, although that is not apparent at the time of the hearing. It is essential that he be reminded of what he previously said. There is a need for a follow-up of previous sessions, with a precise use of the minutes.

4. Detailed comments on some exchanges

One question dealt with the ECB's forecasts. It was observed that it had been far too optimistic and may have failed to take action to prevent the slowdown. This is a good issue for ECON but it would have been necessary to take into account the obvious answers:

- the ECB's record in terms of forecasting is no worse than that of others
- the ECB's main objective is price stability defined as inflation less than 2% and HICP inflation still exceeds 2%

Another way of asking the question would have been to acknowledge that forecasting is imprecise and that the ECB must decide whether to err on the side of a more or a less restrictive stance, noting that it has chosen the more restrictive option. The Chairman would have noted the overwhelming importance of price stability, leading to a follow-up that would have noted that the ECB has already been missing its inflation target for a year and is now possibly contributing to a slowdown that is sharper than anticipated because it did not realize the restrictiveness of its stance: why are stock prices so depressed while Europe is growing? Why is the euro appreciating?

Another question returned to the ECB's forecasts in view of recent events. The Chairman answered that the ECB was constantly reassessing its forecasts and would release new ones in December as planned. There should have been a follow-up asking why the reassessment was not made public; when the economic situation is so very volatile, shouldn't the ECB share its changed perception? What is democratic accountability about if the ECB keeps to itself the most critical information that is used for monetary policy decisions? ECON could request that the Chairman comes to the Monetary Dialogue with the latest quantitative forecasts (he made a lot of qualitative statements about the impending end of the slowdown, but did not substantiate them with actual figures).

One question dealt with fiscal policies and the overall policy mix. It asks what could the ECB's contribution be. The Chairman answered that the monetary policy stance is appropriate but that governments need to abide by the broad economic policy guidelines.
The question should have noted that the medium term commitments embodied in the broad economic policy guidelines adopted in early 2001 were made obsolete by the then unexpected slowdown and that the way-out was either a relaxation of monetary policy, or tolerance towards reviewing the fiscal policy commitments, or both. The Chairman would have argued that economic policies should be oriented towards "stability in the medium run" and not preoccupied with short term ups and downs which, by definition, take care of themselves. The follow up would have observed that Europe's citizens live in the short run and that the Chairman's distantiation was highly technocratic, that unemployment was rising again, etc. so that EMU may be receiving bad press for good reasons.

There were several questions about Article 2, the ECB's mission, and how it differs from the Fed's and other central banks. One question aptly dealt with the ECB's own interpretation of price stability. The only time when the Chairman was put in difficulty occurred when he was asked why the ECB is the only central bank with such a narrow objective. This a good example of a precise question dealing with a general issue. Faced with the Chairman's answer that he needed to look into what others are doing, a US Senator would have chided him for being unaware of international best practice…

5. Conclusions

The role of ECON can be of two kinds:

- questioning US-style, i.e. bringing the Chairman to accountability. This is not possible as long as every ECON member is allowed to ask questions, thus diluting the examination and cross-examination process.
- thinking through the issues in a friendly atmosphere, thus prompting the Chairman to lower his defensive threshold and to share his own doubts. This would require a change of attitude of ECON, with some members being openly supportive while others are openly critical.

At present, none of the two options is followed. Any change of strategy would seem to require an agreement within ECON. In both cases, there would be a need for agreeing on speakers and for in-depth preparation.

European Parliament

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

The Monetary Dialogue and accountability for the ECB

Karl WHELAN

IN-DEPTH ANALYSIS

Abstract

Over the past five years, the Parliament's Economic and Monetary Affairs committee has had to deal with an extraordinary number of complex events and new issues in its on-going Monetary Dialogue with the European Central Bank. In particular, recent years have seen a considerable increase in the power and influence of the ECB. Its roles in deciding when to provide emergency credit to banks and when to purchase sovereign bonds have led to considerable controversy. The Monetary Dialogue needs to play an important role in keeping the ECB accountable for its actions to the European public but the kinds of complex issues that continue to arise are difficult to handle within the Dialogue's current format. I suggest that the Dialogue needs to more focused, more interactive and make greater use of outside expert advice.

CONTENTS

EXECUTIVE SUMMARY

- The Parliament’s Economic and Monetary Affairs committee has had to deal with an extraordinary number of complex events and new issues in its on-going Monetary Dialogue with the European Central Bank.
- In particular, recent years have seen very considerable increase in the power and influence of the ECB. Its roles in deciding when to provide emergency credit to banks and when to purchase sovereign bonds have led to considerable controversy.
- The ECB’s new role as the single supervisory mechanism for banks will further add to the institution’s already considerable powers.
- While traditionally responsible for implementing monetary policy in a relatively straightforward manner, recent years have seen a wide range of discretionary decisions by the ECB in areas where the rationale for policy decisions are unclear and where accountability is generally lacking.
- Areas such as the use of the risk control framework to deem certain securities or counterparties ineligible for Eurosystem operations and decisions relating to the provision of Emergency Liquidity Assistance have been very important in recent years but there is very little clarity as to how these decisions are taken. The same applies to decisions to purchase sovereign bonds.
- In its current format, the Monetary Dialogue has had limited success in shedding light on the new powers that have been used by the ECB in recent years.
- The Monetary Dialogue needs to play an important role in keeping the ECB accountable for its actions to the European public but the kinds of complex issues that continue to arise are difficult to handle within the Dialogue’s current format.
- I suggest that the Dialogue needs to more focused, more interactive and make greater use of outside expert advice.

1. INTRODUCTION

The current European Parliament's legislative term is coming to an end in June. Looking back over the past five years, the Parliament's Economic and Monetary Affairs committee has had to deal with an extraordinary number of complex events and new issues in its on-going Monetary Dialogue with the European Central Bank. The Dialogue has covered the factors underlying the global financial crisis and severe recession of 2008/09, the need for improvements in the regulatory framework for the financial sector, the debt crisis in the euro area and the creation of new European institutions with substantial powers, the introduction of non-standard monetary policy measures and the current roll out of the single supervisory mechanism and its associated comprehensive assessment of the euro area's banking system. This has proved to be a hugely challenging agenda for the committee and for the leadership of the ECB itself.

In considering the events of the past few years, the development that stands out for me is the very considerable increase in the power and influence of the ECB. In addition to its important role in undertaking standard monetary policies, the Eurosystem has played an extensive role as lender of last resort to financial institutions. This has proved to be a particularly complex area and there have been a series of instances (in Greece, Ireland, and Cyprus for example) where its use of these powers has led to the ECB becoming involved in political controversies.

The ECB's ability to purchase sovereign bonds has also moved the organisation into new areas of controversy, most notably when the purchases under the Securities Market Programme were combined with letters to Spain and Italy urging specific policy changes. The as-yet-unused Outright Monetary Transactions programme has also played an important role in changing the public perception of sovereign default risk in the euro area while the ECB's new role as the single supervisory mechanism for banks will further add to the institution's already considerable powers.

In light of these considerable new powers, it is legitimate to ask whether there should also be changes to the institutions designed to hold the ECB accountable for their actions to the European public. Effectively there are two such institutions, one informal and one formal. The informal one is the Governing Council press conference. While an important source of information about the actions of the ECB, this event is controlled by the ECB itself and is not a good forum for the detailed discussion of complex issues. That leaves the formal institution of the Monetary Dialogue playing a crucial role in promoting transparency and accountability at the ECB. In my opinion, the current format of the Dialogue falls short of what is necessary to achieve these goals.

The rest of this paper is structured as follows. In Section 2, I discuss the widening of the ECB's powers that has occurred in recent years and highlight a number of controversial events that have taken place without a sufficient role for public accountability of the ECB. In the light of this discussion, Section 3 focuses on the strengths and weaknesses of the Monetary Dialogue as it currently operates and makes a number of suggestions for how the Dialogue could be improved.

2. THE ECB'S POWERS AND HOW IT USES THEM

This section discusses the new roles the ECB has played in recent years, first focusing on the emergency provision of credit to banks and then on other new tasks.

2.1. The ECB and the Provision of Credit to Banks

Central banks generally implement monetary policy through their interactions with the banking system. For most of its existence, the ECB influenced money market interest rates – the rates at which banks lend to and borrow from each other over short periods of time – by providing alternative liquidity facilities, with the most important being the weekly main refinancing operation. By providing a relevant alternative to private money market transactions, the ECB could largely control the interest rates in these markets.

In recent years, however, the nature of the ECB's interaction with the banking sector has fundamentally changed. Many banks that had previously had complete access to private money markets and longer-term bond markets found this access curtailed. Many of these banks, most notably those in countries undergoing debt crises, found themselves reliant on funding from the ECB to continue operating.

At first viewing, it may appear that the ECB has adopted a clear and transparent policy of widespread support for the European banking system over the past few years. Since late 2008, the Eurosystem has offered a full allotment of credit to banks which has generally meant that banks can borrow as much money as they want provided they have the necessary eligible collateral.

A closer examination of the ECB's relationship with troubled banks shows their policies in this area to be unclear and lacking in accountability. Two areas stand out as repeated sources of controversy:

- The use of the ECB's risk control framework which allows it to deem certain securities and counterparties as ineligible for ECB financing operations.
- The treatment of banks that have requested Eurosystem funding but have run out of standard eligible collateral.

In relation to these two areas, the ECB has taken a series of important discretionary decisions in recent years that have had a huge impact on outcomes across Europe. In general, the processes by which these decisions have been taken and the justification for the relevant actions have not been well explained to the European public.

This isn't the place for a comprehensive documentation of these decisions but I will list a few of them here to give a sense of the wide range of issues involved.

Ireland: ECB officials spent much of 2010 publicly discussing their plans to implement an 'exit strategy' from their fixed-rate full allotment policy. Working against this plan, however, were developments at Ireland's banks. With deposits flowing out, these banks were increasing their dependence on Eurosystem funding and becoming more reliant on Emergency Liquidity Assistance (ELA) programmes. In September 2010, ECB officials including Jean-Claude Trichet began making public statements about their unhappiness with (unnamed) "addict banks" that were reliant on Eurosystem funding.[1]

In November 2010, the ECB played a crucial role in Ireland's application for a bailout from the EU and IMF. As I have discussed elsewhere, there is strong evidence that Jean-Claude Trichet sent a letter to Irish finance minister, Brian Lenihan, on November 12, 2010 and

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1 See for example, the Financial Times article from September 13, 2010 'Fears grow over banks addicted to ECB funding' http://www.ft.com/intl/cms/s/0/580109dc-bf43-11df-a789-00144feab49a.html

that this letter contained suggestions that the ECB would withdraw funding from Irish banks if the government did not apply for assistance from the EU and IMF.[2] The ECB has acknowledged the existence of a letter from Trichet to Lenihan in November 2010 but has refused to release it and also insisted the letter has a different date than that suggested by other evidence.

The ECB also played a key role in the negotiations of Ireland's EU-IMF programme. Though not formally supplying any funds to the Irish government as part of the programme, the ECB influenced its design by insisting, contrary to the advice of the IMF and the preferred approach of the Irish government that all senior bonds of the Irish banks should be repaid in full. It is again likely that the threat of withdrawal of credit to these banks was the key bargaining chip used by the ECB to obtain this outcome.

Greece: A consistent theme of the Greek debt crisis was the ECB's regular threats (either implicit or explicit) to withdraw funding from the Greek banking system and thus trigger a full-scale banking crisis. Greek government bonds were regularly withdrawn and then added again to the eligible collateral list and while they were withdrawn, the Greek banks relied on ELA from the Bank of Greece. These ELA programmes were constantly reviewed by the ECB Governing Council and could be cancelled at short notice if the Council decided. It was this power to threaten the Greek banking system (rather than legal issues relating to monetary financing) that lay behind the ECB's ability to carry through on its refusal to participate in the debt restructuring that took place in 2012.

Cyprus: While the situation with Cyprus's two largest banks became known to the wider European public in March 2013, it was clear to closer observers from early 2012 that these banks were in severe difficulties. Due to ill-advised purchases of Greek government bonds, poorly-timed expansions into the Greek market and a weakening Cypriot economy, both Bank of Cyprus and Laiki Bank were effectively insolvent from early 2012 onwards. Despite this insolvency, however, the ECB approved the provision of large amounts of credit via an ELA programme from the Central Bank of Cyprus. This ELA partly financed fund withdrawals by informed depositors who were aware of difficulties at these banks.

In March 2013, the ECB refused to continue approving ELA programmes unless Cyprus recapitalised its banks via a write-down of customer deposits. The deal that was agreed required that the large amounts of ELA provided to the insolvent banks and deposits at Greek branches of the Cypriot banks be repaid in full: These requirements greatly increased the size of the "haircut" for depositors with the Cypriot banks. Laiki Bank was wound down and the large amount of ELA owed by Laiki Bank was transferred to Bank of Cyprus. While Bank of Cyprus has been restored to solvency, it appears that the ECB wants to place relatively hard limits on the amount Eurosystem funding for this bank and this is a key factor in the continued extension of capital controls that are preventing people from taking their money out of banks in Cyprus (which violates the principle of free movement of capital that is intended to be a pillar of the single European market).

My purpose in providing this list of events is not to argue that the ECB has been mistaken in each of its policy actions (though some are clearly more questionable than others). Instead, my point is just to make clear the large number of highly discretionary and yet highly important decisions ECB officials have made in relation to the provision of credit to banks and to illustrate how these decisions have given the ECB considerable power to influence other events. Since the events detailed above, the ECB has been taken on the role of the single supervisor for the euro area's banks. This will further increase the ability of the ECB to make discretionary decisions about banks that are experiencing difficulties.

[2] See my article for Forbes 'The ECB's Secret Letter to Ireland: Some Questions' http://www.forbes.com/sites/karlwhelan/2012/08/17/the-ecbs-secret-letter-to-ireland-some-questions/

2.2. Bond Purchases, Letters and Discretion

From the earliest days of the euro area crisis in 2010, it has been understood that the ECB's ability to create money to purchase sovereign bonds was a key power that could be invoked to contain the crisis. Thus far, this power has been used in a highly discretionary fashion and in a way that has drawn the ECB into political controversy.

The ECB announced its Securities Market Programme (SMP) in May 2010 but at no point was it made clear what the criteria were by which the ECB would choose to purchase a country's sovereign bonds or how much it was willing to purchase. What did become clear over time, however, was that the ECB was willing to use the powers associated with the SMP to wield influence over fiscal and structural policies of euro area Member States. In particular, letters from Jean-Claude Trichet to the heads of the Italian and Spanish governments in August 2011 recommending a list of specified policy changes were widely seen as linked to the ECB's discretionary support for sovereign bond yields for these countries through SMP purchases. While the details of events of this period are undoubtedly complex, there is a widespread perception that the ECB played a key role in ending the administration of Prime Minister Berlusconi.

The SMP has now been retired and replaced by the Outright Monetary Transactions (OMT) programme. The OMT programme has not yet been activated but, relative to the SMP, there is a slightly greater level of transparency in relation to how such a programme would be activated. In particular, any government wishing to access such a programme would have to negotiate a structural adjustment programme with the European Stabilisation Mechanism (ESM).

Unfortunately, this still leaves a fairly large amount of discretionary "wiggle room" in relation to the conditions under which the ECB will activate OMT. The ECB's official statement on the OMT programme declares ESM conditionality to be a *necessary* requirement for OMT purchases but stops short of stating that is a *sufficient* requirement.

Indeed, recent discussions about Ireland's eligibility for OMT purchases illustrate the significant discretionary element that exists. The original press release on OMT stated that purchases under this programme were possible for Member States "currently under a macroeconomic adjustment programme when they will be regaining bond market access."[3] Ireland in late 2013 satisfied these criteria (it was under an adjustment programme and regaining bond market access) and yet ECB Executive Board members such as Jörg Assmussen stated that the country was not, in fact, eligible for this programme.[4] Thus, it appears that this significant power still resides with the ECB, which can choose to use it in a highly discretionary manner.

[3] This statement is available at http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html

[4] See http://uk.finance.yahoo.com/news/ecbs-asmussen-says-ireland-not-092547854.html

3. ACCOUNTIBILITY VIA THE MONETARY DIALOGUE

Here, I discuss how the current monetary dialogue operates and then make a number of suggestions as to how the process could be improved.

3.1. The ECB Press Conference and the Monetary Dialogue

Given the wide range of hugely important decisions taken by ECB officials, it is important that there be a vigorous and open debate about these decisions, including the opportunity for the public to seek explanations directly from the ECB.

One important way that the ECB is held accountable is via the questions asked by journalists at the monthly press conference following the Governing Council's monetary policy decision-making meetings. These press conferences are an important opportunity for the ECB president to communicate the full rationale behind the decisions taken at these meetings. With the ECB now committed to using "forward guidance" (i.e. providing guidance as to what it expects to do with interest rates in the future) these meeting are perhaps more important than ever for communicating the complexities of monetary policy to the public.

That said, the press conferences are of limited usefulness in shedding light on the many complex issues surrounding the provision of credit to distressed banks, the purchase of sovereign bonds or interactions between monetary policy and banking supervision. Journalists are limited to two questions. The answers from the ECB president are as long or as short as he chooses and there is generally no opportunity for a journalist to follow up if the questions are not fully answered. As a result, when complex issues about the ECB's use of its powers are raised, satisfactory answers are rarely provided.

This leaves the ECB president's appearances at the Monetary Dialogue meetings as a more appropriate forum for holding the ECB accountable in relation to its actions across a wide range of areas. There are a number of positive aspects to these meeting. The current committee has been ably chaired by Sharon Bowles, who has a remarkable grasp of all the relevant technical details relating to monetary policy and banking regulation. The meetings also provide an important and useful opportunity for elected politicians to relate concerns they may have about the ECB's actions directly to its President. Their status as public representatives means there is a greater moral incentive for ECB officials to respond to their concerns than to questions from journalists.

Despite these positive aspects, I believe the current format of the Monetary Dialogue meetings is not well suited to the necessary detailed exploration of the various complex issues that have become important in recent years. After an opening statement from the ECB president, the meetings proceed with a large number of questions (usually over fifteen) from MEPs. As I understand from my attendance in person at the meetings, each MEP is given five minutes in total, including their questions and the ECB president's answer. In general, this gives very little time for follow-up and provides the ECB president with the opportunity to "run down the clock" if he chooses, thus preventing a follow-up. Relative to, for example, US Congressional hearings, the meetings are more "stilted" with less focus and far less interaction.

Perhaps unsurprisingly, given their large number, the questions put to the president during the Dialogue vary widely in content and quality. While many of the questions asked are well-informed and address key issues relating to the ECB's policies, questions that focus on narrow national interests (and thus add little to our understanding of the ECB's role or policies) are also unfortunately common. Overall, my biggest concern is that the Dialogue sessions generally do not allow for a sustained focus on a smaller number of important (and potentially complex) issues.

3.2. Recommendations

Given the substantial increase in the powers exercised by the ECB in recent years and the increasing complexity of the issues involved, I would recommend that the format of the Monetary Dialogue meetings be changed in a number of ways.

First, it would be preferable to have a smaller number of MEPs ask questions in any given session. Again a comparison with US committee hearings is useful. While the politicians that are involved in these hearings are sometimes allocated a specified amount of time for questioning, this time allocation is usually long enough to allow for a satisfactory interaction involving a series of questions, responses and further reaction. In some cases, these hearings often allow for other politicians to become involved by following up on a line of questioning being pursued by another committee member. By cutting down on the number of questions, the nature of the interaction at the committee could be substantially improved. (I would also note that the room the Dialogue takes place in is very large and the questioners are often very far away from the ECB president. A setting that allowed those MEPs designated to ask questions to sit closer and be more engaged with the president would be preferable.)

Second, the dialogue could benefit from themed sub-sessions. For example, the ECB President could be informed that a first group of MEPs will be asking questions on a particular topic and that the sub-session on this topic will run for 45 minutes. The Chair of the committee could take soundings from other committee members, economic advisers and ECB officials on which topics would be appropriate for sessions of this kind. In some cases, it may be helpful for the committee to solicit a briefing paper from experts on a particular topic with this paper containing a number of questions for the ECB. Such a paper could be provided to the ECB president prior to the meeting and could be used as a focus point for discussions at the meeting.

Third, it is my impression that the questions at the Dialogue are co-ordinated in advance with the Chair. I believe the usefulness of the meetings to the European public would be improved if the selected questions focused mainly on topics that relate directly to the ECB’s powers. Committee members are often interested in asking about Mr. Draghi’s opinions on matters such as French fiscal policy, Italian pension systems or the performance of the Irish economy. While they may find his answers on those topics interesting, the time allocated to these discussions crowds out opportunities to focus on more relevant issues.

To conclude, I would like to offer a few words about the role of the Monetary Experts panel. I am almost certainly biased but I believe the briefing papers provided by the panel represent a good investment by the committee. For a comparably small budget, the panel produces a wide range of highly accessible papers on topics of relevance to the committee and to the wider public. In future, perhaps the committee and its staff could consider ways to allow the briefings to achieve a higher public profile. There is a strong public interest in high quality readable material on the European economic policy issues and I think the briefing papers could potentially find a larger audience if promoted in the right way.

Finally, I think the committee would get a greater benefit from its panel of experts if it involved them in designing more focused sessions with the ECB president and perhaps considered altering the format of the interaction so that occasionally panel members provided focused briefing papers of the type described above. Such papers could end with a series of detailed questions that could be addressed to the ECB president during the Monetary Dialogue meetings.

NOTES

European Parliament

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Monetary Dialogue 2009-2014: Looking backward, looking forward

Anne SIBERT

IN-DEPTH ANALYSIS

Abstract

This note describes the forward guidance undertaken by the ECB, the Fed and other central banks and the theory behind it. It describes its limitations and opposing views. It also describes unanticipated negative effects that may be associated with a more general class of central bank announcements. Finally, it discusses the role of the Quarterly Monetary Dialogue in clarifying the intentions of the ECB with respect to forward guidance and its beliefs about the likely outcomes. It also discusses the past efforts of the ECON committee to promote transparency at the ECB through the Quarterly Monetary Dialogue and the prospects for promoting additional transparency – a necessary condition for greater ECB accountability.

CONTENTS

EXECUTIVE SUMMARY

- Since the current crisis began in late 2007 central bank policy rates have been reduced to near zero and unconventional monetary policy measures have been put in place; central bank balance sheets ballooned and their maturity structure lengthened. The latest unconventional monetary policy to be adopted by the Fed, the ECB and other central banks is *forward guidance*.
- Some economists believe that the global economy is stagnating because real interest rates are too high. With a zero lower bound on nominal rates only expected inflation can reduce real rates. There is a view that the central bank can lower both actual and expected real rates, despite being constrained by the zero lower bound, by raising actual and expected inflation through credible commitment to a path of low policy rates that continues even after growth revives.
- It is a widespread view that it would be difficult for central banks to follow through on such a commitment to pursue excess inflation; once recovery begins it is beneficial to raise policy rates and it improves the central bank's reputation for being a credible inflation targeter. Such a policy is not *time consistent* and will, therefore, not be credible.
- Other economists believe that lowering real interest rates will not restore growth or they believe that the current stagnation is not caused by a failure of monetary policy and cannot be cured by monetary policy. An incorrect belief that monetary policy can reverse stagnation causes policy makers to delay making difficult decisions about real economic reforms that might improve matters.
- In general, central bank announcements about the state of the economy or the intentions of the central bank can have unintended consequences in the form of coordinating market participants' beliefs on a socially undesirable outcome.
- The Quarterly Monetary Dialogue should be used as a forum to question the ECB about its intentions with regard to forward guidance. Has the central bank changed its objectives? Has it changed its view of the world? Has it changed its view of the transmission mechanism? What is the theory behind what they are trying to accomplish? Is there any empirical evidence that this unconventional monetary policy is likely to work? If the forward guidance is effective, will the central bank have any incentive to follow through on the policy actions implied by forward guidance.
- From its beginning the ECON committee has used the Quarterly Monetary Dialogue to pressure the ECB to be more transparent. There are signs that the new regime may be more receptive to this than its predecessors. It is to be hoped that the committee will be able to successfully use this opportunity promote a more accountable ECB.

1. INTRODCUTION

The Fed and the ECB initially responded to the financial crises with conventional monetary policy; by December 2008 the federal funds rate had been lowered to 0 – ¼ % and by May 2009 the ECB's refinancing rate was cut to 1 %. With policy rates hovering near the zero lower bound, unconventional monetary policy measures were brought in. Both the Fed and the ECB engaged in aggressive balance sheet expansion, through large-scale outright asset purchases and collateralised lending. The Fed's balance sheet more than quadrupled between August 2007 and November 2011; the Eurosystem's balance sheet nearly tripled between August 2007 and the summer of 2012, although it has since contracted to about twice its pre-crisis size. Unfortunately, this did not have the desired effect; in accordance with the predictions of standard economic theory most of the additional liquidity was parked as depository institutions' deposits at the Fed and as counterparties' deposits at the ECB. The desired stimulative (unanticipated) inflation was not forthcoming. In the hope of flattening the yield curve the maturity structure of the Fed's and ECB's balance sheets was shifted dramatically. Standard economic theory again suggests that this should have no effect and while it is difficult to assess the impact in the absence of a counterfactual scenario, it is unlikely that it has been significant. Still hoping to use monetary policy to achieve further recovery, the Fed and the ECB are now attempting to use announcements known as "forward guidance" to influence inflationary expectations.[1]

The second section in this note considers forward guidance: its use by central banks, the theory behind it and its limitations. The third section considers more generally the benefits and possible dangers of central banks attempting to use announcements to influence expectations. The fourth section considers the role that the Quarterly Monetary Dialogue between the Economics and Monetary Affairs Committee and the President of the ECB could play in clarifying the goals and expected outcomes of the new monetary policy strategy of affecting expectations and beliefs. The fourth section assesses the past and future role of the Quarterly Monetary Dialogue in shaping the ECB's communication strategy.

[1] The Fed and the ECB also engaged in fiscal policies to restore order to dysfunctional markets and to act as a lender of last resort to both illiquid and insolvent institutions. This note, however, is solely concerned with monetary policy.

2. FORWARD GUIDANCE

The first part of this section describes forward guidance in practice. The second part describes it in theory and explains its limitations.

2.1. Forward guidance in practice

Forward guidance is not new; between 1983 and 1999 the FOMC's views about the direction of the future policy path were put to a vote. The Reserve Bank of New Zealand has published its projection of future policy rates since 1997. It was joined by Norges Bank in 2005 and the Swedish Riksbank in 2007. The idea behind this forward guidance was to make monetary policy surprises smaller; to lower the responsiveness of longer-term rates to surprises and to increase the central bank's influence over medium and longer-term rates. There is scant evidence that it was beneficial; Anderson and Hoffman (2009) found that monetary policy decisions were highly predicable and longer-term inflation expectations were well anchored in all three countries – whether or not they published their policy rate projections – and there was only weak evidence that New Zealand's publication of an interest rate path potentially enhanced its leverage over the medium-term structure of interest rates.

Recently, forward guidance has taken the form of announcing that accommodative policies (near-zero policy rates and/or balance sheet expansion) will continue for some time. Since the onset of the crisis the Federal Reserve's FOMC has provided guidance on the likely duration of events. In December 2008 it said that "… weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time". In March 2009 the expression "some time" was replaced with "an extended period". In August 2011 the Fed became more specific, saying that the policy rate would be "exceptionally low until at least … mid 2013". In January and March 2012 the time horizon was extended to late 2014. In September 2012 it became mid 2015. In December 2012 the FOMC announced a state-contingent approach: its exceptionally low target range for the federal funds rate of 0 to ¼ % would continue to be appropriate as long as the unemployment rate was above 6.5 %, inflation between one and two years ahead was projected to be no more than a half a percentage point above the Committee's 2 % longer-run goal and inflation expectations continued to be well anchored. This same forward guidance was repeated every month until Dec 2013 and January 2014 when the Committee added that it is likely that it will be appropriate to maintain the current target range for the federal funds rate well past the time unemployment declines below 6.5 %, especially if projected inflation continues to be below 2 %.

At its 4 July 2013 post-rate-setting press conference the Governing Council of the ECB announced that "the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation is based on the overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics. In the period ahead, we will monitor all incoming information on economic and monetary developments and assess any impact on the outlook for price stability." This forward guidance has been repeated at every meeting since.

2.1. Forward guidance in theory

Unlike the previous announcements of inflation-targeting central banks, the Fed's and the ECB's announcements of a likely future interest rate path is not about gaining or maintaining a reputation for toughness on inflation. In normal times, a promise to commit to a particular contingent policy path is an attempt to gain credibility and to reduce the inflation bias associated with the familiar time-inconsistency problem in monetary policy design when current outcomes depend at least in part on anticipated future policy actions. In the current scenario, a promise to keep rates low, subject to some extent to economic events, is not about rational expectations and the expectations-augmented Philip's curve; it is instead a Keynesian story.

In an old-style Keynesian view, the current real interest rate consistent with full employment is negative and has been since the crisis began. Larry Summers (2013) suggests that, as a result of an (ex ante) global savings glut, the real interest rate consistent with full employment may have fallen to minus 2 or 3 % some time in the middle of the last decade. Given the lower zero bound on the nominal interest rate the real rate has not adjusted. Thus we have large output gaps and unemployment. To restore employment and growth, expected inflation needs to increase. In an old-style Keynesian story, investment is decreasing in the interest rate. If the interest rate could be lowered, investment would increase, increasing output and consumption, which would further increase output and so on. Unfortunately, despite the efforts of monetary policy makers, the necessary expected inflation has not been forthcoming.

Willem Buiter (2013) argues that for most of the world this secular stagnation view is overly pessimistic. Growth in the emerging market economies that account for over 45 % of global GDP is projected (by Citi) to be about 5 % per year for the next five years and growth in the United States is expected to be about 3 % per year for the next three years. In the United Kingdom growth is expected to be over 3 % per year over the next two years. However, the euro area remains at risk of falling close to the output gap, as does Japan.

A new-style Keynesian argument has been made as well. In a conventional intertemporal representative agent model, optimality for the household requires that the proportional change in consumption is a strictly positive function of the difference between the real interest rate and the household's rate of time preference: this is the Keynes-Ramsey condition. The intuition is that an increase in the real interest rate reduces current consumption and increases current saving. The latter effect increases future consumption. Hence the increase in the real interest rate increases the change in consumption. Solving this difference or differential equation forward gives current consumption as a decreasing function of the current and all future real interest rates. Add uncertainty to the model and current consumption becomes a decreasing function of the current real interest rate and the expected path of all future real interest rates. Thus, it is not just the current real interest rate that matters; it is the entire expected path of the real interest rate.

The New Keynesian story is that a negative shock has temporarily dislodged consumption from its long-run trend value. Over time consumption will return to this trend value. If expected real interest rates are expected to be relatively high the shock will be associated with a relatively sharp drop in current consumption and a relatively high proportional growth in consumption as it returns to trend; if expected real interest rates are expected to be relatively low the shock will be associated with a more dampened drop in current consumption and lower expected growth in consumption as it returns to trend. Thus, if expected real interest rates were lower, current consumption would be higher. As noted in the previous paragraph, it is the entire path of real interest rates that matter. Thus in the New Keynesian story, if nominal interest rates are stuck at zero, anything that monetary policy makers can do to make current or *future* expected inflation rise will cause current consumption to increase as well.[2]

A problem with the New Keynesian story is that while the current level of consumption is indeed low, it is not accompanied by high growth in consumption. Dominguez and Shapiro

[2] See Cochrane (2013) for an interpretation and critique of the New Keysian view.

(2013) suggest that this is due to the succession of shocks, notably the lengthy impasse over the US debt ceiling in 2011 and the growing awareness of the magnitude of the EU debt crisis. Alternatively, Cochrane (2013) suggests that the explanation is that we are seeing not just a deviation from trend consumption, but a lowering of trend consumption that that is due to bad economic policies.

In the Keynesian framework, the solution to secular stagnation is for the central bank to somehow increase current or expected future inflation. But, this view of the world is not universal. Some economists argue that decreasing nominal interest rates or keeping them at the zero lower bound for longer would do little to reverse stagnation.[3]

Others argue that monetary policy neither caused nor can fix the recession. Meltzer (2013) comments that, “America’s biggest problems are not liquidity problems. As every economics student learns early on, monetary policy cannot fix problems in the real economy; only policy changes affecting the real economy can.” The two obvious policies that might affect the real economy are expansionary fiscal policy in the form of increased government spending and fundamental economic reform reform of laws, regulations, rules and institutions affecting economic behaviour. The benefits of increased government deficit spending are much debated and there is little empirical evidence one way or the other. However, in a world already excessively burdened with public debt adding more might not be advisable.

Many economists view secular economic stagnation (that is sluggish growth of both potential and actual output rather than a large and negative output gap) as a response to too much regulation, the disincentives of ill-designed social programmes, policy uncertainty and high marginal tax rates. In the United States it may have been worsened by the impasses over the US debt ceiling, the continuing resolutions (risking shutdowns of the federal government) and Obama’s Affordable Care Act that hurt employment growth, as it gives firms an incentive to reduce both the number of workers employed and individual workers’ hours. In Europe it is caused in part by the need of impaired sovereigns and banks to deleverage and the need for reforms of the distortions that make many European countries, especially the southern ones (and including France), unattractive places to do business. It is mitigated by such positive economic reforms as the Single Supervisory Mechanism. An argument against economic reform as a solution to the current stagnation is that the benefits of fundamental policy change are primarily in the future and the costs are upfront. The permanent income hypothesis, however, suggests that the future benefits that increase future output and income should increase current consumption demand and possibly investment demand as well.

It is not costless for central bankers to make a show of policies that are not likely to be effective. By acting as if they can solve the world’s economic problems, monetary policy makers reduce the incentives of other policy makers to undertake politically costly but necessary economic reform. As Rajan (2013) commented, "’What would you have us do when we are the only game in town’, [central bankers] say. But that may well be the problem. When the central banker offers himself as the only game in town, in an environment where politicians – from their own partisan political perspectives - only have choices between the bad and the worse, he becomes the only game in town.”

[3] See Rajan (2013).

3. SHOULD CENTRAL BANKS TRY TO SHAPE EXPECTATIONS?

The current scenario leads to the question, should central banks try to shape expectations by making announcements? In the first subsection I consider forward guidance that is intended to be a public statement of credible commitment; in the second I describe forward guidance that is meant to be a forecast. In the third subsection I briefly note how central bank announcements can sometimes have unintended consequences.

3.1. Odyssean forward guidance

Campbell et al (2012) distinguish between *Delphic* forward guidance, which is merely the central bank's forecast of what it intends to do, and *Odyssean* forward guidance, which is a public statement of commitment. Central banks engage in Odyssean forward guidance to solve their time inconsistency problem.

If a scientist solves an optimal control problem for the optimal state-contingent trajectory for a glider then his optimal plan has the property that at any instant the glider is still in flight it is still optimal to follow that same state-contingent trajectory. This is a consequence of the current location of the glider depending solely on the current and past forces exerted upon it. In contrast if an economic policy maker solves for the optimal state-contingent path of some variable he may later have an incentive to deviate from that path; this is because the existence of forward-looking market participants may imply that the value of the variable being targeted depends not just on the past and the present but upon what the policy maker is expected to do in the future. An example of this is the familiar time-inconsistency problem of monetary policy that leads to a bias toward sub-optimally high inflation. The problem of the policy maker having an incentive to deviate from his optimal plan could be solved if he could find some credible way of binding himself to following the optimal state-contingent policy.

Odyssean forward guidance takes its name from Homer's Odysseus, who – in what may be the first description of a successful commitment device – orders his men to stuff their ears with wax and to tie him to the mast of his ship so that he can hear the sirens sing but will be unable to throw himself into the sea. Unfortunately, as the enforcers of the laws, it is more difficult for policy makers to find commitment devices than it is for the heroes of ancient Greek mythology.

A possible partial commitment device might be a public statement of intent that it is costly to one's reputation to deviate from. To mitigate the temptation to produce excess inflation policy makers might announce a point inflation target. If market participants find this target credible and wages and interest rates are set based upon an expectation of target inflation, it may become optimal to have above-target inflation but policy makers might be deterred be a fear that their reputations would be damaged if they were unable to follow through on their public announcement.

In the current scenario, Krugman (1998, 2013) argues that if real interest rates are too high and nominal interest rates are near their zero lower bound then the solution is for the central bank is increase expected inflation by making a promise to engage in irresponsible monetary policy; that is to announce that it will engage in a monetary expansion that it will not be reversed once prices begin to rise. It is difficult to see, however, why such Odyssean forward guidance would be believed. Once the economy begins to recover, it is hard to believe that central banks would continue to produce inflation that is no longer necessary. For many, doing so would flout their mandate; reneging on their promise would give them credibility for being tough on inflation.

3.2. Forward guidance as misrepresentation and cheap talk

"One peso, one dollar, full stop." (Argentinian President Carlos Menem, 1999)

There may be scenarios where policy makers may know either the current or future state of the economy or their ability and willingness to do something about it with greater accuracy than the private sector.[4] They may want to convey some information to the public, but they may also have an incentive to misrepresent the truth; they may not be fully credible. The markets did not, for example, believe Chancellor of the Exchequer Norman Lamont in 1992 when he assured them that there was not a "scintilla of doubt" about the pound. Nor did they pay any lasting attention to Alan Greenspan's warnings of irrational exuberance in 1996.[5] It is frequently suggested that effective signals must be costly and that talk is cheap. This suggests that when there is a conflict of interest between policy makers and the public, Delphic forward guidance might not be useful as a signal of current or future events. However, this is not necessarily the case. As long as the central bank and the private sector's interests are not too divergent, forward guidance can be an additional tool for monetary policy makers; policy makers might be able to credibly convey imprecise, but useful, information to the private sector.[6]

To see this, consider a scenario where the central bank has private information about the health of the economy or about its willingness and ability to affect it. The public wants to know this information so that it can make the best possible decision. The central bank cares about the public making the right decisions, but perhaps for opportunistic political reasons, it would like the private sector to believe that the economy is doing better than it actually is or that the central bank is more able to improve matters than it actually is. Thus, the central bank and the public have some common interest: the central bank does not want the public to be too imperfectly informed. But, their interests are not perfectly aligned.

If the central bank would like to systematically fool the public into thinking that, say, the health of the economy is better than it actually is, there can be no equilibrium where the central bank provides precise information. If the public believed the central bank was biasing its report upward by some amount, the public would subtract off the amount of the bias in forming its beliefs. But, then the central bank would want to report an even higher figure and the public would subtract even more, and so on.

If the central bank and the public's information are not too imperfectly aligned, there may be an outcome, however, where the central bank can provide useful imprecise information: say, information that suggests that the economy is either doing well or not doing well. The reason that this imprecise "cheap talk" can convey information -- even though there is no exogenous cost to misrepresentation -- is that there is an endogenous cost in the form of the public's reaction. Too extreme a statement, say claiming the economy is doing "well" when it is really doing "not doing well" causes the private sector to take an action that is harmful to the central bank.[7]

3.3. Unintended consequences of central bank announcements

This section presents two highly stylised examples that remind us that central bank attempts to shape beliefs through announcements can have unintended consequences.

The first example concerns bank runs or other forms of speculative attacks such as sudden funding stops for solvent but at-risk-of-illiquidity sovereigns or attacks on fixed exchange rate regimes. In the canonical bank run model individual market participants either choose

[4] The material here and in the next section is derived from Sibert (2008).

[5] The examples are due to Financial Times (2007).

[6] This is based on Crawford and Sobel (1982).

[7] This, too, may be a justification for some forms of constructive ambiguity.

not to run on a bank in the belief that other market participants will not run and the bank is safe or they choose to run in the belief that other market participants will run and the bank will fail. In both cases their beliefs are self-fulfilling. A drawback of this story is that it is difficult to see how either outcome arises; how is it that all market participants are coordinating their beliefs in such a way?

Consider now a stylised description of a more modern version of the tale. If all market participants have only their own noisy and uncorrelated idiosyncratic information about fundamentals then bank runs can happen if the fundamentals are bad enough, but they cannot happen just because of self-fulfilling expectations. Market participants do not have enough information about other agents' information either to launch a coordinated run or to coordinate on refraining from a run. Now suppose that a central bank makes a credible announcement. The announcement may play a similar role in coordinating expectations. Suppose that the central bank has its own information about the state of the economy and suppose that in addition to each private sector agent receiving his own signal that there is a public central bank announcement of its useful information. This signal plays two roles: it provides each private sector agent with additional information and it gives them something to coordinate on.

Extracting policy advice from this is somewhat difficult. It is impossible to say whether the multiple equilibrium outcome with a useful central bank announcement or the unique equilibrium outcome with no central bank announcement is better as we do not have a theory of how likely the different equilibrium outcomes are in scenarios with multiple possible equilibria.

A second example is due to Morris and Shin (2002). In their model informative central bank announcements can make society *worse* off and lower quality central bank announcements can be better than higher quality announcements.

The intuition is similar to that in the previous subsection. In financial markets, if there is no information that is common knowledge, then people will act on the basis of what they know about the fundamentals. But if there is some common knowledge, then people might coordinate on it and ignore their own potentially useful information. An example of this was the announcements of Henry Kaufman, the Solomon Brothers economist who was famous during the 1970s and early 1980s for his interest rate forecasts. In Morris and Shin (2002) market participants may use the central bank's announcements to coordinate and this can be good or bad. By providing useful information the central bank can make the private sector better informed. But, if the private sector has an incentive to coordinate and this coordination is not socially beneficial then the private sector will place too much weight on the central bank's information and too little weight on its own information: the central bank information crowds out the private sector's information. If the second effect dominates the first, the central bank information can be harmful.

While the harmful case in Morris and Shin is probably pathological it serves as a reminder that evaluating the value of announcements is not as straightforward as it might seem. There may be more to ‘constructive ambiguity’, the communication style preferred by many old-style central bankers, including Eddie George of the Bank of England and Alan Greenspan of the Fed.

4. ROLE OF THE QUARTERLY MONETARY DIALOGUE

4.1. The Monetary Dialogue, forward guidance and other announcements

The possible dangers and well as benefits associated with central bank announcements and forward guidance suggest that the topic is one that should be discussed at the Quarterly Dialogue. If a central bank suddenly offers forward guidance where it did not do so before or if it changes the nature of its forward guidance a number of obvious questions arise. Has the central bank changed its objectives? Has it changed its view of the world? Has it changed its view of the monetary transmission mechanism?[8]

In the current scenario it is important for central banks to be clear about whether their forward guidance is intended to be Delphic or Odyssean. If the forward guidance is to be Odyssean a number of clarifications should be made. Is the central bank *really* committing itself to excess inflation in the future in an attempt to lower nominal interest rates in the short term? Does that mean it is planning to violate an inflation mandate? Is it feasible for current members of a monetary policy committee to bind future members to following a particular policy rate path? If a committee votes to commit to a policy rate path are dissenting members later required to vote for the rates specified in the path?[9]

The ECB should be asked to explain clearly what is the economic theory that lies behind exactly what it is that they are trying to accomplish. Is there any empirical evidence that their measures are likely to be effective? If the likely impact of forward guidance is believed to be small and uncertain that should be made clear. Policy makers facing difficult choices about economic reform should not be waiting for monetary policy to restore prosperity.

Two ECB Executive Board members Benôit Cœuré and Peter Praet have provided a detailed description of the ECB's forward guidance that answers some, but not all of the questions that one would like to ask.[10] Cœuré points out that if the ECB's strategy were purely Delphic, then market participants might take it as a negative signal that the ECB knew something that suggested the recovery would be slower than they had thought. He then explains that it is not a promise to keep rates low after recovery occurs because this is not time inconsistent. Finally, he goes on to explain that the purpose is to curb interest rate volatility and to "anchor rate expectations more firmly around a path that ensures the degree of monetary accommodation warranted by the outlook for price stability". Praet emphasizes that the ECB is not changing its strategy, that its forward guidance is "an expression of commitment to [its inflation] objective". It would be useful for the ECON committee to delve further.

Unlike the Fed, the ECB has so far been firm in asserting that it is not going to have specific quantitative trigger points. This has some benefits. Unlike the world of a stylized economic model the real world is high dimensional; it hard to describe, to measure or to verify. It is not obvious that picking out one or a few trigger-point variables as a proxy is useful. It may be especially unappealing to use unemployment as the Fed has done because unemployment may drop below a trigger point because jobs creation has bounced back or because discouraged workers are leaving the work force in droves. On the other hand, a central bank may be more credible when it links its commitment to some readily observable variable. Also unlike the Fed, the ECB has been cagey about how long it intends to keep

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[8] See Buiter (2013) for a discussion of this.

[9] Charlie Bean, the Deputy Governor for Monetary Policy of the Bank of England, explains, "[Our] guidance is intended primarily to clarify our reaction function and thus make policy more effective, rather than to inject additional stimulus by pre-committing to a time-inconsistent 'lower for longer' policy path in the manner of Woodford (2012). While such a time-inconsistent policy may be desirable in theory, in an individualistic committee like ours, with a regular turnover of members, it is not possible to implement a mechanism that would credibly bind future members in the manner required." See Bean (2013).

[10] See Praet (2013) and Cœuré (2013).

rates low; what "an extended period of time" means. It is unclear whether The ECB's fuzzier statements of intent are better or worse than the Fed's. These are issues it might be interesting to discuss in more detail.

As a practical matter, the time allotted to a monetary policy committee to discuss possible policy rates and to vote or otherwise agree upon a particular outcome is relatively short. How is it possible that in the same amount of time, the monetary policy makers at the ECB are now agreeing upon not only the policy rate but also the rather complicated forward guidance? Are we to believe that the entire Governing Council deliberated on the matter and came up with the current policy? Are we also to believe, as asserted by Cœuré, that it was decided unanimously by the Council; that not one of the governors of the 18 National Central Banks and not one of the six Executive Board member disapproved? Or, is monetary policy being made by some subset of the Governing Council prior to meetings and the Governing Council then rubber stamps the proposal? It might be useful if the members of ECON could intensify their attempts to bring transparency to the ECB. One thing the committee might consider is asking each of the members of the Executive Board to testify before or at least to "have a dialogue" with them.

4.2. The Monetary Dialogue and ECB transparency

The ECON committee has long attempted to cajole the ECB into becoming more accountable. At the July 2012 quarterly dialogue Philippe Lamberts continued its efforts by commenting, "The ECB is already the most unaccountable of all the central banks on the planet. You operate totally independently in your day-to-day management and with absolutely no transparency in your non-standard operations." Initially Mario Draghi tried the proof-by-repeated-assertion response that his predecessors were so fond of: "I think we are transparent. I think we are very transparent." But, he then went on to say, "But if you have any suggestions in this connection we stand ready to be even more transparent." Mr. Lamberts then went on to press the President with a follow-up question, asking "will you give us transparency on the LTRO"?[11] While the ECB policy makers continuing and rather disingenuous insistence that the ECB is a model of transparency is frustrating, the exchange at the July 2012 Quarterly dialogue has two positive aspects. The ECON committee seems willing to keep pressing the President on the ECB's lack of transparency – even in this instance to the point of asking an insistent follow-up question – and the President of the ECB asked for suggestions on how transparency might be improved.

At the October 2012 Quarterly Dialogue Derk Jan Eppink asked, "If you look at the maquette of this building [the new ECB headquarters] it is shiny and transparent from the outside. What about transparency from the inside? When are you going to publish the minutes of the meetings of your bank's Governing [Council]?" As usual, Mario Draghi began by extolling the virtues of the ECB, "As regards the minutes … I would not say that the lack of minutes implies a lack of transparency. The ECB is a transparent institution … it is way more transparent than any other central bank in the world." He then tried the Sir Humphrey Appleby approach to disagreeable suggestions, "…it is not an easy thing to do. You cannot really do this tomorrow. It needs to be thought through…". But, then he said, "The bottom line is that we are collectively thinking about this." He went on to say, "Concerning accountability for the new supervisory tasks, as I said at the beginning a greater task means greater accountability … we are 100 % in the hands of the legislators to tell us what standards they would wish…". Thus, it appears that under its new President, the ECB is contemplating the notion of becoming more accountable; the Quarterly Dialogue has surely played a role in this and it appears that the ECON committee and the European Parliament as a whole are being invited to play an even more important role.[12]

[11] See ECON (2012a, pp. 9 – 10).

[12] See ECON (2012b, pp. 10 – 11).

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European Parliament

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Central bank accountability in times of crisis. The Monetary Dialogue: 2009-2014

Stefan COLLIGNON

IN-DEPTH ANALYSIS

Abstract

The Monetary Dialogue between the European Parliament and the ECB is a major factor in assuring the legitimacy of European institutions. This note provides new evidence in the efficiency of the Dialogue for the crisis management and presents the results of a survey conducted among the members of the ECON Committee.

CONTENTS

EXECUTIVE SUMMARY

- The time of the European Parliament's 7th legislative term (2009-2014) was overshadowed by the severe global and European financial crises. This has transformed the conduct and environment for monetary policy. While the ECB is independent and Member States are autonomous, the Monetary Dialogue is one of the few bridges to link monetary policy with other policy considerations and it contributes importantly to the legitimacy of the ECB.
- The European Central Bank is one of the most independent central banks in the world and it has, therefore, a particular responsibility for ensuring transparency and accountability in the conduct of its policies. The note reviews the theoretical arguments for parliamentary accountability, as well as earlier studies of the Monetary Dialogue.
- In the public debate about monetary policy, the European Parliament was hardly as audible as it deserves. While the Monetary Dialogue has often served to clarify the policy stances of the ECB, the Parliament has never taken a well-defined policy stance for Europe or developed a debate about clear-cut policy alternatives. Although questions posed by MEPs are often pertinent, they remain enmeshed in the day-to-day management of the political machine of which the agenda is set by the Council and the Commission. As a consequence, the Monetary Dialogue has served primarily as one of several communication instruments for the ECB.
- One of the major failures during the legislature was the fact that the European Parliament has not questioned the major policy blunder when the ECB raised interest rates prematurely in 2011. However, the quality of exchanges has significantly improved since Mario Draghi became President of the ECB.
- Econometric evidence does not show a stabilizing effect from the Monetary Dialogue during the Euro crisis. With the exception of Italy, yield spreads amplified in all crisis countries in the days after the Monetary Dialogue (or fell less if the general tendency was to reduce them). Volatility increased slightly in Spain and very marginally in Italy. However in Greece, market volatility falls while spreads increase, which means markets are more certain about the risks for Greece as a consequence of the information obtained from the Dialogue.
- The note also reports the opinions of MEPs about the dialogue. Less than two thirds of the members of the ECON Committee have asked questions to the ECB President. In general, the frequency of interventions by MEPs represents the strength of their parliamentary group in the Parliament overall, although ALDE outperforms other groups and S&D underperform. Crisis countries have more than average questions and non-Euro members have also participated actively.
- Most MEPs are aware that the Monetary Dialogue did not improve the crisis management during the crisis, but they consider it useful for themselves and for the citizens they represent. In general, pro-European parties on the centre-right have a good opinion about the Monetary Dialogue, left of centre and anti-European MEPs are more critical.
- MEPs feel well prepared for the exchanges with the ECB, but they feel less informed how parliamentary control is done in other major economies.

INTRODUCTION

As the European Parliament's 7th legislative term is coming to an end, it is time for stock taking. The time of this Parliament (2009-2014) was overshadowed by the severe global and European financial crises. Financial markets were in uproar. Interest rates were cut to the lower bound close to zero and stimulating the economy in the middle of a liquidity trap became a new task. In all major economies of the world, traditional monetary policy had to be supplemented by unconventional approaches. The global crisis was doubled by the Euro crisis, which nearly brought the European currency and even the European integration project close to the point of implosion.

In this context, parliamentary oversight of monetary policy was certainly more justified than ever. In the end the collapse has been avoided and all the evidence points to the European Central Bank (ECB) as the principal actor for salvaging the euro, while Member State governments have often amplified the crisis.

According to standard economic theory, monetary and fiscal policy ought to be coordinated in a crisis of this dimension, but the euro area's institutional architecture was more an obstacle than help for such coordination. Member States and the Council remain in charge of economic and fiscal policies, despite extensive external effects on all citizens in the currency union. Greece is the paradigmatic case that has shown how much damage for all European citizens can be done by uncooperative national policies, but the logic applies to all other Member States, regardless of whether they are small or large.

The European Parliament has played an ambivalent role in this process. It has been a strong ally for the ECB in holding the euro area together, but many of its reports and proposed remedies in the crisis had little or no impact on Member State policies; when it had legislative competences, the Parliament has been able to foster and deepen cooperation, but often it has simply condoned and only marginally modified policies that were proposed by powerful Member States and promoted by the European Commission.

The Committee on Economic and Monetary Affairs has played a particular part in this context, because it is the only forum in the institutional architecture that can hold the ECB accountable. Of course, its responsibilities are much broader than this, but as economic theory has taught for decades, the interaction between monetary, fiscal and other economic policies is crucial for overcoming the crisis. While the ECB is independent and Member States are autonomous, although fiscal policy is constrained by an ever closer net of rules, the Monetary Dialogue (MD) is one of the few bridges to link monetary policy with other policy considerations.

The European Parliament's role for holding the ECB to account is based on article 284(3) of the Treaty on the Functioning of the European Union, which states: "The European Central Bank shall address an annual report on the activities of the ESCB and on the monetary policy of both the previous and current year to the European Parliament, the Council and the Commission, and also to the European Council. The President of the European Central Bank shall present this report to the Council and to the European Parliament, which may hold a general debate on that basis. The President of the European Central Bank and the other members of the Executive Board may, at the request of the European Parliament or on their own initiative, be heard by the competent committees of the European Parliament." The Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Bank reasserts this function. Formally the Monetary Dialogue was set up by the European Parliament's Resolution on "democratic accountability in the third phase of EMU of 4 May 1998" which called for the organisation of a dialogue between the European Parliament and the future ECB on monetary and economic affairs, the framework for which dialogue should be confirmed through a mutual agreement.[1]

Although the Treaty requires only one meeting a year, the Monetary Dialogue takes place quarterly in the form of a meeting between the Committee on Economic and Monetary Affairs (ECON) and the President of the ECB. This frequency exceeds the average appearances by other central banks before their parliaments (Eijfinger and Mujagic 2004). Prior to the meetings of the Dialogue, two subjects are usually identified for discussion and an expert panel is requested to submit notes as background information. During the formal session, the President is first asked to give a short introductory statement and then he replies to the questions from MEPs which do not necessarily stick to the previously identified subjects. Over the years, the time allowed for the initial statement has been shortened in order to give MEPs the opportunity to ask more questions.

Evaluating the impact of the Monetary Dialogue is difficult, because the consequences of a discussion are diffuse and because the ECB is formally independent and does not take any instructions from European or national institutions. Earlier assessments of the Monetary Dialogue have often been critical.[2] Academics have observed lack of forcefulness and insufficient qualification of MEPs; a tendency to talk cross-purpose; the absence of common grounds or concerns between ECB and EP, reinforced by the large size of the ECON; questions have covered less often monetary and more frequently fiscal policy; and on most issues the ECB holds the discursive monopoly. Nevertheless, in their study of previous parliaments, Eijfinger and Mujagic (2004) have observed that in 71 % of the cases the ECB had implemented changes requested by the ECON. Moreover, they claimed that the transmission from the panel of economic experts to ECON was equal to 100 %. No wonder some of their policy recommendations read as if the experts were driving the Monetary Dialogue. Siebert (2005) also finds some evidence that the Economic and Monetary Committee was more successful in influencing monetary policy when it was in line with the expert panel advising it.

Nevertheless, I believe that the experts (including myself!), who are asked to evaluate the Monetary Dialogue, have a tendency to take themselves far too seriously. Economic theories usually have a fairly short life-cycle (10-15 years) and most academic economists run with the herd because that is required to get published. However, as de Grauwe and Gros (2009) nicely demonstrate, following the mainstream is no guarantee that a theory is true. They present a model in which the exclusive focus on price stability and the neglect of financial stability may have been a cause (!) for mistaken monetary policies leading to the financial crisis. My point is not to say all experts got it wrong, but to insist that plurality in expert opinions, challenges of mainstream views, and questioning orthodoxies must be an important part of the process by which the ECB is held to account, especially in a society as diversified as the euro area's. This diversity is, of course, deeply reflected in the European Parliament, and in fact more so here than in any other European institution. It is precisely for this reason that the Monetary Dialogue is important. The need to respond to all the concerns of citizens will anchor the ECB firmly in society, generate a public sphere and increase the acceptability and legitimacy of European institutions.

In the rest of this note, I will quickly review theories why central bank accountability is important, especially during the crisis, and then look at the impact the Monetary Dialogue has had during the 7th Parliament in terms of the quality of the exchanges, econometric evidence and the views MEPs have themselves about the usefulness of the dialogue.

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:51998IP0110:EN:HTML

[2] See: De Grauwe and Gros, 2009; Amtenbrink and Van Duin, 2009; Wyplosz, 2005; Siebert, 2005; Eijfinger and Mujagic 2004; Gros, 2004.

1. THE IMPORTANCE OF ACCOUNTABILITY AND COMMUNICATION IN CENTRAL BANKING

1.1 Accountability and the paradigm of central bank independence

The European Central Bank is one of the most independent central banks in the world and it has, therefore, a particular responsibility for ensuring transparency and accountability in the conduct of its policies. *Noblesse oblige*. Because money is the economy's hard budget constraint, central bank independence is often criticised for imposing constraints on the sovereignty of states and therefore called undemocratic.[3] In principle this argument applies to an independent national central bank as much as to a transnational central bank such as the ECB: if the central bank can refuse to monetise public debt in order to maintain low inflation, the sovereignty of governments is no longer absolute. However, this concept of state sovereignty is pre-democratic. It has overshadowed political conflicts in the 17th and 18th century, but with the Glorious Revolution in England (1688), with the American Revolution (1876) and Constitution (1787), and with the French Revolution (1789), the idea that *states are sovereign* has been replaced by the democratic principle that people, i.e. *the ensemble of all citizens, are the sovereign* who authorises the laws that are applied to citizens themselves. Since then systems of checks and balances have become the widely accepted institutional guarantee that any form of political *power* remains subordinate to the *authority* and sovereignty of citizens.

The euro and the European Central Bank have been created by law, i.e. by the Treaty on European Union and national monetary laws, and the ECB takes decisions that apply to all citizens living in the euro area, with external effects on the European Union as a whole. There is therefore a need for checking the power of the central bank and doing this is the purpose of parliamentary surveillance and the Monetary Dialogue. Yet, a central bank has by definition only a limited technical task as the bank of banks which alone supplies the legal tender currency. The ECB has a clear political mandate for preserving price stability as the first priority and for contributing to financial stability, as well as supporting other economic policies provided price stability is achieved. In order to fulfil this function efficiently, interferences from other institutions ought to be minimised and this is best achieved by making the central bank independent, i.e. not subject to any orders or directives. Nevertheless, as in all instances of delegated tasks, there is always a question whether an agent, in this case the central bank, makes enough efforts to achieve the mandated purposes. It is, therefore, one of the noblest tasks of the European Parliament to hold the European Central Bank to account and check if and how it fulfils its mandate.

The concept of central bank independence has gained prominence in the 1970s and 1980s. After the System of Bretton Woods had collapsed, money was no longer directly or indirectly pegged to gold; it had become pure fiat money, which is based on the trust and confidence of economic agents. Quickly it became clear that without a credible anchor, unconstrained money supply would only generate inflation, thereby undermining the functionality of a monetary economy. In the 1980s it also became increasingly evident that an independent central bank like the German Bundesbank was likely to preserve price stability better than central banks under political control, so that the necessary stabilisation

[3] For example Baimbridge et al. (1999) wrote: „The ECB's problems arise from its lack of democratic accountability, its arbitrary objectives, its outdated economic philosophy, and its potential for intermittent conflict with the national governments whose destinies it possesses considerable influence over. Therefore the ECB as currently constituted is an anti-democratic, economically inept institution. Its lack of accountability, transparency and democratic legitimacy makes clear that no British government concerned for the efficiency of the UK economy and capacity for self-governance could submit to the ECB's monetary authority." Although this statement is 15 years old, and I believe it is factually wrong, it may have more supporters today than ever.

policies had less negative social consequences for employment.[4] Economists developed the theory of institutions as commitment devices and rules that prevent time inconsistency in discretionary policy making (Kydland and Prescott, 1977). Monitoring that the commitments are met was seen as crucial for maintaining the trust in the system. It was argued that when monetary policy had only one primary objective, namely maintaining price stability, the rule was simple and could be monitored easily. Other objectives were subordinated to attaining and keeping low inflation. Economic growth was thought to be determined in the long run by structural factors in the "real", i.e. non-monetary economy and maintaining stable value of money would allow markets to expand and improve employment and welfare. In countries like the United States, where the Fed was given the mandate to pursue two symmetrical objectives, employment and price stability, monetary policy sought to minimise the deviation from the inflation objective and potential long run growth of output (which was again determined by structural factors). This philosophy was expressed in the well-known Taylor Rule and inflation targeting became the widely accepted framework for the conduct of monetary policy, even when central banks focussed primarily on price stability.

The existence of the monetary pillar in the ECB's operating framework indicates that it is not a pure inflation targeter. However, all important central banks in the world, including the ECB, have accepted that justifying and explaining their policies to a democratically elected body and communicating carefully to markets and the broader public was a necessary condition for the effectiveness of their actions, because the transmission of interest rate changes to the real economy was largely dependent on expectations among economic agents.

1.2. The challenges for monetary policy during and after the crisis

With the Financial Crisis in 2007-9 the foundations of this dominant economic theory have been shaken. While the debate about policy objectives used to focus on the short-term trade-off between inflation and unemployment, it has now become obvious that conventional monetary policy must be grounded in financial stability. Focussing on medium term price stability supported by central bank independence, accountability and clear communications was by itself not enough to guarantee financial stability (Vayid, 2013). The source of the financial instability caused by the global financial crisis was the build-up of asset price misalignments (bubbles), which had led to asset overvaluations and persistent debt accumulation. In principle, the ECB could have prevented credit bubbles by controlling monetary and credit aggregates in the monetary pillar of its strategy framework. In reality, it is extremely difficult to detect the early stages of a bubble and in the euro area asset bubbles were localised in some Member States. The ECB has therefore, like all other central banks, given priority to inflation targeting of consumer prices, which excludes asset prices. Nevertheless, one may ask why the Committee on Economic and Monetary Affairs has not pushed the ECB harder to explain the development of asset prices before the crisis. During the 7th Parliament, the Committee did raise the issue during almost every session, but the ECB's answers have remained evasive and were rarely linked to the monetary pillar.

The crisis has generated new challenges for monetary policy. First of all, how should the ECB deal with financial instability? The euro area was slow to seize the full policy implications from the crisis. The European Commission, under pressure from important Member States, persisted with old-fashioned structural policies and imposed austerity as a response to the debt crisis, while financial markets were heading to a meltdown with massive fire sales re-enforcing the dynamics of financial instability. The disaster was only avoided when the ECB explicitly acknowledged that maintaining financial stability was one

[4] The most prominent economic theory behind this claim is the Barro-Gordon Model, which is now taught in most universities and text books around the world. See De Grauwe (2012) for the application to EMU.

of its objectives and President Draghi declared that the ECB would "do whatever it takes to preserve the Euro". In practical terms, the ECB reacted by unconventional policies, namely by providing ample liquidity through the 3-year LTROs, by open market purchases under the SMP, and finally by setting up the Outright Market Transaction (OMT).

Secondly, the crisis has posed questions for the future conduct of monetary policy. Should the ECB address financial imbalances and asset price misalignments pre-emptively (lean against the wind) or rather clean up after they unwind?[5] As Europe is painfully learning now, a lesson Japan had learned already earlier, unwinding imbalances involves extensive and lengthy debt deleveraging, which is associated with persistently weak demand, low growth, rising unemployment and fiscal constraints (Vayid, 2013: 21).

The implications of these developments are still under debate. How should the objective of financial stability be integrated into monetary policy? In the euro area, discussions focus at the moment on the creation of a Banking Union and macro-prudential supervision. These issues will have far-reaching consequences in the future for the conduct of monetary policy in general and for the communication and accountability of monetary policy in particular.[6]

The European Parliament has not been absent to these discussions, but among all the other voices commenting on monetary policy it was hardly as audible as it deserves. While the Monetary Dialogue has often served to clarify the policy stances of the ECB, the Parliament has rarely taken a well-defined policy stance for Europe or developed a debate about clear-cut policy alternatives. Although questions posed by MEPs are often pertinent, they remain enmeshed in the day-to-day management of the political machine of which the agenda is set by the Council and the Commission. As a consequence, the Monetary Dialogue serves primarily as one of several communication instruments for the ECB. But how efficient is this tool?

1.2. Parliamentary scrutiny of central banks

The academic literature distinguishes between central bank transparency and accountability. Transparency is the broader concept. It applies to all forms of communication about the conduct of monetary policy. It includes setting up a coherent strategic and operating framework, the publication of forecasts, sometimes also the publication of internal records on the debates in the policy making bodies. In addition to these structural arrangements, transparency requires the frequent communication to financial markets and the public at large. The ECB does this through its *Monthly Bulletin*, its *Annual Report*, the *Financial Stability Report* and published research, including forecasts, and the frequent speeches by its staff and directors.

Accountability means explaining and justifying policy decisions *ex post*, i.e. by making clear why the ECB did what it did and why the measures taken may or may not have achieved their purpose. However, with unconventional policies, *ex ante* explanations, or forward guidance, have become important areas where transparency and accountability overlap.

[5] According to J. C. Trichet, the ECB anticipates: "Our monetary analysis, which concentrates on the monitoring of money and credit, (…) is a strategic framework that embeds a degree of implicit 'leaning against the wind' of excessive money, credit and asset price growth. Judgement is, of course, necessary in addressing asset price dynamics. The ECB has developed considerable expertise in the analysis of monetary and credit developments and their implications for risks to price stability, which has proved an invaluable asset also throughout the financial crisis." Monetary Dialogue With Mr Jean-Claude Trichet, Brussels, Monday 22 March 2010; http://www.europarl.europa.eu/committees/en/econ/home.html

[6] Vayid (2013: 1) writes: „Since the global financial crisis, there has been nothing short of a 'revolution' in the use of central bank communications as a distinct policy tool under the unconventional monetary policies. Furthermore, with many central banks now playing a role in promoting financial stability, questions about the extent of transparency in communication on financial risks and vulnerabilities have also been the focus of attention and debate." However, Carréa et al. (2011) are uncertain whether the paradigm shift is permanent or temporary.

This generates new demands on the Monetary Dialogue. Accountability for central banks is always towards democratically elected representatives, either parliaments or governments. Stasavage (2003) has studied the arrangements in 44 countries and found 32 had a specific requirement for central bank officials to testify before a national parliament on a regular basis. However, in some countries there were also provisions for governments to override central bank decisions. The literature has emphasised that transparency and accountability might improve the efficiency of monetary policy although it has been argued as well that if accountability includes the possibility of overriding the central bank, it might be counterproductive. This is why the ECB has been given both instrument and goal independence, which means it can determine the quantitative benchmarks for the realisation of its primary objective as well has the instruments by which it can achieve them.

How strong is the impact of transparency on the efficiency of monetary policy? Stasavage (2003) has estimated the relation between transparency, accountability and the cost of disinflation. He found significant effects for the reduction of these social welfare costs with respect to forecast transparency, the possibility of governments overriding central banks and wage coordination. However, most interestingly, reporting to the legislature was always statistically insignificant and had a positive cost-increasing sign in high income OECD countries. This result ought to encourage modesty and keep us from exaggerating the role of the Monetary Dialogue of European Parliament. Transparency might be more important than accountability in the narrow sense.

However, the European Parliament may also be a driver in making the ECB more transparent. In the past, it has demanded and obtained the publication of forecasts; more recently President Mario Draghi has considered the option of publishing the minutes of discussions in the Governing Council.[7] However, in the future – and that will be a major task for the next Parliament – communicating and clarifying a convincing exit strategy from unconventional monetary policies without creating further instability in financial markets will be the greatest challenge.

[7] http://www.sueddeutsche.de/wirtschaft/ezb-praesident-draghi-will-geheime-ezb-protokolle-veroeffentlichen-1.1734972

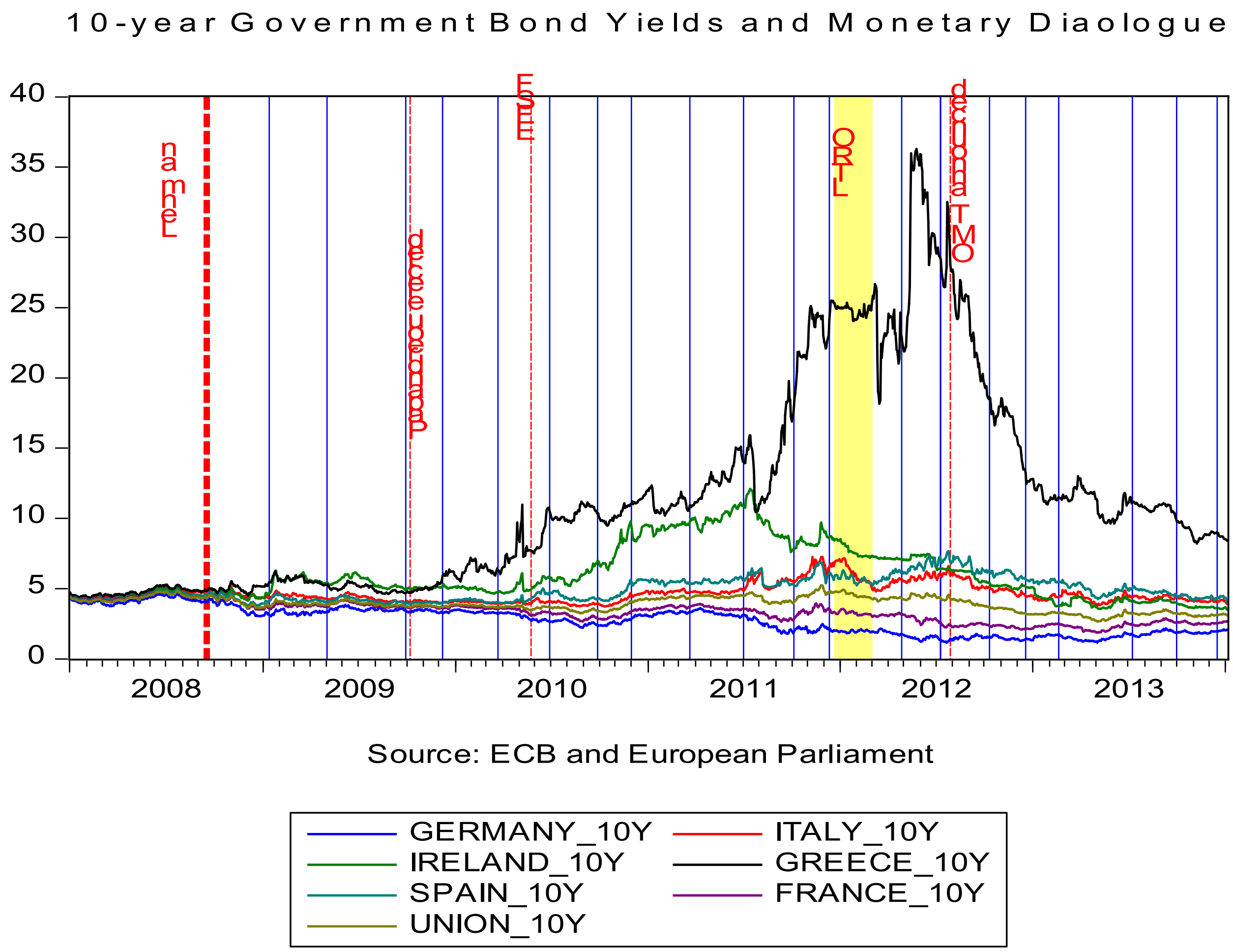
2. THE IMPACT OF THE MONETARY DIALOGUE

Has the Monetary Dialogue made a difference during the Euro crisis? Figure 1 shows the yields on 10-year government bonds for some selected Euro Member States. The widening spread relative to Germany (lowest line) is an indicator for the evolution of the crisis.[8] Interest rate spreads are most dramatic for Greece, but it is clear that Italy and Spain were also increasingly affected.

The blue vertical lines indicate days at which the Monetary Dialogue took place during the 7th legislative term of the European Parliament. Important monetary policy events have often occurred between these dates. Thus, the appearance of the ECB President before the Committee could have been an opportunity to either prepare the MEPs for the next step in the unfolding drama, or to justify decisions taken after the event.

In this section, I will first make some observations about the style and content of the exchanges of opinion and then present some econometric evidence for the impact of the Monetary Dialogue. In the third section I will present the views members of the ECON Committee have about the Monetary Dialogue.

Figure 1: 10-year Government Bond Yields and Monetary Dialogue



[8] The chart also shows the yields for a weighted average, which I have called Union Bonds in the past. See Collignon, 2011.

2.1. Style and content of the dialogue

The 7th Parliament has covered the full unfolding of the Euro crisis. During its term, the Monetary Dialogue has taken place 20 times. Initially, the ECB was represented by President Jean-Claude Trichet, after 1 November 2011 by Mario Draghi. Thus, this Parliament has seen many transformations of monetary policy and its environment and that would have justified thorough scrutiny.

The style of interactions has changed significantly during the five year period. In the early days, MEPs asked Mr Trichet questions in a somewhat submissive fashion, to which he replied in the broadest possible way. Dwyer and Clarida (2012: 38) have argued that this was a deliberate policy: "The ECB realised that keeping a certain level of opaqueness allows more flexibility and credibility in non-standard measures, especially since the ECB does not want to expose itself to speculative attacks". MEPs seemed to go along with this philosophy. However, at the later stages of the crisis it became clear that markets needed clarity and guidance, not opacity. By 2013, the Parliament's exchanges with Mr Draghi had become the expression of an emancipated working relationship, where clearly everyone was a partner trying to solve the euro area's problems, even if in different roles.

Some of the subjects under discussion re-appeared in every session: growth, price stability (in this order), fiscal policy, internal and external competitiveness, financial and macro prudential supervision. Others clearly gained prominence with the intensification of the crisis: liquidity provision and yield spreads; institutional innovations (EFSF, ESM, Fiscal Compact, SMP, LTRO, OMT), even constitutional issues (van Rompuy Report, exit from the euro area), and of course austerity. While the discussions with President Trichet covered broad macroeconomic issues and remained more superficial, the Dialogue with President Draghi has become more operational and technical. Trichet frequently stopped technical questions by referring to the ECB's mandate; Draghi is willing to answer even hypothetical questions as this example shows: "I still claim that our LTROs have been quite timely and, all in all, successful. If the only thing we have achieved is buying time – and it is not the only thing – that would in itself be an extraordinary success. Think about what could have happened: EUR 230 billion-plus of bank bonds due in the first three months of this year and more than that in sovereign funding due, and markets completely closed. We avoided that."[9]

However, if the purpose of the Monetary Dialogue is to hold the ECB to account, there have been some spectacular mishaps.

On 9 March 2009[10] (the last session of the previous Parliament), the global financial crisis had already thrown the world into its deepest recession since World War II,[11] but the ECB President and MEPs still seemed to be in relatively optimistic mood, believing in the euro area's resilience after the earlier important interest rate cuts. Nevertheless, Trichet already pointed at three subjects, which were to dominate the next five years: asset price dynamics, mainly in the housing market, internal macroeconomic imbalances, and the need for macro prudential supervision. John Purvis (PPE), who did not return to the next Parliament, asked the pertinent question whether there was a contingency plan "in case one of the Member States really got into very substantial difficulties and was unable to fund its public debt?" Trichet replied; "it is absolutely absurd to imagine that one member country of the euro area could be in a situation which would create a problem for the euro

9 Monetary Dialogue With Mario Draghi, Brussels, Wednesday, 25 April 2012; http://www.europarl.europa.eu/committees/en/econ/home.html

10 Monetary Dialogue With Mr Jean-Claude Trichet, Brussels, Monday 30 March 2009; http://www.europarl.europa.eu/committees/en/econ/home.html

11 On 22 March 2010, Trichet even ventured to say: "we have had to cope with the worst crisis since World War II, perhaps even potentially the worst crisis since World War I."

area as a whole." One year later, he had to admit: "It is true that the simple fact that a country that only represents 2.5 % of the euro area's gross domestic product – in other words a tiny fraction of the euro area – has an influence on the whole of the euro area that is visible and perceptible to all of our fellow citizens is precisely a way of realising that we do indeed share a common destiny and that all of us therefore – I am talking of the governments here – are justified in exercising this common responsibility, this collective responsibility which is essential."[12] No MEP asked Trichet why he had come to the new conclusion. Maybe it was too obvious in the changed environment, but the incidence shows that mistakes in assessment are often shared by the scrutinised as well as by the scrutiniser.

Another example for insufficient scrutiny is what may actually be the biggest blunder in the short history of the ECB. On 7 April 2011, the Governing Board increased its policy interest rate by 25 basis points, because inflation had shot up above the 2 % target and economic growth had been forecasted between 1.5 % and 2.3 %. Speaking to MEPs, Trichet justified the decision by saying that the Governing Council "sees the monetary policy stance as still accommodative".[13] At the same time he supported fiscal consolidation and the reduction of public borrowing. Not surprisingly in the fragile environment, demand collapsed after the usual 2-quarter lag and the euro area fell again into recession, while in the USA growth was sustained at a moderate level. See Figure 2. The amazing fact is that at the first Monetary Dialogue after the rate hike, on 20 June, not even one MEP questioned or criticised the interest decision. Instead, MEPs kept riding their hobby horses on rating agencies and talking of constitutional quantum leaps.[14] Admittedly, with hindsight one is always smarter.[15] But the case is an interesting example for how little accountability the ECB can get away with in the context of the Monetary Dialogue with the European Parliament. When the ECB corrected the mistake a few month later, President Draghi was not challenged either. However, the President of the ECB explained clearly the purpose of unconventional monetary policies, of which "the first objective is to help restore the credit process for households and for small and medium-sized companies, because that is where we have to work to avoid an even more significant weakening in growth than we have already had". Thus, unconventional policies were different from other central banks like in the USA or the UK, because "banks represent 80 % of the lending to the euro area."[16]

It is, however, true that Draghi responded to certain policy concerns previously expressed by members of the Parliament with regards to the ECB's mandate. In July 2012 he said: "Our monetary analysis gives a picture consistent with price stability over the medium term – and remember, whenever I say 'price stability' I mean price stability in both directions, upwards and downwards."[17] He also acknowledged criticism of austerity: "There is no trade-off between austerity and growth. Austerity creates a short-term contraction. We cannot dispute this. Austerity creates a short-term contraction, but we should ask the

[12] Monetary Dialogue With Mr Jean-Claude Trichet, Brussels, Monday 22 March 2010; http://www.europarl.europa.eu/committees/en/econ/home.html

[13] Monetary Dialogue With Mr Jean-Claude Trichet, Brussels, Thursday 30 June 2011; http://www.europarl.europa.eu/committees/en/econ/home.html

[14] See Monetary Dialogue With Mr Jean-Claude Trichet, Brussels, Thursday 30 June 2011; http://www.europarl.europa.eu/committees/en/econ/home.html

[15] I remember defending the ECB decision myself.

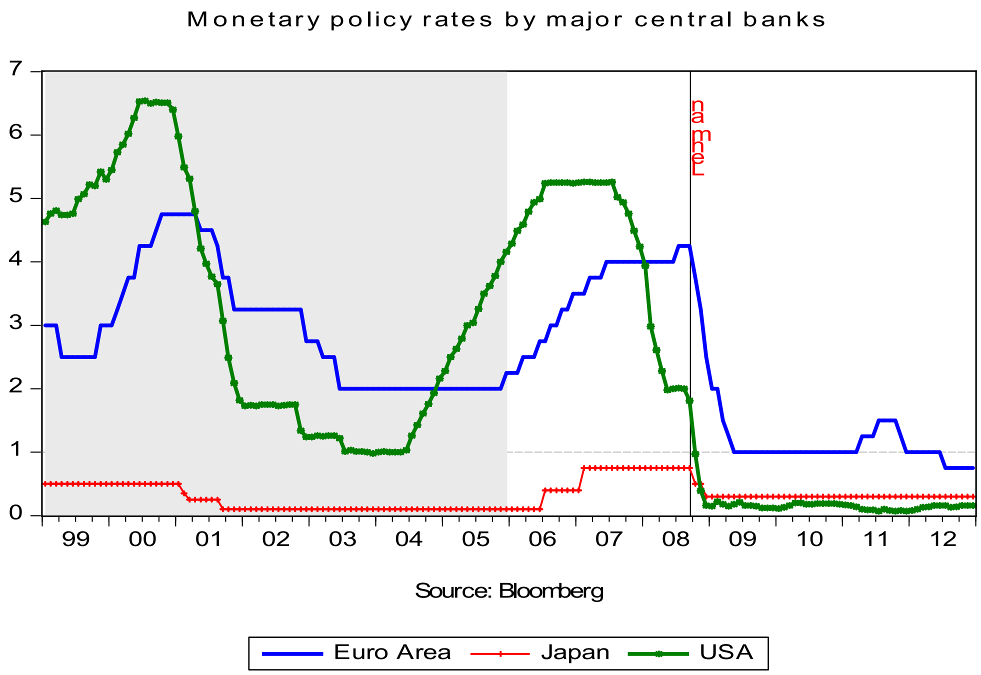
[16] See Monetary Dialogue With Mr Mario Draghi, Brussels, Monday 19 December 2011; http://www.europarl.europa.eu/committees/en/econ/home.html

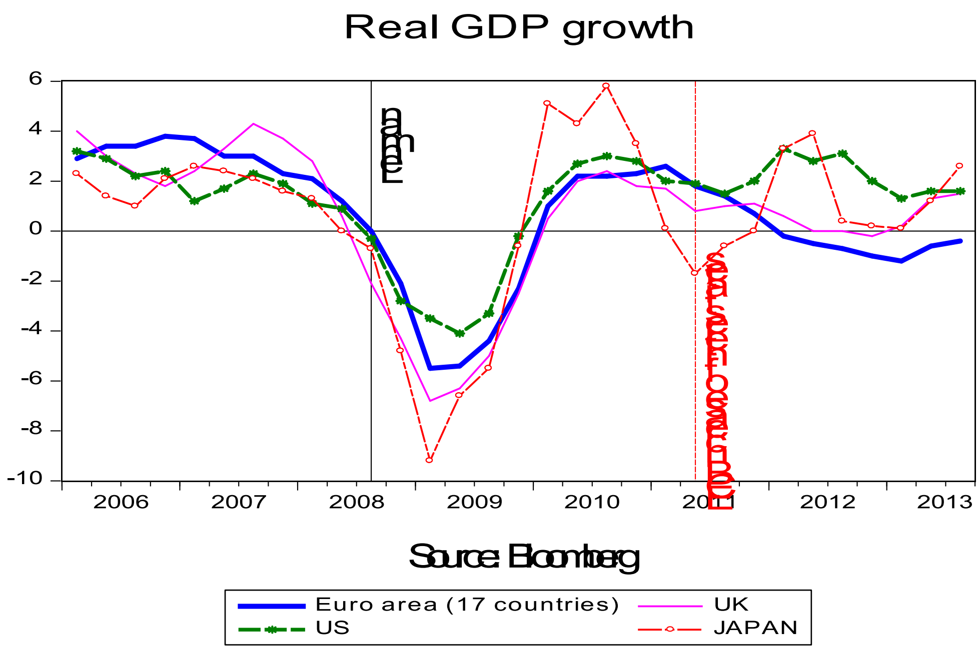
[17] See Monetary Dialogue With Mr Mario Draghi, Brussels, Monday 9 July 2012; http://www.europarl.europa.eu/committees/en/econ/home.html

question: is this avoidable? Was the previous situation sustainable? Basically there was no choice."[18]

In summary, reading the protocols from the Monetary Dialogue conveys a sense of progress towards a clearer way of communicating by the ECB and more pertinent questions by MEPs. One ought to hope that the next Parliament will take up the relay.

Figure 2: Monetary Policy rates by major central banks and real GDP growth





[18] See Monetary Dialogue With Mr Mario Draghi, Brussels, Monday 19 December 2011; http://www.europarl.europa.eu/committees/en/econ/home.html

2.2. Econometric evidence

The previous section has referred to some salient exchanges between MEPs and the President of the ECB that may elucidate certain features and patterns in the Monetary Dialogue, but to see how the process has worked, we need a more thorough assessment of its impact during the life of the 7th Parliament. In accordance with the academic literature, we hypothesise that the transparency and accountability of monetary policy would reduce the cost of economic adjustment in the crisis. The mechanism through which these beneficial effects would come about is a clearer understanding by financial markets of the macroeconomic environment and the generation of more reliable expectations. This could be interpreted as a form of "output legitimacy", because more efficiency in the conduct of monetary policy may increase the acceptance of the institution.[19]

This hypothesis can be formally tested. The alternative hypothesis would be that some forms of communication may at times raise volatility and uncertainty. I mentioned already that Stasavage (2003) has estimated a positive but insignificant sign for the impact of parliamentary accountability on the cost of adjustment. Born et al. (2012) found that while the Financial Stability Report tends to reduce volatility in financial markets, speeches and interviews increase volatility and uncertainty. Collignon, Esposito and Lierse (2013) confirmed that speeches by the German Chancellor Merkel have increased uncertainty during the crisis and pushed up the spreads for Greek bond yields. In that case, the value of the Monetary Dialogue would be the generation of "input legitimacy", namely by the fact that a debate among and with the elected representatives of citizens takes place and thereby satisfies the conditions of democratic control and scrutiny.

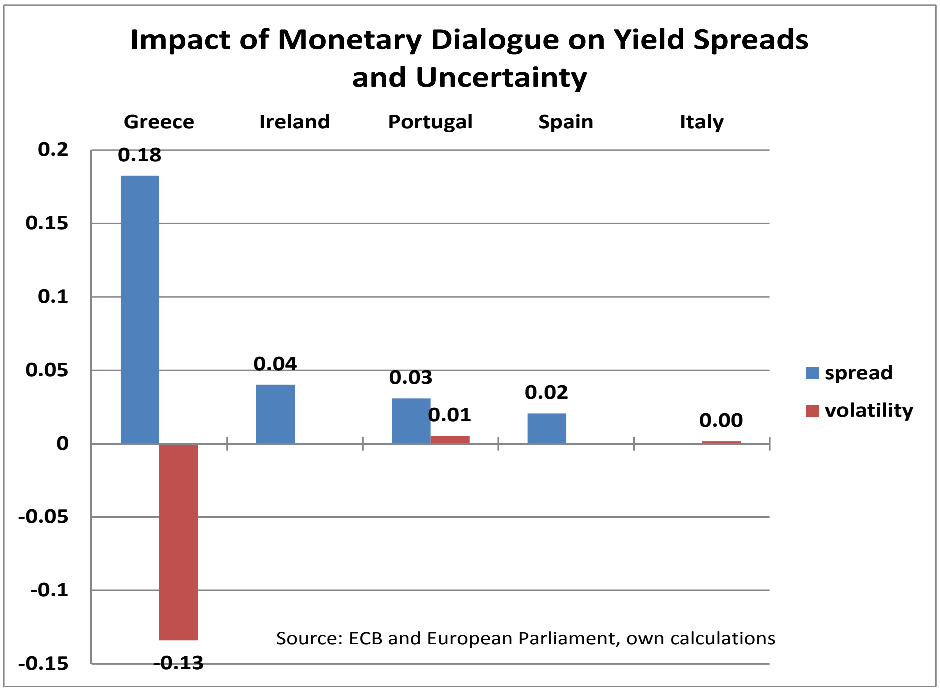
In order to find out whether the Monetary Dialogue has had a stabilising effect in the Euro crisis, I have estimated a Garch model for changes in bond yield spreads of crisis countries on a dummy variable where the day of the Monetary Dialogue takes the value 1 and 0 for all other days. Ideally we would expect that in the day(s) after the Monetary Dialogue the volatility in yield spreads is reduced and spreads come down or at least their increases slow down. At least we would hope to see that volatility and uncertainty decrease. Unfortunately, our results are not confirming the hypothesis of a stabilising effect. The econometric output is available upon request from the author. Figure 3 summarises the information in a chart that shows the aggregate effects over three days on the rate of change of spreads and on the volatility in the bond market.

With the exception of Italy, yield spreads increased more rapidly in all crisis countries after the Monetary Dialogue. If the general tendency was for spreads to fall, say because financial markets felt reassured by OMT, the monetary dialogue slowed down this reduction. Volatility increased slightly in Spain and very marginally in Italy. However, in Greece market volatility fell while spreads increased more rapidly, which means markets were more certain about the risks for Greece as a consequence of the information obtained from the Dialogue. This is odd. Admittedly, the econometric estimates are not very robust and might yield better results if we added a full-fledged economic model, but our results are consistent with the findings by Stasavage (2003), Born et al. (2012) and Collignon et al. (2013) who all found that statements by public authorities rarely calm markets. Actions do. The ECB has helped to overcome the crisis by flooding banks with liquidity and setting up formal mechanisms for intervening in the markets.

The implication of this result is that the Monetary Dialogue is less an instrument for generating output legitimacy, but essentially contributes to input legitimacy.

[19] This distinction between output and input legitimacy was made by Scharpf (1999).

Figure 3: Impact of Monetary Dialogue eon Yield Spreads and Uncertainty



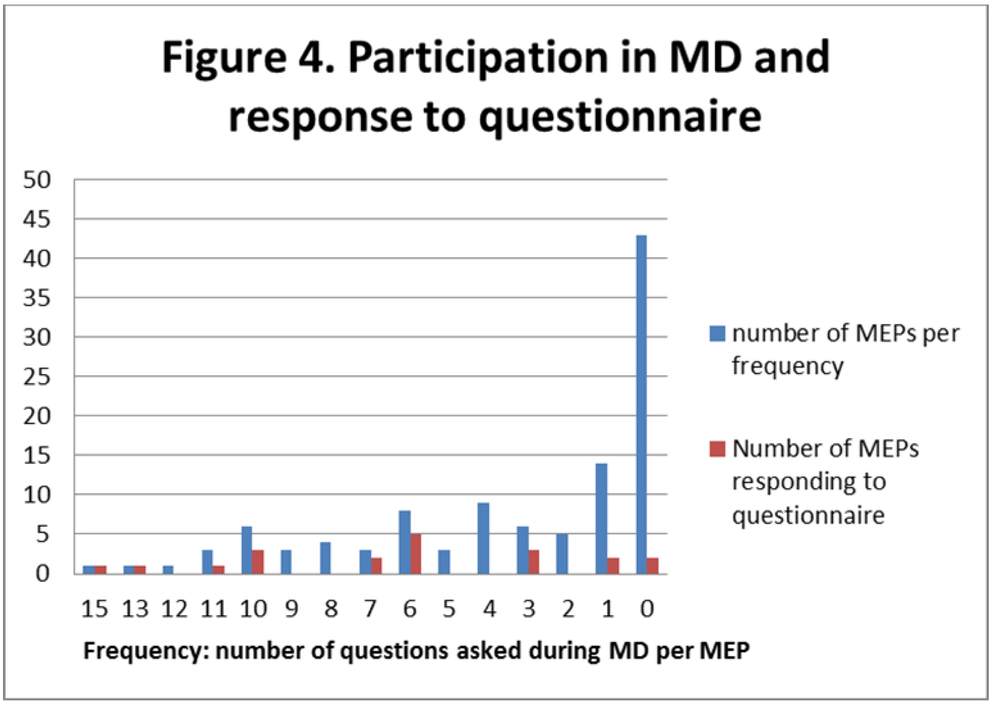
2.3. How MEPs see the Monetary Dialogue

Accountability is a two-way story. While the European Parliament takes the ECB to account, electors will take the Parliament to account. This section reports the performance of the members of ECON during the 7th Parliament and presents the answers to a questionnaire submitted to all members of the ECN Committee inquiring how they assess the Dialogue themselves.

The Committee on Economic and Monetary Affairs has 99 members, of which 43 have never asked a question during the 5-year term of the Parliament. With respect to those who have participated, the average number of questions per session asked by MEPs was 22.5. Sylvie Goulard was the most active member in the Dialogue with 15 questions, followed by Jean-Paul Gauzès (13 questions), Sharon Bowles (12) and Philippe Lamberts (11) and Elisa Ferreira (10). In general, the frequency of interventions by MEPs represents the strength of their parliamentary group in the Parliament overall, although ALDE outperforms other groups and S&D underperforms. The statistical output is available upon request from the author.

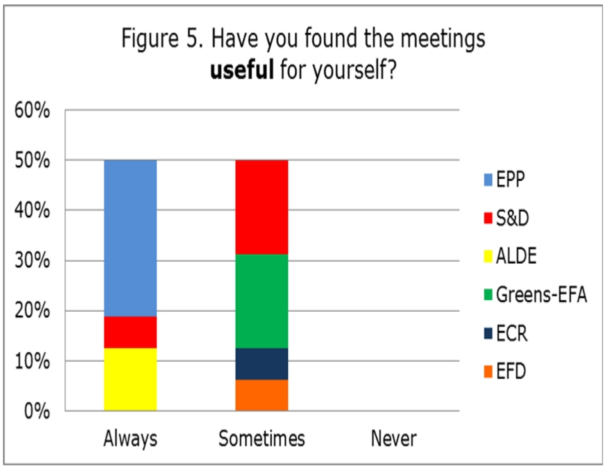
The ECON Committee is made up of 67 % euro area and 32 % of non-euro area MEPs. Members from the euro area have asked 79 % of all questions addressed to the ECB President. Representatives from Germany, France and Spain are the most active participants in the Dialogue. Members from Greece, Ireland and Luxemburg also participated more than their overall weight in the Parliament or the ECON would reflect. Presumably the interest is higher when the country one represents is subject to policy control by the Troika. MEPs from Italy, the Netherlands and Finland have participated least in the Dialogue relative to the number of seats they have in ECON.

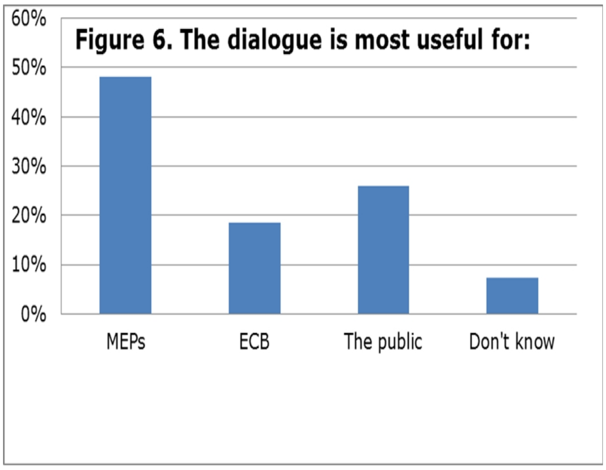
Out of the 99 members, 20 have responded to our questionnaire. Figure 4 shows the frequency of questions asked by individual MEPs over the 7th Parliament. On the horizontal axis we report the number of questions asked by one MEP ("frequency"); on the vertical axis we show how many MEPs have asked a given number of questions and how many of them have responded to our questionnaire. We consider that this is a reasonably equal distribution, which allows making general conclusions.



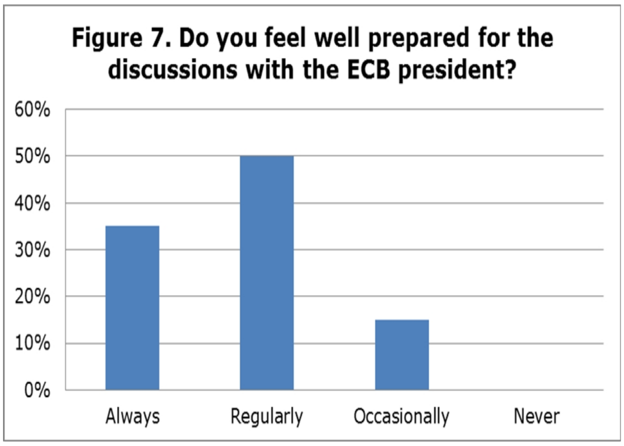
The results from our questionnaire show the following opinions from members of ECON.

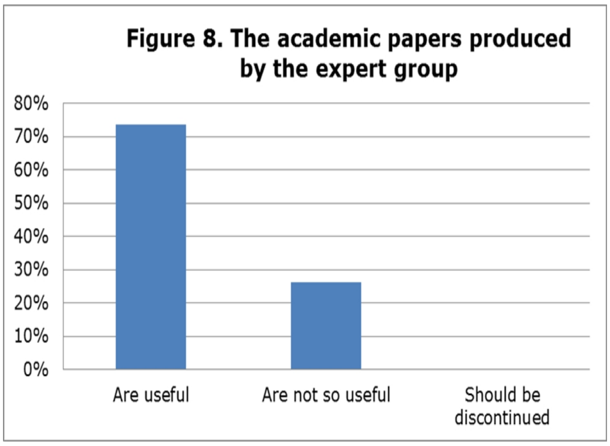
Most MEPs (75 %) say they participate regularly or always in Dialogue and so do 85 % of their staff. 85 % of MEPs find the Monetary Dialogue (at least sometimes) useful for themselves (48 %), for the general public (26 %), and for the ECB (19 %). Broadly, the picture is that pro-European parties on the right of center find the Monetary Dialogue more useful than parties on the left and Eurosceptics. See Figure 5 and 6.



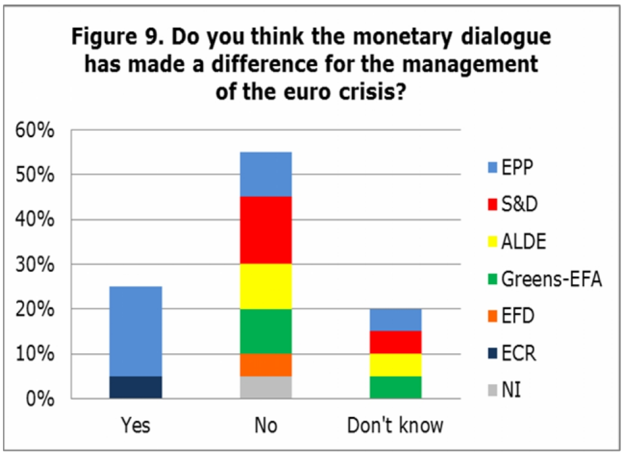


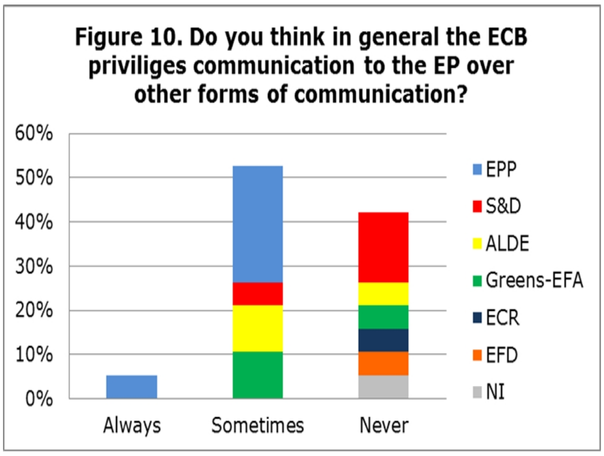
85 % feel always (35 %) or regularly (50 %) well prepared for the dialogue. 74 % find the academic papers produced by the expert group useful. Figure 7 and 8.

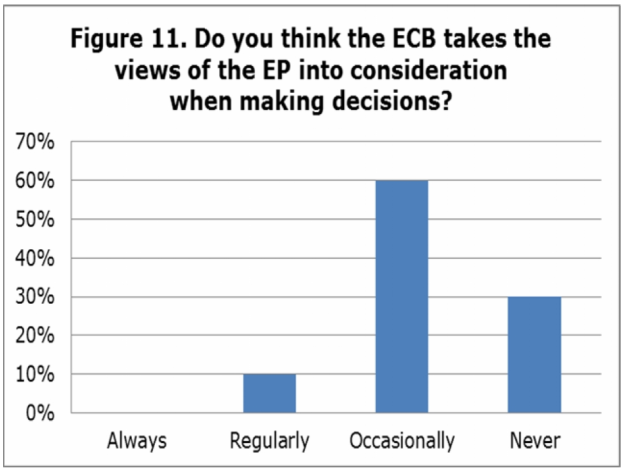


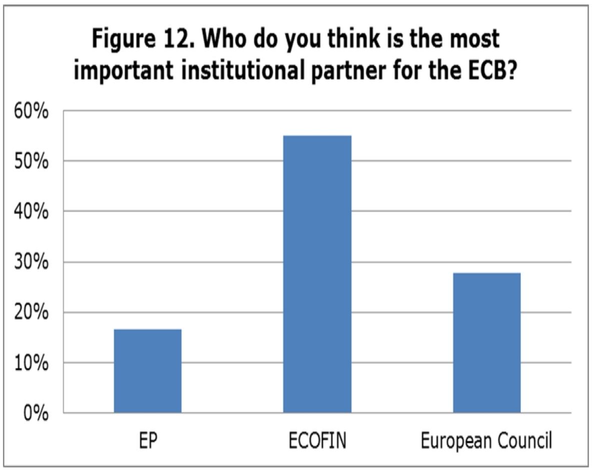


However, most MEPs (55 %) think the Dialogue has had no impact on the management of the crisis and most feel the ECB rarely privileges the EP over other institutions. The ECB is also not trusted to take the opinions of MEPs into consideration when making decisions. 55 % think ECOFIN is the most important partner of ECB (EP: 17 %, European Council: 28 %). See Figures 9-12.

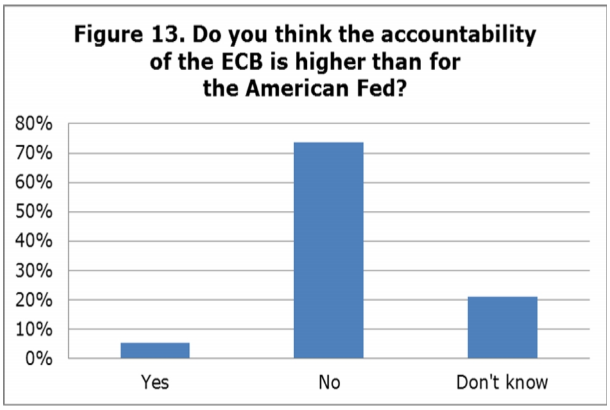


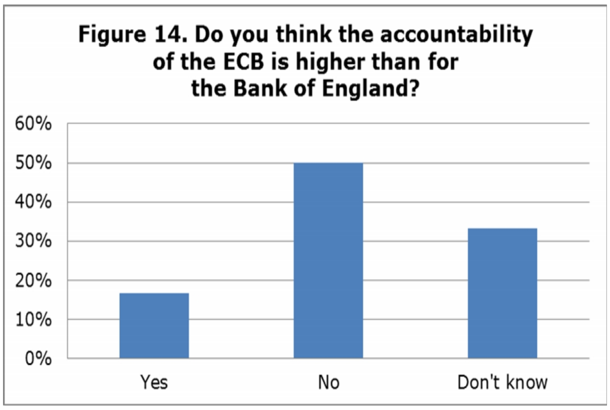


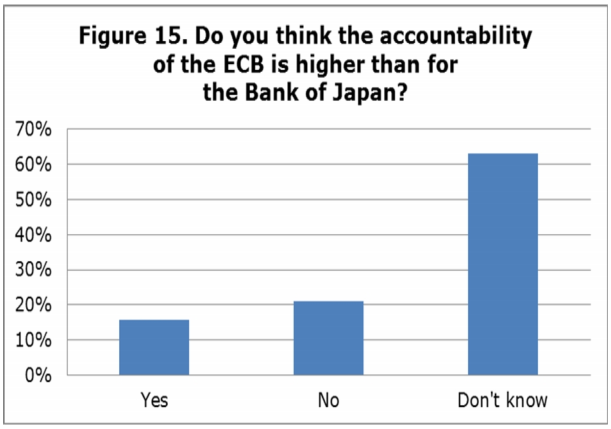




Although all MEPs have responded that Central Bank Independence is "a good thing", only 55 % think ECB's transparency is adequate; 70 % want it to publish internal minutes. Most MEPs feel ECB is less accountable than the American FED (74 %) or the Bank of England, but in general MEPs are not well informed about democratic accountability in the most important euro area partner countries. See Figures 13-15. Half of the responding MEPs think that media coverage of the Monetary Dialogue is insufficient.







3. CONCLUSION

The accountability of an independent central bank is important, but probably less for reasons of policy efficiency than for reasons of democratic legitimacy. Hence, the Monetary Dialogue is and remains an essential pillar of the institutional architecture of European Monetary Union. Our study has shown that yield spreads in most crisis countries of the euro area have increased in the days after the Dialogue, and MEPs correctly feel that the Dialogue did not make a big difference for the management of the Euro crisis. However, they do appreciate its role for informing themselves and the European public, even if they wish an improvement of media coverage.

Not all members of the ECON Committee participate in the Monetary Dialogue, but those who do feel well informed and prepared for their exchanges with the President of the ECB. The quality of these exchanges has continuously improved over time. Pro-European and centre-right MEPs view the Dialogue generally more positively than those of the left and Eurosceptics. However, the personal commitment by some individual MEPs has been crucial for the high quality of the exchanges.

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DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Monetary Dialogue 2009-2014: Looking backward, looking forward

Ansgar BELKE

IN-DEPTH ANALYSIS

Abstract

This briefing paper comments on the role the Monetary Dialogue in the context of an evolving monetary policy. The discussion is conducted in terms of the adoption of forward guidance on interest rates by the European Central Bank (ECB), the ECB's model choice and data revision policies in inflation forecasts, its membership in the Troika, its activities as a financial supervisor, as well as regards its bond purchasing activities and the implication for ECB monetary policy stemming from Fed's envisaged exit from unconventional monetary policies.

The briefing also assesses on a case-by-case basis the actual exchange of information between the European Parliament and the ECB. We argue that the new ECB supervisory role has made the Monetary Dialogue exercise even more important "now" than in "normal" times. Still, we suggest changes, both procedural as well as regarding its focus range, to make it even more effective. In our view, the transparency/accountability issue represented by a Supervisory Board 'hosted' by ECB needs to be addressed. A crucial challenge for the Monetary Dialogue is also to assess the optimal degree of ECB transparency and accountability towards the EP, the key democratic institution.

CONTENTS

EXECUTIVE SUMMARY

This Briefing paper comments on the role the Monetary Dialogue in the context of an evolving monetary policy. This is conducted in terms of the ECB's adoption of forward guidance on interest rates, the ECB's model choice and data revision policies in inflation forecasts, its membership in the Troika, its activities as a financial supervisor, its bond buying activities and its role in the Fed's envisaged exit from unconventional monetary policies. The briefing assesses on a case-by-case basis the actual activity of information exchange between the EP and the ECB and elaborates on how to improve the Monetary Dialogue exercise, taking into account also the ECB's communication strategy.

The Briefing paper first discusses the arguments in favour of more ECB transparency. It then compares the effectiveness of publishing the minutes with reference to the new ECB voting model, i.e. the so-called rotation model which may be soon adopted. The Briefing also describes why a lack of ECB transparency may actually improve the design of the Monetary Dialogue. For this end, the current framework for the Monetary Dialogue and its potential changes are discussed in terms of the ECB's new "forward guidance" communication strategy, the transparency of data revisions and the choice of the underlying macroeconomic model.

The Briefing paper also elaborates on how accountable shall the ECB towards the EP. The need for increasing ECB's transparency and accountability stems from its new supervisory roles. Given their importance, they are emphasised separately. The paper finally discusses issues related to the limits to transparency and communication.

As a whole, the arguments presented give overwhelming support for the Monetary Dialogue's efforts to enhance ECB transparency. In theory, however, it is not clear how far this process should go as the "optimum degree of the ECB's secrecy" is different from zero. This poses an operational problem for the Monetary Dialogue, yet to be solved.

This view is supported also from a policy cycle perspective. Full accountability to and "democratic control" through the EP may conflict with the central bank's policy and instrument independence. Policy independence may be endangered as soon as groups of different political or ideological orientation in the EP pressure for the adoption of specific macroeconomic models or even specific monetary policy measures. Instrument independence may be hampered by the fact that policy tools such as the ECB's sovereign bond purchases may be effective only when they are not anticipated. Because the Monetary Dialogue would lose its social value is ECB's independence is threatened, Monetary Panel experts shall warn as early as possible about the danger of such negative feedback.

While recognising that current times are far from 'normal', we argue that the Monetary Dialogue is even more important "now" than in "normal" times. Still, we suggest changes regarding both design and focus range of the Monetary Dialogue to make it more effective. In this context, the (new) supervisory role of the ECB should also be carefully scrutinized. Overall, the real challenge is to find out the optimal degree of transparency and accountability within the current institutional framework for the Monetary Dialogue.

1. INTRODUCTION

The EP Resolution on democratic accountability in the third phase of EMU of 4 May 1998[1] "calls … for the organisation of a dialogue between the EP and the future ECB on monetary and economic affairs, the framework for which dialogue should be confirmed through a mutual agreement". The Treaty on European Union also contains provisions regarding the issues of transparency and accountability of the ECB vis-a-vis the EP.[2] Based on these requirements it was agreed that the President of the ECB would appear four times a year before the ECON Committee (Economic and Monetary Affair Committee).

With the EP's 7th legislative term approaching its end, it seems appropriate to reflect on the working of the Monetary Dialogue exercise, to review the past five years of monetary dialogues as well as to look forward for potential improvements. To this end, this Briefing uses the main insights of my previous Briefing paper (Belke, 2013), Section 4: "Transparency and Forward guidance – Tools to stimulate the economy in the euro area?" to investigate the role the Monetary Dialogue in the context of ECB evolving monetary policy. This is done along several dimensions, including: the ECB's adoption of forward guidance on interest rates; the ECB's model choice and data revision policies for inflation forecasts; the ECB role in the Troika and, as a financial supervisor; ECB involvement in bond purchasing programmes; and Fed's envisaged exit from unconventional monetary policies and its effects on ECB communication policy strategy. The Briefing paper assesses - on a case-by-case basis - the information exchange between the EP and the ECB and suggests how to improve it via the Monetary Dialogue exercise, taking into account the ECB's communication strategy.

The remainder of the Briefing paper is organised as follows. Section 2.1 discusses the pros and cons of enhanced ECB transparency. The effectiveness of publishing minutes and the instrument of the Monetary Dialogue are then compared in Section 2.2 with reference to the new ECB voting model - the so-called rotation model which will be activated as soon as the 19th member will have entered the EMU. Section 2.3 describes why a lack of ECB transparency may serve as an incentive to improve on the conception of the Dialogue. In Section 2.4 the Monetary Dialogue and potential changes in its conception are discussed in terms of the ECB's new "forward guidance" instrument and the transparency of data revisions and the choice of the underlying macroeconomic model. Section 2.5 discusses how accountable the ECB should be within the Monetary Dialogue. The ECB's increasing transparency and accountability duties from taking over banking surveillance in the euro area appear so important in the context of this Briefing paper that they are emphasised separately in section 2.6. We finally discuss the limits to transparency and communication within the Monetary Dialogue in Section 2.7. Section 3 finally concludes.

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:51998IP0110:EN:HTML

2. TRANSPARENCY AND FORWARD GUIDANCE – A NEW ROLE FOR THE MONETARY DIALOGUE?

In response to the financial crisis, the ECB has been forced to adopt new tools/instruments to support the euro-area economy and preserve the integrity of the single currency. This has challenged the current framework of the Monetary Dialogue exercise.

This Briefing paper briefly assesses the implications of enhanced transparency and "forward guidance" for the effectiveness of the ECB's policies. It then checks whether the Monetary Dialogue if and how the current Monetary Dialogue framework needs to be modified in order to fulfil its goal.

For instance, Transparency International (2012) believes that "the accumulation of the ECB's influence and power especially in the area of banking supervision has not been matched by improvements in transparency and accountability. In this respect, the ECB falls short of the good practices implemented by both its fellow EU institutions and its central banking peers around the globe. Such practices include the publication of meeting minutes and voting records, external independent membership of Boards, robust parliamentary oversight, participation in the EU Transparency Register, clear, detailed policies and procedures for handling conflicts of interest, a "cooling off" period for senior ECB executives returning to the private sector, and a proactive policy on access to ECB documents" (taking care, of course, of confidentiality issues).

The Monetary Dialogue along improved according to the suggestions the lines sketched out in this Briefing paper implies robust parliamentary oversight. With benefits also for democratic legitimacy and accountability as a guiding principle is that 'democratic control and accountability should occur at the level at which the decisions are taken' (Belke, 2013b).

2.1. A growing need for ECB transparency? The arguments

Monetary policy and sovereign bond purchases

The discussion about more transparency of the ECB has been rekindled by a distinct change of ECB role during the financial crisis. "With the Securities Market Programme (SMP) and its announced Outright Monetary Transaction Programme (OMT), the ECB has blurred the distinction between monetary and fiscal policy. As emphasised in more detail in Sections 2.3 and 2.6, this has implications also for the design of the Monetary Dialogue.

The ECB as a member of the Troika

Another critical aspect is the ECB's role within the Troika in the context of financial assistance to programme countries. This has significantly challenged the previous smooth working of the Monetary Dialogue (Eijffinger and Mujagic, 2004). In part because none of the Troika partners seem to view the Troika arrangement as ideal. Indeed, during the Greek programme significant differences of views emerged among the Troika members, in particular with respect to growth projections and their revisions. And partly because internal working procedures were uncoordinated. Lastly, documentation of the vast, sometimes overlapping, and obeys different degrees of secrecy (IMF, 2013).

In the context of this Briefing paper, the main problem is the ECB's role within the Troika (Gros et al., 2014, IMF, 2013). Conflicts of interest are rendering the ECB's membership in the Troika a doubtful venture. The Treaties limit the ECB's role strictly to monetary policy. But the bank may have overdone things relative to its original mandate by taking an active role in prescribing the crisis countries "austerity" measures and structural reforms. Moreover, the ECB's negotiations with the programme countries have clearly been less transparent than necessary – in the same way as the above mentioned emergency liquidity assistance measures. Most strikingly, an important but hidden feature of, for instance, the Greek programme was that there was no conditionality on areas within the competency of the currency union's central bank" (IMF, 2013). In addition, the ECB and the national central banks, for instance in case of emergency liquidity assistance, appeared to be the institutions among the Troika with the largest discretion on setting conditions on its own. This happens to go without democratic accountability and transparency guidelines as set for instance by the European Court of Auditors (IMF, 2013, p. 30).

In order to avoid conflicts of interest and legal grey areas in the future, the role of the ECB within the Troika may have to be reworked fundamentally. Moreover, it should be accompanied by even more transparency and accountability standards imposed through the Monetary Dialogue.[2]

The ECB as a financial market supervisor

In the financial sector of country programmes for Greece, Ireland, Portugal (but less so for Cyprus), the "ECB had an obvious claim to take the lead, but was not expert in bank supervision where the Fund had specialist knowledge" (IMF, 2013, p. 31). It will be crucial for the members of the „Monetary Experts Panel" and the EP in the next years to assess whether and to what extent the ECB gets into conflicts of interest as regards its extended competencies in banking supervision and banking union. The Monetary Dialogue is in principle a suitable forum to cope with these new issues. However, it may have to increase its scope to be capable to do this. This is not only due to the high technical complexity of the new ECB tasks, but also to the high level of non-transparency implied.

Despite large additional competences conferred to the ECB, the foreseen accountability mechanisms "are limited to the usual hearings at Parliamentary committees, presenting an annual report to Parliament and European Council and providing answers to written questions by MEPs. This is the same level of accountability that the ECB currently has for monetary policy functions. There is no reference to increased transparency as well" (Transparency International, 2012). There is also a clear need of more transparency on lobbying.[3] Ideally, joining the EU Transparency Register would be a way forward. But also the Monetary Dialogue could have a function here. For instance, the members of the "Monetary Experts Panel" could check empirically whether specific monetary policy decisions closely follow the Taylor reaction function communicated in the ECB's forward guidance framework or whether the empirical fit is much better with some balance sheet events in one larger euro area bank.[4]

A closer look at the new institutional framework quickly reveals that ECB new tasks *relate mainly to supervisory role and body (Supervisory Board) rather than to the ECB itself*. Therefore, one conceivable and important change in the scrutiny work of the Monetary Dialogue would be to cover activities of the Supervisory Board. However, this will not be an easy undertaking for both political and economic reasons.

The ECB and the exit from unconventional monetary policies

Another issue the conception of the Monetary Dialogue is confronted with is the role of communication in guaranteeing a smooth exit of central banks such as, currently, the US-

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2 See ECB (2013a), Gros et al. (2014) and http://www.europarl.europa.eu/news/en/top-stories/content/20140110TST32314/html/Parliament-investigates-the-decisions-that-have-been-made

3 See, for instance, Masters (2012) : "People familiar with the discussions say the industry has had little success persuading anyone beyond the ECB to accept asset-backed securities, despite extensive lobbying".

4 However, the latter pattern could still be covered by the ECB's mandate as a borderline case, motivated by financial stability considerations. This simple example again shows the technical complexity of the issues involved and the strongly increased need for transparency.

Fed from current unconventional monetary policies and effects on the euro area (Belke, 2013a). In my previous Briefing paper (Belke, 2013a) I dwelled on the issue of adequate communication as an important tool to smooth exit process. Because the *price effect of asset sales* is *ambiguous* and *complex* in technical terms, international institutions such as the International Monetary Fund recommend central banks to adopt communications strategies focussing on the interest rate path instead of a pre-specified sales volumes (IMF, 2013). This a has direct bearing for the contents of the Monetary Dialogue as regards the assessment of forward guidance (see below). Most important, the ECB usual communication strategy through press conferences and the Monthly Bulletin is not sufficient because the potential impacts of exit strategies on the euro area is not the exact counterpart of the effects of unconventional monetary policies.

Implications for the Monetary Dialogue

On the basis of the three arguments discussed above the ECB shall be held accountable in a sufficient detail to the EP like finance ministers are vis-a-vis their national parliaments.[5] To an accountability question raised by the EP in a Troika-related questionnaire the ECB responded that:: "… (t)he members of the ECB's Executive Board stand ready to share with the EP the ECB's views on the situation in programme countries and to explain the technical advice given as part of the troika, as they have done on several occasions in the past" (ECB, 2013a). But to the extent that the crisis has blurred the distinction between monetary and fiscal policy, the working of the Monetary Dialogue needs to be changed so as to make the ECB fully accountable towards the EP and, perhaps, even towards the European Court of Auditors. This is not yet the case. One obvious example is the lack of transparency in the context of (realised or announced) ECB programmes of sovereign bond purchases, which, admittedly, affects EU taxpayers' money and European citizens' savings. But the EP through its monetary experts shall *pay attention that national vested interests do not get too strongly involved in the design of community-wide policies.* To the benefit of ensure the ECB's continued credibility, it is key that ECB policies are publicly communicated as providing an European public good and, as such, must be fully accountable through the Monetary Dialogue.

And in fact there is no alternative to the Monetary Dialogue. For, the Q&A session of ECB's monthly press conferences following Governing Council monetary policy decisions in its present form do not provide any information of the discussion on monetary policy within the Governing Council. In contrast, the ECB president M. Draghi Mario Draghi has become in my view increasingly frank about specific issues such as the relation between monetary policy and structural reforms in his quarterly reporting before the EP (Monetary Dialogue).

As an example of this, let me quote M. Draghi directly from his most recent appearance before the ECON committee : "Second, we look closely at the relation between market interest rates and incentives to reform. Do you really think that a country would change its electoral law because interest rates are a couple of hundred basis points higher? Do you think that a country would actually change its educational system or its judiciary because interest rates are higher? It seems implausible. …regarding the real structural reforms, do you think that a country would really change labour market legislation because of interest rates? I think this would probably be unlikely." (Draghi, 2013).

[5] However, the ECB is not accountable to national parliaments which, in the past, did not exclude ad hoc consultations between ECB staff members and national parliament representatives s for the sole purpose of sharing views on economic conditions (ECB, 2014).

2.2. Publishing minutes and the Monetary Dialogue – The example of the rotation model

A couple of months ago, ECB President Mario Draghi has recommended that the ECB shall publish the minutes of the Governing Council meetings. In one of my recent Briefing papers (Belke, 2013) I argued that by publishing Governing Council meeting minutes, "the ECB may improve the transparency and efficiency of its policies significantly, which would support its stability-oriented orientation. The foreseeable extension of the Governing Council due to the envisaged further extension of the euro area and the reform of the Council's voting modalities enhance the rationale for publishing the minutes. Further euro area enlargement will increase the number of Governing Council members and will have an impact on the effectiveness of the decision process.. The upcoming rotation model for voting makes an increase in transparency effort even more necessary (Belke and Schnurbein, 2012).

Hopefully, the rotation model for voting will not favour the re-surfacing of nationalism. As the rotation model may limit the *representativeness* and the *effectiveness* of monetary policy decisions, the Monetary Dialogue shall gain visibility and importance (Belke and Styczynska, 2006, Belke and von Schnurbein, 2012). In a situation when even big euro area countries such as Germany must drop out form voting every fifth month, accountability and transparency towards the EP must become key to safeguard a common monetary policy.

2.3. Lack of ECB transparency as an incentive to improve on the conception of the Dialogue?

Is the ECB becoming less transparent when taking into account its increasing responsibilities (Belke, 2013)? Can we imagine other instruments to enhance ECB transparency other than the publication of minutes and better explanation of ECB policies within the current framework of the Monetary Dialogue?

To answer these questions it seems to be useful to recall the analysis in section 4 of Belke (2013): "The ECB has regularly been placed quite high in a variety of transparency rankings conducted for the pre-crisis period. But this transparency weakened significantly in the course of its Securities Market Programme (SMP). The ECB merely published the weekly total amount of bonds purchased without informing about the country-specific structure of the purchases, the maturities of the bonds, the criteria and/or the extent of future purchases. This lack of transparency is striking, especially in comparison to the high degree of transparency of the Fed and the BoE in the course of their quantitative easing (QE) programmes".

In the public, the ECB frequently justified its "secrecy" of the sovereign bond purchase programmes for efficiency reasons. If there were no secrecy, the programme would have lost its efficiency. For instance, complete transparency about the large predominance of bond purchases from Greek, Italy and Spain could have resulted in strong disagreement by Northern euro area member countries, endangering the financial stability of the whole system. This argument looks flawed, however, as because traders could have easily identified the geographical location of bond purchases.

The same caveats can be raised with respect to the ECB's lack of transparency about its Long-Term Refinancing Operations (LTROs). Bond spreads fell across the board with the LTRO implementation. This raised the suspicion that the additional liquidity was largely used for bond purchases by the commercial banks (the so-called „Sarko trade"). Although this raised serious doubts about the programme, the lack of published information did not enable analysts, including Monetary Panel experts to assess the LTRO effects.

Enhanced ECB transparency combined with a proper working of the Monetary Dialogue could help in avoiding confusion about and negative side effects of its unconventional monetary policies.

Are there *other instruments* available to enhance transparency and to give a better explanation of ECB policies than previously? Again, recall Section 4 in Belke (2013): "Traditionally, *credible exchange rate pegs* deliver the largest possible transparency of monetary policies. They allow a public monitoring of the policies' compliance with the exchange rate target. The textbook alternative is *direct oversight with formal control through the government*. But, clearly, both solutions are not realistic alternatives with an eye on the flexible exchange rate of the Euro and the strongly emphasised ECB independence. This in turn increases the pressure to strengthen other aspects of transparency in order to make the central bank accountable to its stakeholders, the markets."

From another perspective, this underlines the importance of putting the ECB's inflation forecasts/projections under more scrutiny because the euro is a floating currency and exchange rate forecast have implications for ECB's inflation forecast.

2.4. Monetary Dialogue, 'forward guidance' and the transparency of data revisions and model choice

Before we are able to assess the role the Monetary Dialogue could play in the context of the adoption of forward guidance on interest rates, we have to establish the actual and the optimal extent of the ECB's "forward guidance". Reflecting the increasingly vivid transparency debate, the ECB has moved to deliver an outlook on its future path of policy rates ("forward guidance"). In this context, a second question becomes relevant: will the ECB adhere to the "forward guidance" instrument even after the crisis period has ended? This is important in our context because the design of the Monetary Dialogue may be adapted to this systematic change in the ECB's policy toolbox.

In Belke (2013), section 4, we argued: "Forward guidance as practiced right now is not a commitment to keep official interest rates lower than will be necessary in the future or, expressed differently, to create inflation. It does just not represent an additional stimulus by an ex ante commitment to a time inconsistent policy path. Instead, the main aim connected with the interest rate outlook is to elucidate the ECB's assessment against the background of the overall subdued inflation prospects and, more specifically, the bank's policy *reaction function*. From this perspective, the ECB … does not describe anything else than a *policy rule for its future interest rate path*. Forward guidance is thus meant as strengthening the credibly of ECB monetary policy strategy". This seems overall adequate under current circumstances in order to calm down markets and to curb speculation on rapidly increasing interest rates, because in times of higher uncertainty transparency and clarity help to give orientation and to stabilise expectations of market participants. Hence, "forward guidance" is an indirect instrument to loosen credit conditions and thus stimulate credit supply and economic growth without conducting any further interest rate cut under non-normal circumstances. Most importantly, "forward guidance" cannot correspond with any long-run commitment to a specific interest rate level because this would insinuate an intended change in the medium-term oriented monetary policy strategy". And here I would now add with the benefit of hindsight: "which ECB representatives are utterly publicly denying".

If this is true, however, it is clearly *not appropriate* to speak of a *change in the reaction function* of the ECB driven by forward guidance, which makes a change in the design of the Monetary Dialogue necessary. Moreover, most likely, the ECB will not be able to decouple its policies from those of the Fed during and after the process of normalisation (Belke and

Gros, 2005, Belke and Cui, 2010). *As soon as the crisis is over and we will have entered more "normal times", the ECB should and probably will not abide by this instrument.* This is so because such kind of "forecasts" are vexed by much uncertainty and entail risks, also for the reputation of central banks. From this point of view, the instrument of *forward guidance is almost surely not the most relevant challenge* for appropriate communication and transparency requirements and, thus, *for the design and structure of the Monetary Dialogue*.

However, there are also arguments in favour of a short- to medium run relevance of the forward guidance tool for the Monetary Dialogue. In Belke (2013), Section 4, I argue that "the ECB will have to struggle to avoid confusion of different interpretations of „forward guidance" by ECB representatives. … The ECB President knows too well that „forward guidance" should be formulated as only dependent on the bank's inflation forecast/projection.. … What is more, the ECB's announcements may not necessarily be conceived as credible – for instance because there are election dates in between the announcement and the dates for which the inflation outlook is published. In that case, deviations of the markets' action and the central bank's ideal projection of market behaviour cannot be excluded.. By indicating the need to curb official rates also for the next years could convey the impression that the bank anticipates the crisis lasting for several years to come. But if markets become more pessimistic, consumers' and investors' spending suffer."

On a more general level, it thus seems fair to state that „forward guidance" and also the discussion about the publication of minutes have indicated that during the crisis the relevance of the classic interest rate instrument has decreased. The future Monetary Dialogue should thus take into account that *expectations* of future monetary policy will play a higher role than before, especially in the context of the North-South debate (e.g. financial repression of Northern savers through lower long-term interest rates). Hence, "manipulating" expectations does potentially represent the more effective monetary policy. This is exactly the point where the Monetary Dialogue has to set in in the future to avoid this kind of "manipulation". The euro area long-term interest rate is the result of the expected patterns for short-term rates which, in turn, are driven by the inflation forecasts. A key task of "Monetary Experts Panel" shall be assess the current ECB inflation forecasts/projections and the pattern of revisions to detect systematic downward or upward biases.[6].

Revisions of, for instance, output gap estimations in Europe which usually enter inflation forecasts may turn out to be especially worrisome since (medium-term) adherence to the ECB's inflation target is assessed with reference to initial data vintages. (De Castro, Perez and Rodriguez-Vives (2013))

Ley and Misch (2013) find that output data revisions alone may significantly undermine the reliability of real-time estimates of the overall and structural fiscal balances, and that output data revisions may result in unplanned and substantial debt accumulation. The paper also shows that there are significant differences across country income groups (Ley and Misch, 2013).

Kempkes (2012) analyses real-time output gaps for EU-15 countries over the 1996-2011 period suggest that the ECB's monetary policy (Taylor) rule should incorporate ex-post checks of the un-biasedness of the cyclical components used within the rule. Potential

[6] Mayer (2014), for instance, argues that the current low-interest rate policy in the euro area affects also the long-term yields of euro area savings negatively (in contrast to Mario Draghi's view), exactly because long-run interest rates are driven by the sequence of the inflation forecasts by the ECB staff.

biases would then decrease or increase future limits for the monetary policy stance as measured for instance by the policy rate.

Another issue at stake is the choice of appropriate models and their adequate application to inflation forecasting at the ECB.[7] Best academic practice requires that the choice of the adequate model should not be based on ideological priors of the contracting authority (‘Keynesian’ versus ‘non-Keynesian’, socialist versus conservative, etc.) but, instead, on the much more neutral use of widely accepted empirical model selection criteria (Gros et al., 2014, Pesaran and Pesaran, 1997). The Monetary Dialogue should move significantly more into the direction of focusing on the issue of non-partisan macroeconomic model choice.

2.5. The ECB - How accountable within the Monetary Dialogue?

Through more openness in its communication, the ECB intends to convey financial markets more orientation regarding the bank‘s future course (Belke, 2013). The widespread view among economists is that „more information is better“ (Belke, 2013). Why?

In Belke (2013, Section 4), I argue that “… (t)hey tend to assume a model with rational expectations and exogenously provided public and private information. As such, these models do not consider that the provision of public information may weaken the incentive of market participants to privately collect information on their own.

The more predictably monetary policy becomes, the better market participants are able to align their decisions with those of the central bank. Frictions and volatility decline since actors are better able to forecast the future time path of monetary policy and related variables. This view that more transparency reduces market volatility is corroborated by empirical evidence.

However, things may be different in some specific settings, according to theory. Under a different set of assumptions, a public provision of information can interfere with the function of markets. As the „theory of the second best “suggests, the abolishment of a bias may not improves competitive allocations if further biases exist. It follows that enhanced transparency may not not necessarily lead to an welfare improvement. There may be an *optimal degree of “secrecy*“ which is larger than zero.

But a policy of limited transparency will hardly be able to solve internal disputes and hassles in the ECB Council. On the contrary, it may cause irritating signals which in turn trigger undesirable volatility on financial markets.” While more transparency is welcome, it is not clear how far this process should go as the upper bound for transparency is likely to be lower than 100 per cent. The “optimum degree of the ECB’s secrecy” is an issue which has a direct bearing for the Monetary DialogueThis view can also be supported from policy cycle perspective (Belke and Potrafke, 2012). Full accountability to and “democratic control” through the EP may conflict with the central bank’s policy and instrument independence. Policy independence may be endangered as soon as different political groups in the EP pressure for the adoption of specific macroeconomic models or even different monetary policy measures (for details see Gros et al., Section 2.4).

Instrument independence may be hampered by the fact that policy tools such as the ECB’s sovereign bond purchases may be effective only when they are not anticipated. Because the Monetary Dialogue would lose its social value is ECB’s independence is threatened,

[7] Anyway, since the business cycle and financial cycle are of different length also in the euro area (Borio, Disyatat and Juselius, 2013), the ECB may still fail to use adequate output gaps in its inflation forecasts/projections. This is another aspect which has become virulent since the start of the financial crisis and should be object of the Monetary Dialogue.

Monetary Panel experts shall warn as early as possible about the danger of such negative feedback.

2.6. The ECB and banking surveillance in the euro area: increasing transparency and accountability duties

Let us now briefly revisit the new ECB role *as a financial market supervisor*. Are there particular transparency and accountability obligations resulting from this? If yes, , how can these best accomplished?[8]

In fact, the ECB must " … become even more transparent, as soon as the bank is tasked the surveillance of the large majority of the EU banking system. Indeed, a bank restructuring may imply additional burden for the public budget and, in addition, the ECB will have to take up law making powers once it is tasked to issue regulations regarding banking oversight. The ECB shall therefore become fully accountable to the EP in the context of the Monetary Dialogue exercise, something which did not happen with regards to SMP and OMT programmes " (Belke, 2013).

To this end, the "Monetary Experts Panel" shall have sufficient access to the minutes of the ECB Supervisory Board as well as ECB Governing Council, as far as "the latter are related to questions regarding financial oversight issues. Information with respect to company secrets of single banks or specific group of banks must be exempted of course." (Belke, 2013).

2.7. Limits to transparency and communication within the Monetary Dialogue?

In this section, we tackle the *confidentiality versus accountability trade-off* issue of the ECB.. Otmar Issing, the former ECB chief economist warned against a so-called "crystalline central bank" (FAZ, 2006). What exactly are the limits of transparency and communication of central banks towards financial markets and the public?

"Surely, transparency becomes critical if the publication of minutes improves the markets' understanding of monetary policy as strongly as if people would have taken part in the Council meetings themselves. This is well understood by market participants. " (Issing in FAZ, 2006).

In Belke (2013, Section 4), I argued: "(w)hat is more, central banks must *avoid to be driven by financial markets and their expectations*. For this purpose, they shall dispense with ex ante publishing the exact dates of planned interest rate movements and, thus, the future long-term rate. It is equally important to counteract market expectations that the ECB will change its official interest rates as a rule only on days at which the bank publishes its new inflation growth projections. This is because other forces such as, for instance, credit and money growth could decisively drive Council decisions to change interest rates.

Furthermore, limits to transparency are reached if the publication of the minutes allows interest groups to lobby on Council members. Limits to transparency also stem from the necessity to avoid all the details of internal discussions among Governing Council members. Secrecy A certain degree of secrecy may prove to be useful as a threat potential to curb expectations of market participants.

A high degree of transparency would also protect Governing Council members against undue pressure from national governments as potential deviations of ECB policy from a stability oriented monetary policy would be brought to the surface. ."

From this perspective, an well designed monetary dialogue would *support rather than hamper a stability-oriented monetary policy*. But what does "well-designed" actually mean? Key aim of the Monetary Dialogue is to better understand the ECB Council's decisions.

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8 The following is taken from Belke (2013), Section 4.

Hence, the Monetary Dialogue exercise shall not scrutiny each single ECB decision. Rather, it should make sure that the ECB's strategy is well understood, enable the EP and the market participants to get an idea of the ECB's policy targets and of how the bank is intending to reach it.

3. CONCLUSIONS

According to Eijffinger and Mujagic (2004) the ECB has been highly accountable to the ECON in the first years of EMU (1999-2003), i.e. in normal times. In this Briefing, we argue that the Monetary Dialogue is currently even more important than in "normal" times. We suggest changes, both procedural as well as regarding its focus, to make it more effective. In our view, the (lack of transparency) issue represented by a Supervisory Board 'hosted' by ECB need to be addressed by the Monetary Dialogue. A crucial challenge is to find out the optimal degree of ECB transparency and accountability towards the EP.

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NOTES

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Monetary Dialogue 2009-2014: Looking backward, looking forward

Sylvester C.W. EIJFFINGER

IN-DEPTH ANALYSIS

Abstract

When comparing the transparency of the ECB now and one decade ago, we notice that there is still room for improvement. In particular, as regards the information disclosure on how ECB policy decisions are reached and what is the envisioned path of policy. We call for action and suggest the ECB to release the Governing Council minutes and voting records, while also engaging in more explicit and concrete forward guidance. At the same time, we call for a reflection on the institutional setup of the ECB. While being a necessary exercise in the medium term, this is less urgent than the reform of transparency. We believe that the Monetary Dialogue will have a role in spurring the debate and possibly influencing the ECB also in the upcoming 8th legislative term, as it has done in the past.

CONTENTS

BACKGROUND

With the 7th legislative term of the European Parliament (EP) coming to an end, this briefing note reflects on the workings of the Monetary Dialogue. The Monetary Dialogue has its origins in the European Parliament Resolution on democratic accountability in the third phase of the EMU of 4 May 1998.[1] The Monetary Dialogue was founded to provide a platform for discussion between the EP and the European Central Bank (ECB). At the same time the Monetary Dialogue supports democratic accountability. One of the hallmarks of modern Central Banking is the (political) independence of Central Banks.[2] In a democratic environment independence needs to be balanced by accountability. Accountability requires information disclosure because correct and sufficient information regarding the behaviour of the Central Bank is necessary to evaluate its performance. The dialogue is in this way conducive to accountability of the ECB.

In this note we reflect on the workings of the ECB and on potential improvements in terms of accountability, transparency and communication. Communication is one way to achieve transparency which is, as argued above, necessary for accountability. Our assessment suggests that the ECB could improve with respect to both the procedural dimension and the policy dimension. The former refers to the way decisions are reached, the latter refers to what the policy outlook is for the future and how the ECB expects its policy to influence interest rates.

We end our note with a call for reflecting on the institutional design of the ECB as well. While less urgent than the suggested improvement in terms of transparency, we feel that the Monetary Dialogue is an excellent venue to reflect on the institutional setup of the ECB as the Central Bank is maturing.

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1 European Parliament (1998), Resolution on democratic accountability in the third phase of EMU of 4 May 1998. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:51998IP0110:EN:HTML

2 There is an enormous academic and policy literature on this issue. See for example Eijffinger, S. and De Haan, J. (1996), The Political Economy of Central-Bank Independence, Special papers in International Economics, No. 19, Princeton University.

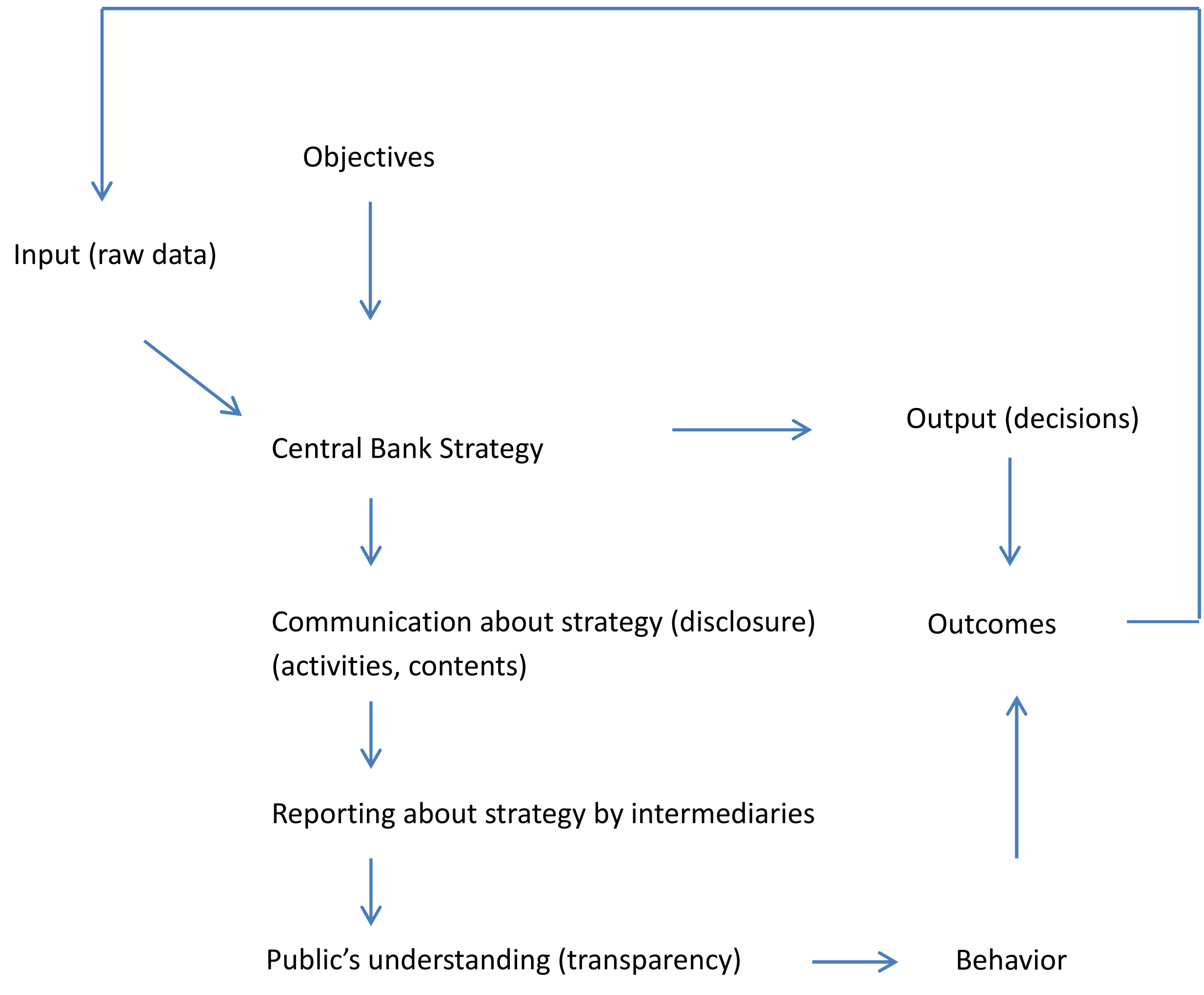
1. TRANSPARENCY AND DISCLOSURE

Before discussing the performance and evolution of the ECB in terms of transparency and disclosure, we develop some concepts.[3]

Central Bank disclosure (i.e. the information provided by the Central Bank) and transparency of monetary policy (i.e. public's understanding of the monetary policy process) are interrelated. Figure 1 provides a stylised account of this relationship.

The Figure shows how the Central Bank reaches a decision on the basis of its strategy which is communicated to the outside. The public receives its information primarily through the media which use the communication by the Central Bank as input. The effect of Monetary Policy is determined not only by the decisions but also by the expectations and behaviour of the public.

Figure 1: Monetary Policy Strategy and Communication



Source: De Haan, J., Eijffinger, S. and Waller, S. (2005), p.85; adapted from Winkler (2000).

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[3] A fully developed treatment of these issues can be found in: De Haan, J., Eijffinger, S. and Waller, S. (2005), The European Central Bank: Credibility, Transparency and Centralization. The MIT Press, Cambridge, Massachusetts.

It is clear that communication is key in this story because it has a big impact on transparency. Transparency and disclosure are however multifaceted concepts which could pertain to different aspects of economic policy making. Following Geraats (2000, 2002), we distinguish five dimensions of disclosure. An overview is given in Table 1.

A first dimension is *political disclosure* which refers to the preferences of the policy makers. Sufficient disclosure could reduce uncertainty about these preferences. Additionally, institutional arrangements like Central Bank independence and override mechanisms contribute to political transparency as they clarify the relationship between the government and the Central Bank. Secondly, we have *economic disclosure* which means transparency on the economic data and models used in guiding policy. In the past, academics have focused on disclosing economic shocks and forecasts. Thirdly, we have *procedural disclosure* which pertains to the way decisions are reached. Transparency in this dimension can be achieved by providing guidance on how decisions came about. The publication of minutes, transcripts or voting records can be instrumental in achieving procedural transparency. A fourth dimension is *policy disclosure*. This refers to the prompt announcement of the policy decision. Finally we have *operational disclosure*. This relates to the implementation of Central Bank policy and in particular it involves a discussion of control errors in achieving the operating targets of monetary policy and macroeconomic disturbances affecting the transmission process.

De Haan, Eijffinger and Waller (2005) provide some evidence on the performance of several Central Banks on these different dimensions.[4] With respect to political disclosure and economic disclosure the ECB scores historically very well and belongs to the best performing Central Banks. Also with respect to operational disclosure the ECB performed well. However, the performance with respect to procedural disclosure and policy disclosure was much worse and the ECB received the lowest score in a group of nine influential Central Banks.[5]

The question is then, to what extent has the situation improved? The low score with respect to procedural transparency was caused by the absence of publicly available minutes and voting records. On this aspect we have seen little improvement by the ECB. In 2013 there was some discussion on whether minutes (with voting records) should be published. Jörg Asmussen and Benoît Cœuré supported in a joint interview the idea of publishing these minutes and voting records, but their recommendation was not followed by the ECB. Some have argued that publishing the voting records in the ECB is a bad idea as secrecy shields the voting members from harmful influence of national governments. Secrecy in this regard can encourage behaviour which promotes well-being of the whole union as a whole.[6] There is also empirical evidence suggesting that transparency in the voting process induces behavioural changes, see for example Meade and Stasavage (2008).[7]

If we look at other Central Banks, we see that there is a tendency to become more open on this dimension with countries like Sweden or the Czech Republic now also releasing their voting records. Major Central Banks like the Federal Reserve or the Bank of England already did.

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[4] A detailed explanation on and discussion of the (empirical) performance of Central Banks with regard to transparency can be found in Eijffinger, S. and Geraats, P. (2006) How transparent are Central Banks? *European Journal of Political Economy,* Vol. 22, No. 1, 1-21.

[5] De Haan, Eijffinger and Waller (2005), The European Central Bank: Credibility, Transparency and Centralization. The MIT Press, Cambridge, Massachusetts, p. 94.

[6] Gersbach, H. and V.Hahn (2009), Voting Transparency in a Monetary Union. *Journal of Money, Credit and Banking*, Vol. 63.

[7] Meade, Ellen and Stasavage, David (2008), The dangers of increased transparency in Monetary Policymaking. *Economic Journal,* Vol. 118.

Our opinion is that improving the procedural transparency is warranted. It allows the ECB to be held accountable more easily. Moreover, the secrecy surrounding the procedural dimension seems something from the past. The concerns expressed by authors such as Gersbach and Hahn[8], should be dealt with directly rather than keeping an atmosphere of secrecy. A reform of the executive board and Governing Council could solve the concerns regarding national influences as well. We return to this issue in a next section.

Providing minutes and voting records allows ECB watchers (and by extension the general public) to analyse and understand decisions. [9] Moreover, the increasing importance of the ECB (in part due to other developments) warrants some measures to hold the institution accountable. Transparency of the decision-taking process helps to overcome the democratic deficit created by the secrecy surrounding the decision-taking process.

With respect to policy disclosure we feel that there have been some improvements. In 2005, de Haan, Eijffinger and Waller (2005) reported that the ECB was lacking in communication on the policy inclination as well as giving relatively little policy explanation. Nowadays it seems the ECB tries to convey more information on its policy trough press statements and speeches by Executive board members. However, publishing inclinations regarding the path of future policy interest rates in the spirit of Norway, Sweden or New Zealand is not on the table (yet).

A higher degree of policy disclosure can be obtained by more actively engaging in forward guidance. Forward guidance is nowadays a hot topic in Central Banking and heavily debated among policy makers and academics. [10] A key motivation for forward guidance is provided by Woodford: *"Greater clarity within the policy committee itself about the way in which policy is expected to be conducted in the future is likely to lead to more coherent policy decisions, and greater clarity on the part of the public as to how policy will be conducted is likely to improve the degree to which the Central Bank can count on achieving the effects that it intends through its policy."* [11] While forward guidance and expectations management by communication is applied by different Central Banks to different extents, it seems often too vague to us. We feel that forward guidance should be explicit about the path of interest rates. [12] Specifically, the ECB should communicate the evolution of interest rates it envisions conditional on what the ECB knows. The ECB would then communicate the evolution it foresees for both short and longer maturities and this up to at least one year (or longer if feasible). The idea is that the ECB communicates in concrete terms, and clearly, coherently spells out what the envisioned policy is for the (near) future and the

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8 Gersbach, H. and V.Hahn (2009), Voting Transparency in a Monetary Union. *Journal of Money, Credit and Banking*, Vol .63.

9 We have recently analysed the voting records of the Bank of England as well as the voting records of some continental Central Banks. Our analysis gave us insight into the different preferences of Central Bankers and how these are related to their professional background (e.g. internal vs. external). We could do such an analysis only because the voting records are publicly available. See Eijffinger, S., Mahieu, R. and Raes, L. (2013) Inferring hawks and doves from voting records. CEPR Discussion Paper, No. 9418, Centre for Economic Policy Research,, London; Eijffinger, S., Mahieu, R. and Raes, L. (2013) Estimating the preferences of central bankers: An analysis of four voting records. CEPR Discussion Paper, No. 9602, Centre for Economic Policy Research, London.

10 An excellent overview can be found in "Forward Guidance Perspectives from Central Bankers, scholars and market participants" VoxEU eBook edited by Wouter den Haan (2013).

11 Woodford, Michael (2013), Forward Guidance by Inflation-Targeting Central Banks. Manuscript prepared for the conference "Two Decades of Inflation Targeting" at the Sveriges Riskbank, June 2013.

12 An often cited study to demonstrate that statements (forward guidance) contains information not related to the announced target value of the policy rate is Gurkaynak, R., Sack, B. and Swanson, E.T. (2005), Do actions speak louder than words? The Response of Asset Prices to Monetary Policy Actions and Statements. *International Journal of Central Banking*, Vol. 2. This article has spurred a large follow-up literature suggesting that statements indeed may matter. See for example Eijffinger, S., Mahieu, R. and Raes, L. (2011) Can the fed talk the hind legs off the stock market? CEPR Discussion Paper, No. 8450, Centre for Economic Policy Research, London.

envisioned implications for the interest rates over different maturities and for different horizons.

Table 1: Five dimensions of disclosure

Dimension	Meaning	Enhanced by
Political disclosure	openness about policy objectives	institutional arrangements
	explicit targets	
	prioritization of goals	
Economic Disclosure	economic information used	
	models and methods used	
Procedural Disclosure	the way decisions are reached	release of minutes, transcripts and/or
	account of deliberations	voting records
	a policy rule	
Policy Disclosure	prompt announcement of decision	
	explanation of decision,	
	policy inclination	
Operational disclosure	control errors in achieving the monetary	
	policy targets	

Source: De Haan, J., Eijffinger, S. and Waller, S. (2005), p. 86-87.

2. THE ROLE OF THE MONETARY DIALOGUE

The Monetary Dialogue has played an important role in the past and we envision a (potentially) more important role in the future. The panel of monetary and economic experts that have been submitting briefing papers for the Monetary Dialogue have influenced the workings of the ECB in the past. A well-known example is the publication of inflation projections by the ECB in December 2001 which was a response to the call by the Monetary Dialogue with the ECB president in 2000.[13]

With the increasing responsibilities of the ECB we feel that the Monetary Dialogue will preserve it relevance.

In the previous section we called for increased transparency with respect to the procedural and policy dimension. When discussing the procedural disclosure and calling for more openness with respect to the decision-taking process (publication of minutes and voting records) we mentioned that some feel that secrecy is warranted as to shield individual members from national pressures. Such a solution is aimed at a symptom and does not catch the underlying problem. Maybe it is time to rethink the design of the governing council (and executive board). As the ECB is maturing we feel that it may be warranted to rethink the institutional design. While certainly not a pressing issue, we feel that it may be wise to start discussing this in time. In our opinion it is clear that we should evolve to a system with representation on a regional level, perhaps with rotation (similar to Bank Presidents in the FOMC). Smaller economies could be represented by one vote (e.g. the Benelux countries) whereas large countries would be considered as a region on their own. Combined with a limited and non-renewable appointment national influences could be mitigated. We are open to other reform proposals. We only aim to start a debate on this matter.

[13] De Haan, J., Eijffinger, S. and Waller, S. (2005), The European Central Bank: Credibility, Transparency and Centralization. The MIT Press, Cambridge, Massachusetts, p. 94.

3. CONCLUSION

In this briefing paper we have argued that going forward, the ECB could and should improve with respect to its procedural and policy disclosure. The procedural disclosure can be improved by releasing minutes and voting records. With this call we support the proposal made by Jörg Asmussen and Benoît Cœuré in the summer of 2013. Improving in this respect would respond to an increased demand for transparency and accountability.

The policy disclosure could be improved by providing more explicit and detailed forward guidance. Our proposal follows the lines set out by others[14] and calls for more *concrete and explicit* communication about the path of policy and the envisioned evolution of interest rates.

Finally we mentioned that as the ECB is maturing, it may be warranted to reconsider the institutional setup. Each aspect discussed above is feasible and in our opinion inevitable. The role of the Monetary Dialogue is to keep the debate going, also in the 8th legislative term of the European Parliament.

[14] See Woodford, Michael (2013), Forward Guidance by Inflation-Targeting Central Banks. Manuscript prepared for the conference "Two Decades of Inflation Targeting" at the Sveriges Riskbank, June 2013.

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DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Improving Monetary Dialogue with the ECB

Guillermo de la DEHESA

IN-DEPTH ANALYSIS

Abstract

During the 7th legislative term (2009-2014), the Monetary Dialogue between the European Parliament and the ECB has taken place in the context of a very difficult economic juncture for the monetary union and the ECB. Partly because of exceptionally adverse economic circumstances, little progress has been achieved in terms of better accountability and transparency of the ECB towards the EP. Going forward, the Monetary Dialogue can be improved along several dimensions as the role of the European Parliament is reinforced in the new institutional framework for EMU governance and the ECB seems to be open to a new phase of information disclosure and transparency. Further progress in terms of ECB accountability and transparency stems from the publication of the minutes of the Governing Council meetings as well as by widening the scope of the Monetary Dialogue as the ECB takes up the task of Single Supervisory Authority of the euro area banking system. That said, the problems of financial fragmentation in the euro area could only be overcome by a fiscal union.

CONTENTS

EXECUTIVE SUMMARY

During the 7th legislative term (2009-2014), the Monetary Dialogue between the European Parliament (EP) and the ECB has taken place under very difficult economic circumstances. ECB monetary policy was confronted with the most dramatic economic crises in the euro area since WWII. First, the US subprime crisis and then the Lehman collapse in September 2008 led to a liquidity breakdown in the world's interbank market and a high probability of a financial meltdown. Euro area's GDP fell by 4.4 % in 2009, the largest drop in decades. The ensuing euro area's sovereign debt and banking crisis provoked another recession in 2012 and 2013.

In this period the ECB adopted several unconventional monetary policy measures[1] to preserve the stability of the euro area financial system and the common currency. In the absence of a fiscal union tasked to counter the effects of asymmetric / national shocks, the ECB has been forced to take up a quasi-fiscal role. Looking forward, progress in terms of ECB accountability and transparency stems from the publication of the minutes of the Governing Council meetings as well as by widening of the scope of the Monetary Dialogue as the ECB takes up the task of Single Supervisory Authority of the euro area banking system. That said, the problems of financial fragmentation in the euro area could only be overcome by a fiscal union.

[1] These include: Marginal Refinancing Operations (MRO) in October 2008 carried out as fixed rate tenders and with full allotment, the Securities Markets Programme (SMP) in May 2010, the 3-year Long Term Refinancing Operations (LTRO) in November 2011 and the Outright Monetary Transactions Programme (OMT) in August 2012.

1. THE ECB

1.1. Looking backward

Between 2009 and 2014, the ECB has been facing the most serious economic crises in the euro area, since its birth in 1993.

The first shock was the US “subprime” crisis of 2007.

The second shock was the Lehman collapse of September 2008, which led to a liquidity breakdown and an almost complete the euro area interbank market. To provide funding for banks that could not access the interbank market and to avoid a “sudden stop” of the liquidity chain, in October 2008 the ECB was forced to introduce Main Refinancing Operations (MRO) carried out as fixed rate tenders with full allotment.

The third shock was the recession in 2009, which was to a large extent the result of a late macro-prudential reaction. On October 9, 2009, Andreas Papandreou, Prime Minister of Greece announced on the same day he took office that Greece was close to bankruptcy. This generated huge swings in financial market sentiment - particularly in the Member States of the periphery - and the risk of a global financial meltdown. Euro area GDP fell by 4.4 % in 2009, the largest drop in one single year since the creation of the Common Market in 1958.

The fourth shock was the euro area sovereign debt crisis of 2010 originated by the 2009 recession. The sovereign debt crisis was the result of several factors: fiscal mismanagement in some euro area Member States in good times, widening government deficits due to the working of automatic stabilisers, discretionary government spending to withstand the negative effects of the crisis, large current account imbalances in some Member States in the periphery due to lack of competitiveness. The ECB was forced to intervene for the first time with 'non-standard' monetary policy measures in order to save the monetary union and the euro. Jean Claude Trichet introduced the Securities Markets Program (SMP) in May 2010 to buy government debt of the Member States under pressure. A prolonged period of low interest rates since the early 2000s may have also exacerbated the sovereign debt crisis. ECB policy rate was cut from 4.5 % in 2001 to 2.5 % in 2002, to 2.0 % in 2003 and kept at that level until 2005 to help Germany getting out of recession as well as to spur Italy's and France's growth performance as these three Member States represent about ¾ of the euro area GDP. However, such low policy rates translated into negative real interest rates in those Member States featuring high inflation rates (e.g. Spain, Greece, Ireland), thereby generating a boom in internal demand.

The fifth shock came in 2011, as a result of the vicious cycle between the sovereign debt crisis and the banking sector. To counter it, the time frame of the LTRO programme was extended up to 3 years.

The sixth shock started in 2012 when financial markets realised, first, that the single euro area monetary union could not work without a fiscal union and second, that the Eurogroup and the Council were muddling through rather than reacting swiftly to solve the financial crisis. Financial instability in the euro area increased, with large swings in the sovereign debt yields of Spain and Italy. The ECB reacted with the announcement of the Outright Monetary Transactions (OMT) programme in August 2012. Finally, in July 2013, the ECB introduced for the first time, “forward guidance” that is, a decision to keep ECB key interest rates at present or lower levels for an extended period of time.

Between 2010 and 2013 euro area GDP growth came down from +2.0 % to -0.4%, with the Member States in the periphery suffering the most in terms of activity and job losses.

During this period, ECB decisions, were, severely criticized by some members of the Governing Council. The disagreement on ECB unconventional monetary policy was the reason behind the resignation of Jürgen Stark in December 2009 and Axel Weber in February 2011.

The ECB's key mandate is to maintain price stability. However, in situations of large financial instability, a central bank may be forced to take unconventional monetary policy measures to avoid the real consequences of a large financial crisis. Financial stability becomes the priority.

EU Treaties grant the ECB total independence in the formulation of euro area monetary policy. The ECB is however accountable to the EU Parliament through its quarterly Monetary Dialogue.

The independence of the ECB has been challenged several times. Recently the German Constitutional Court has taken the decision to refer the complaint against the OMT programme to the European Court of Justice (ECJ), threatening confidence in the overall scheme. It is rather awkward that the OMT programme announced by the ECB in the context of euro-wide monetary policy decisions can be challenged by a national constitutional Court.

2.1. Looking forward

The main difference between the euro area and the US is that the latter is a federal nation since 1787 and the US central bank (the Fed) was created in 1913, while the European monetary union was created only in 1993 with the Maastricht Treaty. As it is well known, the euro area is not (yet) a federal nation nor does it have a federal treasury.

The lack of a common fiscal policy tool in the euro area makes it difficult to counter the effect of asymmetric / national shocks. The EU budget is too small to be used for this purpose, especially if compared to the budget of federations (e.g. US and Canada). Thus, in crisis time, monetary policy must step in to address spillover effects originating in specific Member States. By doing so, however, it loses its key feature of 'common euro area monetary policy'. Moreover, in contrast to the US and Canada, the euro area is not yet an optimal currency area (OCA). When goods, services and people can circulate freely, the task of monetary policy is of greatly facilitated.

According to the European Commission's report "Blueprint for a deep and genuine Economic and Monetary Union" (2012), the future of the euro area should encompass a Banking Union by 2014 and enhanced economic and budgetary policy coordination and integration by 2019. To the extent that the latter implies a proper fiscal capacity it requires Treaty changes. Beyond 2020, a progressive pooling of sovereignty and solidarity to the European level shall possibly result in the design of an autonomous euro area budget large enough to absorb asymmetric shocks as well as to allow for a common issuance of public debt (Eurobonds)

The Banking Union would be a major euro area achievement. It would be instrumental to end the present financial and credit fragmentation of the euro area, to complete a presently uneven banking supervision and to stop the persistency of the sovereign debt crisis in some euro area Member States. At the same time, the new level playing field would facilitate the transmission of monetary policy. The Banking Union shall obviously comprise the Single Resolution Mechanism as a backstop instrument.

The steps to achieve a fiscal union are also extremely important. At present, the debt to GDP ratio of the euro area is close to 96%, thus significantly above the 60% Maastricht convergence criteria. The Fiscal Compact obliges Member States to maintain a balanced structural budget and to reduce the excess of debt to GDP over 60 %, by 5 % each year. This is a significant adjustment. It is therefore extremely important to make progress towards a Debt Redemption Pact among euro area Member States, which would eventually allow for the creation of a Debt Redemption Fund and the issue of Euro bills. The euro area "legacy debt", i.e. the share above 60 % of GDP, shall be put into this fund. It is not clear yet whether the setting up of such Debt Redemption Fund requires a Treaty change or not.

The Redemption Fund, originally proposed by the German Council of Economic Experts and later and supported by the INET Council on the euro area crisis[2], would be tasked to refinancing the sovereign debt of the euro area Member States exceeding 60 % of GDP. This Redemption Fund would refinance its debt holdings by issuing Euro-bills in the financial markets at very low rates of interest, given that investors would benefit from a very high risk diversification thanks to a debt instrument which bundles debt instruments of 18 euro area Member States.

At present, the viability of this Redemption Fund and the issuance of Euro bills is being analysed by a group of experts, under the Chairwomanship of Gertrud Tumpel-Gugerell ex Vice Governor of the Austrian National Bank and former member of the Executive Board of the ECB. The decision to form this group was announced by J. M. Barroso and by H. Van Rompuy, President of the European Council.

This Fund would allow euro area Member States to fund their debt at cheaper rates than the average of the euro area, unleashing more resources for growth. It would also facilitate the path towards a further change in the Treaties aiming at the creation of a euro area Treasury and eventually a Fiscal Union.

2 www.ineteconomics.org

2. MONETARY DIALOGUE

2.1. Looking backward

In the 7th Legislative term of the EP, the Monetary Dialogue was confronted with issues more relevant than in all the previous EP legislative terms.

These years have been the most dramatic in the history of the monetary union, with the euro area suffering a prolonged period or negative or very low growth compounded by financial and banking fragmentation and high risks of a euro break-up.

At the beginning of the crisis, the ECB was quite self-confident. It did not realize that the crisis was changing the citizens’ perception about the advantages of being part of a single currency area. Between 2002 and 2006 the proportion of euro area citizens who consider the adoption of the euro as advantageous had decreased from 59 % to 48 %.

C. Wyplosz (2007) has summarised with unparalleled clarity the problems stemming from the current set up of the Monetary Dialogue and the way forward to improve it. In a nutshell, Wyplosz blamed ECB’s opacity, the lack of an open debate and the refusal to decide by voting. He argued forcefully against the current format of the Monetary Dialogue as it resemble more ‘a gentleman discussion’ rather than an open fore to grill ECB president with precise questions. On substance, he expressed his dissatisfaction for the lack of transparency of ECB monetary policy decisions and in particular for the ECB refusal to publish the minutes of Governing Council decisions. This raises scepticism about the way the ECB conducts its business.

2.2. Looking forward

The Monetary Dialogue of the EP with the ECB has several purposes.

First, the Monetary Dialogue shall improve monetary policy efficiency and make the ECB accountable to the EP. In this regard, the publication of the 'minutes' of the monthly Governing Council meetings would increase the transparency of the ECB, as pointed out repetitively by both the ECON Committee and Monetary Dialogue experts. The publication of the minutes would also significantly reduce the likelihood of leaks by Governing Council members who disagree with the decisions taken. As a matter of fact, the number of leaks is increasing every year, damaging the reputation of the ECB

That said, two technical issues deserve some consideration. The timing of publication of the minutes has to be calibrated very carefully. The reason is that the ECB President holds a press conference the same day the monetary policy decisions are taken. That press conference is highly scrutinized by media and financial markets. Therefore, should the minutes be published too late, they might turn to be at odds with market sentiment. Should they be published too early, markets’ reaction may depend on the number of members who voted against, possibly negatively affecting the arguments to be spelled out in the press conference. I addition to the timing, the length, extent and information content of the minutes matters. If they are too short and with little detail, they won't add much to the press conference. If they are too long, they might end up generating confusion.

Second, the Monetary Dialogue shall contribute to the effectiveness of a common monetary policy in the euro, thus reducing current financial market fragmentation. A quantum leap in this direction would be the approval of the Banking Recovery and Resolution Directive (BRRD) of the Single Resolution Mechanism (SRM). This would increase the confidence in the euro area financial system.

Third, the Monetary Dialogue shall contribute to an orderly separation of ECB two main tasks: monetary policy and banking supervision. Some economists (e.g. Beck and Gros (2012)), however, argue that the separation between financial supervision and standard monetary policy might not be as desirable as often claimed. The reason being that the systemic (in)stability of a financial system during a financial crisis represents the biggest threat and the key issue to be addressed and solved by a central bank which aims at a low but stable inflation rate. The functional separation between the two tasks may also prove difficult to achieve as, for instance, the Supervisory Board will be composed of representatives from the same institutions, which also dominate the Governing Council. Beck and Gros believe that a strong set up for Bank Resolution Mechanism is more important than setting up Chinese walls. In a similare vein, A. Blinder (2010) claims that 'what some people see as a worrisome conflict of interest between bank supervision and monetary policy might be viewed instead as the rational balancing of two competing objectives. If so, shouldn't a single agency do the balancing? And who can balance those competing objectives better than the central bank?'

Fourth, the Monetary Dialogue shall contribute to achieve a viable trade-off among the distinctive demands coming from Member States facing different economic situations, partly as a result of financial fragmentation (M. Fratzscher, M. Huther and G. B. Wolf (2014)). Saving prone members states, such as Germany, tend to demand higher interest rates to get better returns on their savings and pensions and present low interest rates risk overheating the economy. Exactly the opposite is happening in some peripheral Member States, which are just coming out of a strong and long recession and need very low interest rates to support the recovery of consumption and investment.

Cross-country differentiation is also visible in the latest figures for quarterly GDP growth: In 2013Q3, the average euro area growth was0.5 %, but some countries outperformed (Germany 1.4 %, France 0.8 %, Belgium 0.9 % and Netherlands 0.7 %), while some others underperformed markedly (Spain -0.1 %, Italy -0.8 %, Finland -1.4 %, Portugal -1.6 % and Greece -2.6 %).

And similarly happens for inflation. Average inflation in the euro area has recently fallen to 0.7 % well below the ECB target, but it was close to 2 % in Finland, 1.5 % in Austria and above 1.2 % in Germany. In others Member States, where consumption is still very weak, inflation was close to zero (Portugal) or even negative (Spain, Ireland, Cyprus and Greece).

Fifth, the Monetary Dialogue shall contribute to improve the transmission mechanism of monetary policy, as monetary and financial policy is still not working properly in some bank lending segments. To this end, an important effort should be made to widen credit instruments and promote the use of marketable credit instruments, such as ABS and CBS, backed up by the European Investment Bank.

Sixth, the Monetary Dialogue could also prove useful for the delivery of a clear message on the ECB 'forward guidance' policy. The only difference between 'forward guidance' and normal interest rate setting is that the ECB communicates a clear signal to the financial markets that it will keep key interest rates at present of lower rates for a considerable length of time. As P. Praet (2013) explained, the formulation 'for an extended period of time' marks a change in the communication of monetary policy. It is a form of 'forward guidance', a communication instrument by which central banks convey their monetary policy orientation going forward, conditional on their assessment of the economic outlook.

This is not the same 'forward guidance' adopted by the FED and the BOE which sets up a target in terms of the unemployment rate. The ECB 'forward guidance' does not mention any target. A paper by J. Campbell, J. Fisher and A. Justiniano(2012) shows that more than half of the business cycle variation in the Federal Funds rate before the financial crisis is accounted for by 'forward guidance'. This suggests that the traditional interest rates rules are miss-specified. Moreover, forward guidance has explained about 9 % of output fluctuations at the business cycle frequencies, but much more in certain episodes.

Finally, the Monetary Dialogue may prove useful for confidence building. It is important to recognise that, even if the trust of European citizens in the euro area, the ECB and the EU has been falling during the crisis, the EP and the ECB are still among the most trusted institutions of the EU according to both the Euro-barometer as well as other sources (C. Arnold, E. V. Sapir and G. Zapryanova (2013)). EU citizens appear to trust more the EP than in the ECB. A fortiori, the quarterly dialogue of the ECB President with the ECON Committee of the EP could be a very effective way to enhance transparency of monetary policy and promote better accountability of the ECB towards its democratically elected body.

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