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The ECB's Role in the Design and Implementation of (Financial) Measures in Crisis-Hit Countries

Monetary Dialogue November 2015

COMPILATION OF NOTES

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Abstract

Since 2010, the ECB – as a component of the so-called Troika - has been providing technical assistance/advice in the design and adoption of measures for contributing to the financial stability of crisis-hit countries. The ECB's role has been especially - but not exclusively - important in decisions concerning the recapitalization of national financial systems. Actions taken by the ECB in that context have been sometimes criticized as undemocratic and questioned for granting an excessive power to the institution and interfering with Member States' national sovereignty. The notes in this compilation by key monetary experts discuss the pros and cons of these ECB actions in the light of ECB mandate and its institutional dimension. In particular, the note discuss whether similar actions put ECB independence at risk.

The notes have been requested by the Committee on Economic and Monetary Affairs (ECON) of the European Parliament as an input for the November 2015 session of the Monetary Dialogue between the Members of the ECON Committee and the President of the ECB.

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DISCLAIMER

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INTRODUCTION

Since 2010, the ECB – in particular as a component of the so-called Troika - has been providing technical assistance /advice in the design and adoption of measures for contributing to the financial stability of crisis-hit countries, in particular Greece, Ireland, Portugal, Cyprus, Italy and Spain. The ECB's role has been especially - but not exclusively - important in decisions concerning the recapitalization of national financial systems.

Actions taken by the ECB in that context have been sometimes criticized as undemocratic and questioned for granting an excessive power to the institution and interfering with Member States' national sovereignty. While it is true that ECB statute grants the ECB the power to offer opinions on matters in its "field of competence", the measure effectively adopted following also ECB's advice are likely to have a direct impact on taxpayers, bank depositors and bond holders. A clear example is the controversy surrounding the recapitalization of Irish banks in 2011 and the alleged involvement of the ECB in the area of "burden-sharing of debt" in Ireland[1]. Another example is the letter sent to Italy[2] in 2011, detailing the "appropriate policy actions" expected to be taken by the government. A similar letter with a list of "essential policy measures" was sent in 2011 to the Spain[3].

Some argue that these ECB "actions" go beyond "opinions" on matters in the ECB "field of competence". The ECB argues that it has been acting with the purpose of safeguarding the financial stability of the euro area, which is fully within its mandate.

The notes in this compilation by key monetary experts discuss the pros and cons of these ECB actions in the light of ECB mandate and its institutional dimension. In particular, the note discuss whether similar actions put ECB independence at risk. The main conclusions and policy recommendations 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 November 2015 session of the Monetary Dialogue between the Members of the ECON Committee and the President of the ECB.

Ajai Chopra (PIIE). The ECB has been thrust into an expanded and pivotal role during the euro area crisis, including in areas that took it outside its core competence and tasks. Many of the tasks that it took on reflected the inadequate institutional structure of the monetary union. Some of these institutional deficiencies are being addressed, for example the establishment of the European Stability Mechanism and initial steps toward a banking union, but much more still needs to be done to establish a robust architecture to strengthen the resilience of the monetary union. Meanwhile, the ECB has failed in its core task of maintaining price stability at enormous cost for the euro area.

One of the ECB's new tasks has been to participate as a member of the troika in the design, implementation and monitoring of EU-IMF financial assistance programs for troubled euro area countries. The formal designation that the ECB acts only "in liaison" is a myth as it exercises substantial power and influence in the troika, not least because its willingness to threaten the withdrawal of liquidity support gives it tremendous leverage.

In the case of Ireland, the ECB sent a gratuitous letter to the authorities with an ultimatum about emergency liquidity assistance (ELA) access and with dubious advice on fiscal policy and structural reforms. It did not permit burden sharing with bank senior

[1] http://www.ecb.europa.eu/press/html/irish-letters.en.html
[2] http://www.corriere.it/economia/11_settembre_29/trichet_draghi_inglese_304a5f1e-ea59-11e0-ae06-4da866778017.shtml
[3] https://www.ecb.europa.eu/pub/pdf/other/2011-08-05-letter-from-trichet-and-fernandez-ordonez-to-zapateroen.pdf

creditors even for essentially defunct banks, resulting in Eurosystem liquidity support being used to pay off bank creditors. The ECB also pushed for rapid deleveraging of the banking sector to quickly reduce its exposure to Ireland and was slow and grudging in providing a public commitment to continue liquidity support under the agreed program. In many of these decisions, the ECB saw the interest of Irish tax payers as being subordinate to protecting its own balance sheet. These missteps and lack of accountability have understandably tarnished the ECB's reputation and legitimacy in the eyes of the Irish public. Similarly, the ECB's recent decision to freeze ELA for Greece has strong political overtones, compromising its cherished independence.

Against this backdrop, it will be important to re-think the ECB's role in the management of financial assistance programs with distressed euro area countries. As the central bank and bank supervisor of each individual euro area country and also the entire euro area, the ECB should not be a part of the troika where it sits across from the country authorities. It belongs on the country's side of the table. Furthermore, ELA should no longer be provided via national central banks and instead should be in the hands of the ECB under transparent procedures and proper accountability. The ECB's priority should not be to protect its own balance sheet but rather to enhance euro area stability.

Daniel Gros (CEPS). It is not new that monetary policy decisions may have a fiscal element. However, at the time the Maastricht Treaty was written and ratified, it was assumed that the fiscal implications of monetary policy would be diffuse and of second-order importance. This changed with the financial crisis, forcing the ECB into a delicate position. There is little point in judging the ECB's actions on specific cases, like Ireland, with the benefit of hindsight.

In terms of future European Stability Mechanism (ESM) programmes, the ECB should limit itself to providing general advice, refrain from going into the details of the programme and should not participate in missions to national capitals. One has to keep in mind that the ECB has three decision-making bodies. The Executive Board has managed the participation in the Troika on its own. The Governing Council, theoretically the supreme body of the ECB, has only been informed ex post. Moreover, the Single Supervisory Mechanism (SSM), which if formally part of the ECB, will at any rate most probably be involved in any future ESM programme, as also will the Single Resolution Board (SRF), with funding provided by the Single Resolution Fund (SRF).

Given that the ECB is an independent institution, it can in principle exercise broad discretion (within its mandate) in its decisions. But it might be well advised to follow the example of the Federal Reserve, which usually abstains from commenting on the general economic policy of the US government. The independence of the ECB is formally much stronger than that of Federal Reserve. Moreover, the ECB does not face one unified political actor, but many different national governments whose opinions are often at odds with one another, thus providing another, de facto, layer of protection of its independence. But the ECB was granted its full independence so that it could make its monetary-policy decisions without political interference.

The single task (price stability) combined with clear decision-making provide the conditions for the accountability of the ECB. With ambiguous tasks (and responsibilities) and multifaceted involvement in adjustment programmes, it becomes difficult to hold the ECB accountable in this respect. This provides another reason why the ECB should limit its future involvement to giving advice.

Kar Whelan (University of Dublin). The paper discusses the ECB's role in Ireland's EU-IMF programme and briefly raises some issues regarding its decisions relating to the Greek banks during this year's crisis. The absence of clear procedures for lender of last resort led to a number of key decisions being taken by the ECB in a way that fell short of the relatively transparent and accountable standards that it has set in the monetary policy area. The paper recommends that the ECB should no longer be involved in designing or monitoring fiscal policy or structural reform conditionality for financial assistance programmes. Some institutional changes have occurred that make some of the negative aspects of the ECB's involvement in Ireland's programme less likely to occur again. However, this year's events in Greece show that as long as the ECB's lender of last resort role remains confused, questions about whether the ECB is acting beyond its legal mandate and becoming overly involved in political developments will continue to be aired.

European Parliament

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

The ECB's role in the design and implementation of crisis country programmes: Ireland and beyond

Ajai CHOPRA

IN-DEPTH ANALYSIS

Abstract

The ECB has been an integral participant in the design and monitoring of financial assistance programmes for euro area countries. This paper focuses on the role the ECB played in the Ireland programme and points to several missteps made by the ECB, including preventing burden sharing with senior bank creditors, pressing for swift deleveraging to reduce its exposure, and failing to provide ex ante commitments to provide liquidity support under the programme. These missteps have tainted the ECB's legitimacy in Ireland. Similarly, the ECB's recent decision to freeze emergency liquidity assistance (ELA) for Greece has strong political associations, undermining its independence. The paper recommends that the ECB should not be a part of the troika, negotiating and monitoring programmes. Furthermore, ELA should no longer be provided by national central banks and instead should be in the hands of the ECB under transparent procedures and proper accountability.

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EXECUTIVE SUMMARY

- The incompleteness of the euro area's institutional design, especially the absence of a banking and fiscal union, has propelled the ECB's role in the design and implementation of EU-IMF programmes for euro area countries. This role gives the ECB great power and influence but also generates controversy and resentment in these programme countries.

- In a gratuitous November 2010 letter to the Irish Finance Minister, the ECB threatened to cut off liquidity support for Irish banks unless the government agreed to a financial assistance programme with the EU and IMF. The letter also made demands in the areas of fiscal austerity and structural reform that were not only beyond the ECB's remit but were also wrong for Ireland's circumstances.

- The ECB opposed imposing losses on Irish banks' senior bond holders and made it clear that it would not support a programme that included this feature. Even if the ECB believed that spillover risks dominated at the time, why should Irish taxpayers bear a disproportionate burden to address wider euro area concerns? Furthermore, why was the ECB unwilling to consider forceful liquidity support for euro area banks at the time to mitigate potential contagion in bank funding markets?

- The ECB initially pressed for swift deleveraging of Ireland's banking sector through front-loaded and large-scale asset sales to reduce quickly in its large exposure to Ireland. In doing so, it put protection of its own balance sheet before the cost to the Irish taxpayer. Later the ECB accepted that fire sales of assets would be counterproductive, but by then trust in the institution and its legitimacy had been damaged.

- Even though ECB liquidity support for the Irish banking system was a critical component of the programme, the ECB was unwilling to make an ex ante commitment on this front. More vocal public support by the ECB from an early stage would have inspired greater confidence and would have likely reduced the required amount of Eurosystem funding.

- Looking beyond the Ireland programme, the ECB's monetary policy has been much too tight since the start of the crisis in 2008. This has damaged the economic recovery not only of crisis countries but the entire euro area. Countries' debt burdens are harder to bear because low inflation moderates nominal income while leaving debts untouched.

- The ECB's asymmetric view of its inflation target makes it important have a debate about the appropriate definition of price stability to guide a more pro-active monetary policy. For example, an explicitly symmetric inflation target of 2 percent should be considered.

- The ECB threatened to cut off emergency liquidity assistance (ELA) in Ireland and Cyprus, but in Greece it actually did so. The discretion exercised by the ECB in the provision of ELA has made it more of a political actor instead of an independent technocratic institution. An overhaul of procedures for granting ELA with the aim of increasing transparency and accountability should be a high priority. As the ECB is now the single supervisor for large euro area banks, ELA should no longer be provided via national central banks and instead should be fully in the hands of the ECB.

- The ECB is the central bank and bank supervisor of each euro area country and the entire euro area. It should therefore not be a part of the troika where it sits across the table from country authorities and negotiates and monitors financial assistance programmes. The ECB belongs on the country's side of the table.

1. INTRODUCTION

When the financial and sovereign debt crisis hit the euro area, it brought to the forefront the incompleteness of the area's institutional design, especially the absence of a banking and fiscal union. Related to these deficiencies, the euro area also lacked an area-wide treasury to issue and pool debt and a sovereign lender of last resort. As euro area policymakers tried to save the euro, stabilize financial markets, and deal with severe distress in some countries, the institutional vacuum resulted in the ECB gaining substantial power and influence despite its narrowly-defined core task, which is to ensure price stability.

This paper focuses on a specific aspect of the ECB's power and influence, namely its participation in the design and implementation of EU-IMF financial assistance programmes for euro area countries. Although four countries have had such programmes—Greece, Ireland, Portugal and Cyprus—the paper puts emphasis on the case of Ireland.[1] Section 2 describes the impact that the ECB had on the Ireland programme. It points out that the ECB's advice on fiscal policy and structural reforms, areas outside the ECB's mandate, was wrong for Ireland's circumstances; that the ECB prevented the imposition of losses on senior creditors of Irish banks thus increasing the burden on Irish tax payers; and also that it took positions, for example on the pace of deleveraging, in the interest of protecting its own balance sheet rather than in the Ireland's interest.

Section 3 considers some broader implications of the ECB's policies and role. It notes that the ECB's delays and half measures to loosen monetary policy since the start of the crisis have been costly not only for the crisis countries but the entire euro area. The section also discusses the discretion exercised by the ECB in the provision of emergency liquidity assistance (ELA) to distressed banks, which has taken the ECB's politicization to new heights. A key recommendation is that the ECB should step aside as a member of the troika (that is, the European Commission, the ECB and the IMF) tasked with negotiating and monitoring financial assistance programmes. Section 4 summarizes the main conclusions.

[1] For full disclosure it is important to state that the author was responsible for the IMF staff's work on Ireland from 2009 to 2013. He led the IMF team that negotiated the EU-IMF programme in November 2010. He has also testified before the Irish Parliament's Committee of Inquiry into the Banking Crisis on some of the issues covered in this paper. This paper draws in part on that testimony, available at: https://inquiries.oireachtas.ie/banking/.

2. ECB IMPACT ON THE IRELAND PROGRAM

2.1. The ECB's letters to Ireland

In November 2014, the ECB published two letters (dated 19 November 2010 and 15 October 2010) sent by former ECB President Jean-Claude Trichet to Brian Lenihan, Ireland's Minister for Finance at the time.[2] Prior to their publication, the ECB had insisted that the letters needed to remain secret; their publication has ended speculation about the content of the letters.

The two letters were sent against the backdrop of a sharp increase in ECB liquidity support to the Irish banking system starting in September 2010 when Irish banks were unable to roll over large quantities of maturing bank bonds that had been issued under an Irish government guarantee established in September 2008. In addition, the outflow of non-resident corporate and wholesale deposit accelerated as confidence in Irish banks eroded. When the ECB released the Irish letters, it reported that the level of liquidity provided by the Eurosystem to Ireland's banking system had reached about €140 billion by November 2010, including ELA, which are loans from the Central Bank of Ireland against collateral that is not eligible for standard Eurosystem operations. This level of support was equivalent to 85 percent of Irish GDP. It also represented about one fourth of the ECB's total lending, while Ireland's share in the ECB's capital was about one percent.

By November 2010, the Irish banking system had become fully dependent on Eurosystem liquidity support to survive. The ECB's discomfort with this unprecedented level of exposure was evident. Although ECB rules on liquidity support were designed to provide strong credit protection to the ECB, the ECB had not anticipated the need to fund an entire banking system, especially one where doubts around its solvency persisted despite the findings of the European stress tests. Perturbed by the situation in the Ireland, the 15 October 2010 letter stated, "the large provision of liquidity by the Eurosystem and the Central Bank of Ireland should not be taken for granted as a long-term solution."

Although the letters were kept secret, there is evidence that ECB officials made their disquiet about Irish banks reliance on ECB funding public by briefing market analysts and journalists.[3] Such briefings drove speculation that the ECB was considering the withdrawal of liquidity support to Irish banks, which helped fuel the wholesale bank run and exacerbated what the Irish were trying to avoid. Moreover, borrowing from the Eurosystem was used to pay off maturing Irish bank bonds, effectively bailing out the holders of these bonds at the insistence of the ECB as discussed in greater detail below.

The 19 November 2010 letter stated that "… only if we receive in writing a commitment from the Irish Government vis-à-vis the Eurosystem on the four following points that we can authorize further provision of ELA to Irish financial institutions…" (emphasis added). The four demands were: (i) Ireland must request financial support from the Eurogroup; (ii) the request must include a commitment to fiscal austerity, structural reforms and financial sector restructuring "in agreement with the European Commission, the International Monetary Fund and the ECB" (emphasis added); (iii) the recapitalization of banks using financial assistance under the programme and Ireland's own resources; and (iv) a guarantee of the repayment of ELA funds. The letter demanded a swift response before markets reopened after the weekend.

[2] The two letters and the ECB's rationale on key points were published on the ECB's website at: http://www.ecb.europa.eu/press/html/irish-letters.en.html.

[3] See Alan Ahearne's testimony to the Irish Parliament's Committee of Inquiry into the Banking Crisis available at: https://inquiries.oireachtas.ie/banking/wpcontent/uploads/2015/09/09092015_Aherne_vol2.pdf. Whelan (2012) also notes that ECB officials began briefing widely about their concerns about "addict banks" that were overly reliant on ECB funding.

As the lender of last resort for banks, the ECB was entitled to ask the Irish authorities about the viability and solvency of the banks it was supporting and about how the problems of Irish banks were going to be addressed. It is also within the ECB's rights to say that if the Irish sovereign could not borrow on the market to recapitalize banks, it should seek financial assistance from the EU and IMF to accomplish this task.

But the ECB's ultimatum provided in an imperious tone is unbecoming of the way in which EU institutions and nations should conduct business. Moreover, Ireland's central bank governor, Patrick Honohan, was correct to describe the 19 November letter as "gratuitous"[4] because work was already underway by the Irish authorities, the European Commission, the IMF, and indeed also the ECB, to prepare the ground for a programme because Ireland had lost access to the sovereign bond market at interest rates compatible with public debt sustainability. Ironically, the absence of an instrument such as the ECB's Outright Monetary Transactions (OMT), which markets have viewed as a de facto sovereign lender of last resort, contributed to this situation.

Furthermore, the demands in the 19 November letter about fiscal austerity and structural reforms were in the remit of the European Commission and the IMF, and the ECB had no special expertise in these matters in Ireland and other crisis programme countries.

More fundamentally, this problem of overreach was compounded by the wrong position taken by the ECB in these two policy areas. First, on fiscal policy the ECB pressed for even greater front loaded adjustment in Ireland and it wanted a faster return to the Stability and Growth Pact deficit threshold of 3 percent of GDP than advocated by the staff of the European Commission and the IMF. The ECB believed that substantial austerity would convince markets that public finance problems were being addressed and hence speed up a return to sovereign bond market access, without regard to the deflationary effects of fiscal cuts that tend to push public debt-to-GDP ratios up rather than down in the short term. Moreover, at the time the ECB did not seem to recognize that problems euro area countries were facing in government debt markets were due more to the absence of an instrument such as the ECB's OMT than to particularly high government debt ratios (De Grauwe 2011).[5] And finally, the ECB failed to realize that its constant exhortation to euro area governments to tighten fiscal policy when interest rates are approaching or at the zero lower bound makes it more difficult for monetary policy to achieve its objectives.

Second, the ECB's willy-nilly call for structural reforms regardless of country or macroeconomic circumstances indicated muddled thinking about the nature of the euro zone crisis. Ireland's crisis was due to a gigantic boom-bust property cycle with an over-extended banking sector, which then resulted in a collapse in growth and a large fiscal shock. As the Irish economy was flexible, structural distortions played a negligible role either as a cause or remedy for the crisis. But the ECB and other European policy makers attributed poor growth in euro zone economies, including Ireland, to structural rigidities, and hence mistakenly believed that reform would rekindle confidence and economic activity. Even more damaging, implementing structural reforms when demand is depressed and monetary policy is constrained at the zero lower bound can have adverse consequences for the economy.[6]

The ECB's letters to Ireland were not unique. Similar ECB letters with wide-ranging policy advice were sent to other countries as well. The letter to the Spanish government (co-signed by the national central bank governor) pressed for reforms in areas such as the wage bargaining system, limits on spending increases, and increasing competition in the

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[4] See his statement to the Irish Parliament's Committee of Inquiry into the Banking Crisis available at: https://inquiries.oireachtas.ie/banking/wp-content/uploads/2015/06/25062015-Opening-Statement-Patrick-Honohan.pdf

[5] Mody (2015a) correctly points out that the issue goes beyond the conditional purchase of government bonds under the OMT scheme and to the broader question of the absence of a fiscal union.

[6] See Chopra (2014) for additional details on this point.

energy sector.[7] And the letter to the Italian government (also co-signed by the national central bank governor) urged liberalization of public and professional services, privatization, and reform of the wage bargaining system.[8] At the same time, as discussed in greater detail below, while it was hectoring countries on policies outside its mandate the ECB was failing to meet its own mandate of keeping inflation close to 2 percent.

2.2. Burden sharing with senior bank creditors

When the financial rescue programme for Ireland was designed, IMF staff argued that sovereign obligations would be lower if debt owed by banks was restructured. By containing costs borne by the public sector, burden sharing with bank creditors would weaken the bank-sovereign loop that can undermine public debt sustainability, as was the case in Ireland. Sharing losses with creditors also reduces moral hazard and helps contain the risk of future crises.

Sizeable liability management exercises for banks' junior debt helped reduce fresh injections of capital by the government. But imposing losses on bank creditors should not be restricted only to junior bondholders. A decision to share losses with senior unguaranteed and unsecured bank bondholders should, in principle, be based on (i) the magnitude of a banks' overall losses; (ii) the need to return the bank to a more stable funding structure; and (iii) the potential knock-on effects on others. Burden sharing would also need a robust legal and institutional framework that strikes a reasonable balance between creditor safeguards and flexibility. The "Credit Institutions Stabilization Act" passed in late 2010 provided such a framework.

The ECB, however, was vehemently opposed to imposing losses on banks' senior bond holders and made clear that it would not support a programme that included this feature. In the explanation for this decision when the Irish letters were published, the ECB noted that "any potential burden-sharing of senior debt in the immediate aftermath would first and foremost have had negative spillover effects on the financial stability of Ireland, as well as on other European countries." In addition, the ECB argued that the decision was taken during a period of still acute uncertainty and that the potential savings for Ireland were limited.

Thus, when the programme was agreed in December 2010 it did not include burden sharing with senior bank creditors, as the Irish government was unable to act against the wishes of the ECB. When a new Irish government took office in March 2011, about three months after the launch of the programme, and prepared to announce the results of the bank asset quality review and stress tests on 31 March 2011, they made a distinction between "pillar banks"—that is, going concern banks such as Allied Irish and the Bank of Ireland undergoing restructuring with public support—and failed banks such as Anglo Irish and Irish Nationwide. They stated that pillar banks must operate in the market as strong banks with a positive future and ongoing relations with all counterparties. In making such a distinction, the hope was that the ECB would allow burden sharing with the senior creditors of the failed banks. In particular, Anglo Irish would have met the three criteria mentioned above – it was a failed bank with losses that were many multiples of its capital; it did not need to worry about future counterparty relations; and it's long-anticipated demise was unlikely to have spillovers for Irish pillar banks or euro area banks. The ECB, however, precluded even this more limited approach to burden sharing with senior bank creditors.

It is understandable that there is a strong sense in Ireland that burden sharing between Irish taxpayers and bank creditors has been unfair. In late 2010 around the time the programme was launched, remaining unguaranteed and unsecured senior bondholder

[7] The letter is available on the ECB website at: https://www.ecb.europa.eu/pub/pdf/other/2011-08-05-letter-from-trichet-and-fernandez-ordonez-to-zapateroen.pdf.

[8] See http://www.corriere.it/economia/11_settembre_29/trichet_draghi_inglese_304a5f1e-ea59-11e0-ae06-4da866778017.shtml.

exposure for all domestic banks was about €16 billion, somewhat above the magnitude of envisaged fiscal tightening over the next four years. And in March 2011, having continued to pay out a large quantity of maturing debt using ELA, outstanding senior bonds issued by Anglo Irish had dropped to somewhere between €3 and €4 billion, equivalent to one year's worth of government spending cuts and tax increases. These comparisons made the issue very visible to the public and are contrary to the ECB's claim that the amounts involved were "limited."

Furthermore, as pointed out in IMF (2015), the evidence is not clear on the risks of cross border spillovers from bailing in senior bank creditors in Ireland, and policies could have been put in place to address these risks more directly if they arose. To quote:

> "Spillovers should have been limited if markets and bondholders of Irish senior unsecured bank debt were expecting a bail in. Indeed, Irish (senior unsecured) bank bonds traded at the time at levels consistent with clear anticipations of a principal haircut, reflecting that some burden sharing was anticipated by bondholders and markets. While the anticipation of risks does not always preclude additional repercussions if these risks actually materialize, the magnitude of the repercussions should generally be more contained. Moreover, even if cross border contagion risks were considered important, steps could have been taken to ring fence these through appropriate policy responses in the affected markets. This could have included supporting steps by country authorities in cases where their banks' solvency would be threatened from writing down their direct exposures to Irish senior unsecured debt; and/or, if needed, by forceful liquidity support by the ECB to ensure no disruptions in euro banks' funding markets" (page 28, paragraph 51).

Similarly, Whelan (2012) pointed out that by late 2010 it is likely that a significant fraction of the Irish bank bonds were owned by hedge funds and distressed-debt specialists willing to gamble that the bonds might be paid out. Although not available at the time, recent academic research by Bonaldi, Hortaçsu, and Kastl (2015) confirms the view that spillover risks were exaggerated. Their empirical analysis of funding cost spillovers in the euro zone finds that contagion between most euro zone banks is limited because they have fairly weak links, and that contagion risks are significant only when the biggest euro zone banks are involved.

Even if the ECB believed that spillover risks dominated at the time, two questions remain. First, why should Irish taxpayers have to bear a disproportionate burden to address wider euro area concerns? And second, why did the ECB not consider forceful liquidity support to ensure minimal disruption in euro banks' funding markets and thus mitigate possible contagion?

Based in part on the Ireland experience, under the EU's subsequent Bank Recovery and Resolution Directive, which came into force on 1 January 2015, bailing in banks' investors and creditors will become the norm before resolution authorities can access public support.

2.3. Promissory note transaction

As the Irish government had not been allowed to impose losses on senior bondholders, the authorities began to seek alternative means to improve debt sustainability. These efforts started in 2011 with various approaches being considered and debated, some trying to take advantage of policy initiatives floated in the broader euro zone context. Securing better terms was seen as essential to help contain the political cost of the decision on burden sharing, thereby protecting coalition support for fiscal consolidation.

From the start, a priority was to find a way to tackle the much-hated promissory notes. With the government unable to borrow on the market during 2010 to recapitalize banks, the promissory notes were essentially non-tradable government debts placed in Anglo Irish

Bank and Irish Nationwide to ensure these entities were adequately capitalized in order to be eligible for Eurosystem liquidity. These notes ended up on the balance sheet of their successor, the Irish Bank Resolution Corporation (IBRC) and served as collateral for the ELA provided by the Central Bank of Ireland to IBRC. The notes carried a high debt service burden of approximately 2 percent of GDP per year, requiring politically toxic offsetting budget cuts in the short term because Ireland lacked market access.

The objective was to extinguish both the promissory notes and ELA, thereby achieving the twin goals of lowering the government's annual financing needs over the next decade and removing the uncertainty overhanging IBRC funding because ELA, which requires ECB Governing Council approval every two weeks, is not stable funding. Finding a solution to the heavy amortization schedule for the notes was important to help restore market access for the sovereign and thus reduce and eventually eliminate reliance on official funding.

Initially, the ECB insisted on adhering to the original debt service schedule for the promissory notes because they wished to see the ELA repaid according to previous commitments. But following tenacious efforts by the Irish authorities over two years, a satisfactory promissory note transaction was eventually concluded in February 2013.

In brief, the transaction involved early liquidation of IBRC, which allowed the Central Bank of Ireland to seize its collateral and eliminate ELA. The promissory notes were restructured and replaced by a portfolio of new tradable long-term government bonds with maturities of 25 to 40 years. By eliminating the need to make principal repayments for more than two decades, the new bonds obviated the potential need for damaging additional fiscal austerity in the short run and helped address long-run concerns for debt sustainability. The extension and back loading of maturities also reduced the net present value of the obligation. The Central Bank of Ireland also indicated its intention to sell the bonds into the market on a specified schedule, thus signalling that it's holdings were temporary and helping to counter possible accusations that the prohibition of monetary financing was being violated.[9]

ECB staff worked constructively with the Irish authorities to devise this solution, and it required many iterations to bring the ECB on board. Although the ECB's Governing Council was deliberately silent about the transaction, its "non-objection" was essential for the Irish government to proceed with the transaction.

2.4. Pace of bank deleveraging and ECB exposure

The purpose of bank deleveraging plans under the programme was to reduce the size of the enormous banking sector. It was important to align the size of bank assets with stable funding sources and reduce reliance on wholesale funding and ECB liquidity support, but at a reasonable pace over a period of time. A central issue, however, was ECB financing, which had peaked at almost €160 billion by early 2011, of which more than a third was ELA. That size of funding simply could not be obtained by credit enhancements using programme resources.

Initially, the ECB pressed for swift deleveraging through front-loaded and large-scale asset sales to induce the quick reduction of its huge exposure to Ireland. As on other key policy issues, the ECB tended to take positions to protect its own balance sheet rather than in the country's interest and cost to the Irish taxpayer. The Irish authorities, however, resisted this pressure from the ECB, arguing that judging long-term property values or expecting to get reasonable prices for asset sales was impossible in the midst of a global financial storm and at the bottom of a recession. Eventually, in late-February 2011, almost three months after the launch of the programme, the ECB relented and accepted that fire sales of assets would be counterproductive and should be avoided. The ECB still wanted to see visible progress in the reduction of its exposure to Ireland, but they agreed it did not need to

[9] See Whelan (2013) for additional details about the transaction and an assessment of its benefits.

happen at an unreasonable speed. But by the time of this turnaround, trust in the institution and its legitimacy had already been damaged.

Even though ECB liquidity support for the Irish banking system was a critical component of the programme, the ECB was unwilling to make this part of any explicit agreement. Thus, when the programme was launched in December 2010 there was no ex ante commitment that the ECB would continue to provide liquidity support to Irish banks over the course of the programme. Restructuring of the Irish banking system would have benefitted from the availability of long-term financing. Instead, the need to get ELA re-approved every two weeks introduced an element of threat that it might not be renewed at some point, hurting confidence and the availability of needed bank funding. Indeed, more vocal public support by the ECB from an early stage would have inspired greater confidence and would likely have reduced the required amount of Eurosystem funding.

Subsequently, on 31 March 2011, when the Irish authorities announced the results of their bank asset quality review and stress tests, the ECB issued two supportive press statements.[10] One stated that in view of bank recapitalization and other measures being adopted by the Irish authorities to stabilize the banking system, the Eurosystem would continue to provide liquidity to banks in Ireland. The other announced the suspension of rating thresholds for Irish government debt making such paper eligible as collateral for ECB operations.

[10] The two press releases are available at: https://www.ecb.europa.eu/press/pr/date/2011/html/pr110331.en.html and https://www.ecb.europa.eu/press/pr/date/2011/html/pr110331_2.en.html.

3. BROADER IMPLICATIONS OF ECB POLICIES AND ROLE

3.1. ECB: behind the curve

The ECB's monetary policy has been much too tight since the start of the crisis in 2008.[11] The central bank's delinquency in providing needed monetary accommodation damaged the economic recovery not only of crisis countries but the entire euro area. Indeed, in an inglorious episode, the ECB tightened monetary policy in 2011, making the error of not recognizing that with unemployment still rising, commodity price inflation would not lead to a wage-price spiral and threaten its inflation goal of less-than-but-close-to 2 percent. This tightening took place at a time when the ECB was also exhorting euro area countries to implement greater fiscal tightening, worsening the restrictiveness of policy.

When the ECB eventually started to gradually lower interest rates, it followed rather than anticipated the deceleration in inflation as it took an asymmetric view of its inflation target. This asymmetric view of the inflation target is well depicted by this statement by former ECB Executive Board member Jürgen Stark: "The current inflation rate of 0.3% is due to the significant decline in commodity prices and the painful but unavoidable adjustment of costs and prices in the peripheral countries. Only Greece currently has a slightly negative inflation rate. In other words, price stability reigns in the eurozone. This strengthens purchasing power and ultimately private consumption. The ECB has fulfilled its mandate for the present and the foreseeable future. There is no need for policy action in the short term."[12] Such views, especially if believed by some current members of the ECB's Governing Council, are made more dangerous because of the zero lower bound.

Six years after the U.S. Federal Reserve and the Bank of England, in January 2015 the ECB eventually overcame its reluctance and began an aggressive programme of quantitative easing. In October 2015, the ECB signaled that it is prepared to do more to stimulate the economy.

The ECB's delays and half measures to loosen monetary policy since the start of the crisis have been costly (Mody 2015b). Greece and Spain are already in deflationary territory, and Italy is at the cusp of falling into the same trap. These countries' debt burdens are much harder to bear because deflation reduces nominal income while leaving debts untouched. In addition, asymmetric adjustment based on internal devaluation in the euro area's crisis countries becomes even more costly and ineffective.

Although Article 127 (1) of the Treaty on the Functioning of the European Union lays down price stability as the primary objective of the ECB, the ECB itself gets to choose how to interpret price stability. It is important, therefore, that there be a debate about the appropriate inflation target and definition of price stability to guide a more pro-active monetary policy. This is a vast topic and in the interest of brevity only a single example is provided here: Ubide (2014) recommends that the ECB should revise its definition of price stability to an explicitly symmetric 2 percent over two to three years in order to arrest the decline of inflation expectations.

This discussion has focused on the stance of monetary policy, but it is important to highlight that the absence of a sovereign lender of last resort for the euro area also caused damage. It took two years of an existential euro crisis before the ECB's OMT instrument was introduced, allowing the ECB to purchase government bonds of weaker euro area countries under strict conditions. Earlier introduction of this instrument could have allowed

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[11] See Kang, Ligthart and Mody (2015a) for a comprehensive comparison of the monetary policy actions by the ECB and the US Federal Reserve.

[12] See "The ECB's Leap into the Unknown" Project Syndicate, October 1, 2014. https://www.project-syndicate.org/commentary/jurgen-stark-has-sharp-words-for-the-european-central-bank-s-decision-to-double-down-on-monetary-stimulus

countries such as Ireland and Spain to avoid a bad equilibrium when faced with a multiple equilibrium problem.

3.2. Greece and the further politicization of the ECB

On 28 June 2015 the ECB refused to provide additional emergency funds to Greek banks that were facing a slow-motion run.[13] By doing so, it fueled the self-fulfilling logic of a bank run, requiring the Greek authorities to declare an extended bank holiday and impose capital controls. The ECB had threatened to cut off ELA in Ireland in 2010 and Cyprus in 2013, but in Greece it actually did so.

Why did the ECB take such a step? Although the ECB's motivation appeared to be that Greek banks might be insolvent if there was no agreement between Greece and the Eurogroup, the perception is unavoidable that it froze ELA funding as punishment for calling a referendum and not agreeing to the Eurogroup's terms. Wyplosz (2015) forcefully argues that the decision to freeze ELA takes the ECB's politicization to new heights: "The ECB will undoubtedly come up with all sorts of legal justifications. Whether true or not, this will not change the outcome. If the ECB is truly legally bound to stop ELA, this means that the Eurozone architecture is deeply flawed. If not, the ECB will have made a political decision of historical importance. Either way, this is a disastrous step. Whether it likes it or not, every central bank is a lender of last resort to commercial banks."

In a similar vein, Wren-Lewis (2015) says the ECB took sides when it froze ELA for Greek banks and states that "The ECB was not, and never has been, a neutral actor just following the rules of a good central bank. It has always been part of the Troika, and right now it is the Troika's enforcer." As the ECB has the legal mandate to be a more independent central bank, Wren-Lewis notes: "The really interesting question is why it has turned out not to be such a bank."

The discretion exercised by the ECB in the provision of ELA is also evident in its handling of Cyprus. Although the Bank of Cyprus and Laiki Bank, the two largest Cypriot banks, were effectively insolvent from early 2012 onwards, the ECB approved substantial ELA for them from the Central Bank of Cyprus. But in March 2013 the ECB switched its position and insisted that these banks be recapitalized via a write-down of customer deposits before it could continue approving ELA. Based on this example and examples from Ireland and Greece, Whelan (2014a) states: "…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."

In a subsequent paper, Whelan (2014b) makes an important proposal for a new approach for the ECB as lender of last resort. Now that the ECB has become the single supervisor for euro area banks, the case that ELA should be provided by national central banks with ECB approval has been substantially weakened. As bank supervisor, the ECB is now in the best position to assess whether liquidity problems faced by a bank applying for ELA are due to temporary or more fundamental problems. Whelan therefore proposes that ELA requests should be handled and approved directly by the ECB and not the national central bank and that the entire Eurosystem should share the risk associated with this lending. Such an approach would also help speed up the restructuring of problem banks and avoid a repeat of long-term ELA provision where the funding is used to allow private creditors to get their money out of insolvent banks.

As a corollary to this proposal, it will be important for the ECB to be transparent and accountable for its ELA decisions, and that it have well-defined criteria for granting or cutting off ELA consistent with maintaining independence from political pressure.

[13] See ECB press release at: https://www.ecb.europa.eu/press/pr/date/2015/html/pr150628.en.html

3.3. The ECB in the troika

The "troika" originated during the discussions for the first EU-IMF programme with Greece in March-April 2010 and refers to the three negotiating partners, the European Commission, the ECB and the IMF. Formally, the European Commission "in liaison with the ECB" represents the EU side, and this configuration of negotiating and monitoring partners has persisted for all euro area crisis programme countries. With the greater role played by the European Stability Mechanism (ESM), the troika has recently evolved into the "quadriga," an equally ugly label.

Pisani-Ferry, Sapir and Wolff (2013) suggest that the rationale for ECB involvement is the inadequate institutional arrangement in the euro area, which forced the ECB to act as a quasi-fiscal actor in programme countries. Similarly, Mody (2015a) notes that the ECB's safety net for insolvent or near-insolvent banks and sovereigns in effect substituted for the absent fiscal union and drew the ECB into the political process. The result is that the ECB sits on the lending side of the programme table, whereas the national central bank of the country sits on the other side. As such, the ECB has played a vital part in programmes by either relaxing its collateral standards (as in Greece, Ireland, Portugal and Cyprus) or tightening them if it so desires (as it did for Ireland in October 2010), and by turning the tap for ELA on or off (as it did in Greece and Cyprus).

Although the ECB has a clear role in lending to banks and ensuring their viability and solvency, being on the lender's side of the table allows it to impose and monitor programme conditions in other areas as well. The formal designation of "in liaison with the ECB" is a myth, as the ECB has taken positions on a range of programme matters. Furthermore, the ECB's willingness to threaten the withdrawal of ELA access gives it enormous leverage. As discussed earlier, the ECB vetoed plans to impose losses on Irish banks' senior bondholders, insisting that they be repaid in full for the programme to proceed. The ECB also takes a harsh line on fiscal policy, urging more rapid consolidation and instructing countries on deeply redistributive policies for which it does not have a mandate. ECB inflexibility also took certain beneficial policy actions (such as early restructuring of the Irish promissory notes) "off the table" until their preferences were met. As the practice has been that troika members would not publicize disagreements among themselves, the weight exercised by the ECB increases the pressure on other troika members to compromise and show consensus.

The fiction of "in liaison with the ECB" allows the ECB to take tough positions, often to protect its own balance sheet rather than in the interest of the country, but then use this designation as cover to avoid responsibility and accountability. Unlike the European Commission and IMF, the ECB does not produce and publish its own programme documents, which would allow public scrutiny of its analysis and recommendations. Even apart from the lack of accountability, the rationale for the ECB's involvement in aspects of programme design and monitoring outside the banking system is weak. Whelan (2012) notes that linking the performance of public finances with the "privilege" of receiving support from the Eurosystem suggests a role for the ECB that does not exist in European treaties.

The ECB's new role as the single supervisor for euro area banks adds an additional layer of complexity to its role on the troika. It is therefore time for the ECB to step aside as a member of the troika or quadriga tasked with negotiating and monitoring financial assistance programmes for euro area countries. The ECB's legitimate tasks in the banking area can be achieved by assessing each bank on its own merits. The more appropriate role for the ECB is on the country's side of the table as its central bank (together with the national central bank, which over time should acquire the status of regional ECB branch offices) and as the supervisor of the country's banks.

Indeed, in its opinion on the ECB's OMT programme, the Advocate General of the European Court of Justice stated that it is "essential for the ECB to detach itself thenceforth from all direct involvement in the monitoring of the financial assistance programme applied to the State concerned. Nothing would prevent the ECB from being kept informed and even from being heard, … but under no circumstances would it be possible for the ECB, in a situation in which a programme such as OMT is under way, to continue to take part in the monitoring of the financial assistance programme to which the Member State is subject when, at the same time, that State is the recipient of substantial assistance from the ECB on the secondary government bond market."[14] This logic also applies to the present situation where the ECB is the supervisor of euro area banks and a provider of liquidity to banks in programme countries.

[14] See paragraphs 150 and 151 of the European Court of Justice opinion on the OMT programme, Case-62/14, available at: http://curia.europa.eu/juris/liste.jsf?td=ALL&language=en&jur=C,T,F&num=C-62/14.

4. CONCLUSIONS

The ECB has been thrust into an expanded and pivotal role during the euro area crisis, including in areas that took it outside its core competence and tasks. Many of the tasks that it took on reflected the inadequate institutional structure of the monetary union. Some of these institutional deficiencies are being addressed, for example the establishment of the European Stability Mechanism and initial steps toward a banking union, but much more still needs to be done to establish a robust architecture to strengthen the resilience of the monetary union. Meanwhile, the ECB has failed in its core task of maintaining price stability at enormous cost for the euro area.

One of the ECB's new tasks has been to participate as a member of the troika in the design, implementation and monitoring of EU-IMF financial assistance programmes for troubled euro area countries. The formal designation that the ECB acts only "in liaison" is a myth as it exercises substantial power and influence in the troika, not least because its willingness to threaten the withdrawal of liquidity support gives it tremendous leverage.

In the case of Ireland, the ECB sent a gratuitous letter to the authorities with an ultimatum about ELA access and with dubious advice on fiscal policy and structural reforms. It did not permit burden sharing with bank senior creditors even for essentially defunct banks, resulting in Eurosystem liquidity support being used to pay off bank creditors. The ECB also pushed for rapid deleveraging of the banking sector to quickly reduce its exposure to Ireland and was slow and grudging in providing a public commitment to continue liquidity support under the agreed programme. In many of these decisions, the ECB saw the interest of Irish tax payers as being subordinate to protecting its own balance sheet. These missteps and lack of accountability have understandably tarnished the ECB's reputation and legitimacy in the eyes of the Irish public. Similarly, the ECB's recent decision to freeze ELA for Greece has strong political overtones, compromising its cherished independence.

Against this backdrop, it will be important to re-think the ECB's role in the management of financial assistance programmes with distressed euro area countries. As the central bank and bank supervisor of each individual euro area country and also the entire euro area, the ECB should not be a part of the troika where it sits across from the country authorities. It belongs on the country's side of the table. Furthermore, ELA should no longer be provided via national central banks and instead should be in the hands of the ECB under transparent procedures and proper accountability. The ECB's priority should not be to protect its own balance sheet but rather to enhance euro area stability.

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DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Countries under adjustment programmes: What role for the ECB?

Daniel GROS

IN-DEPTH ANALYSIS

Abstract

Providing 'technical assistance/advice' on programmes for countries under financial stress is well within the mandate of the European Central Bank (ECB). Being fully part of the Troika, however, is a different role. Formally the ECB does not participate in the 'decision-making' on programmes (decisions are taken by the Finance Ministers – and the IMF). However, the ECB is part of the 'decision-shaping' process. These two roles have often been confused. The ECB should interpret its formal role in future ESM (European Stability Mechanism) programmes as narrowly as possible. Providing advice but avoid taking part in the operational work of programme surveillance. The ECB should de facto leave the Troika.

At any rate, future incidents like the Italian or Spanish letters will be superseded by the OMTs (outright monetary transactions) and an Irish-type situation would be shaped by the legal framework of the Bank Recovery and Resolution Directive (BRRD) and the potential funding from the Single Resolution Fund (SRF).

An additional issue for the ECB is internal coherence: Its six-member Executive Board manages the participation in the Troika, monetary policy is decided by the Governing Council and banking supervision is under the Supervisory Board, separated in principle by Chinese walls from the (rest of the) ECB.

CONTENTS

EXECUTIVE SUMMARY

- The participation of the European Central Bank (ECB) in the so-called Troika of institutions that manage country adjustment programmes has aroused a lot of political controversy. It is difficult to see why an institution whose task is to ensure price stability for the euro area as a whole should be involved in managing a programme targeting fiscal adjustment and structural reforms in individual member countries.
- It should be borne in mind that when the adjustment programmes started (for the first times in 2010-11) in crisis-hit countries, the entire euro area was facing deep market turbulence and the ECB seemed to be the only institution capable of dealing with the problems at hand. This is important in order to judge the role of the ECB in the country programmes.
- At that moment, it seemed natural to ask the ECB to provide 'technical assistance' and 'advice' concerning the programmes for countries that needed emergency financing. Since the financial stability of the entire euro area seemed at stake, it seemed to fit the mandate of the ECB.
- Being fully part of the Troika is different, however, than providing technical advice. These two different roles have often been confused. The ECB does not participate in the formal decisions concerning the programmes. Decisions on conditions, financing envelopes, etc. are taken by the Finance Ministers (and the IMF). However, the ECB has been very much part of the 'decision-shaping'.
- During the acute phase of the euro crisis, the crucial role of the ECB might have been unavoidable, but in the future, the framework will be different. Incidents like the Italian or Spanish letters will not occur again. The Securities Markets Programme (SMP) has been replaced by the outright monetary transactions (OMTs), which require a European Stability Mechanism (ESM) programme. An Irish-type situation would be managed within the legal framework of the Bank Recovery and Resolution Directive (BRRD) and with potential funding from the Single Resolution Fund (SRF).
- Going forward, the ECB should interpret its formal role in ESM programmes as narrowly as possible. It should limit itself to providing advice and avoid any involvement in the operational work in programme surveillance.
- This already applies to the new programme for Greece. From now on, the ECB should avoid taking part in teams that discuss details of fiscal policy or the many other policy areas (labour markets, competition policy, etc.) covered by the conditionality of the programme. If this happens, in the eyes of the public, the ECB would have, de facto, left the Troika.
- Of course, the ECB retains a legitimate interest in the stability of the banking system of every member state. In this context, it may be faced with a problem of internal coherence. Banking supervision is the responsibility of the Single Supervisory Mechanism (SSM), separated in principle by Chinese walls from the (rest of the) ECB. This implies that any problems in this area should be left to the Supervisory Board (of the SSM), one member of which is also part of the Executive Board that manages the participation of the ECB in country programmes.

1. INTRODUCTION

Since 2010, the European Central Bank (ECB) has been part of the so-called Troika of institutions (with the European Commission and the IMF) that has managed the adjustment programmes of countries that have been hit the hardest by the crisis (Greece, Ireland, Portugal and Cyprus) in exchange for financial support, through different mechanisms, bilateral loans under the Greek loan facility, the European Financial Stability Facility (EFSF) and finally the European Stability Mechanism (ESM).

In this framework the ECB has participated in the design and adoption of the programmes. The stated aim was to re-establish financial stability of crisis countries. Unfortunately, it is impossible to say exactly what the extent of the involvement of the ECB has been (there is only anecdotal evidence, as suggested in the short literature review below). However, there is a widespread perception that the ECB's role has been of crucial importance in many instances, even if formally its role was only to provide 'advice'.

Much of the complexity of the matter comes from the fact that the ECB has also acted as a 'quasi' lender of last resort outside country programmes when it bought Italian and Spanish government bonds in 2011. Although these purchases were made under the Securities Markets Programme (SMP), whose official purpose was to repair the monetary transmission mechanisms, de facto the ECB tried to extract reforms from the countries in question in exchange for intervention on the bond markets. These 'conditions' were put in letters written by the President of the ECB to national governments. The letters themselves were not made public, but were immediately leaked to the press.

All of this has provoked strong criticism of the ECB, which is seen as having interfered too much in matters of national sovereignty.

One difficulty, which is also the reason for different views on the role of the ECB, is that, in a financial crisis, it is impossible to completely separate financial and fiscal matters. Moreover, during a crisis, decisions have to be taken on the spot, under market pressure, and with limited information. It is thus very difficult to second-guess the decisions taken at the time.

The main focus of this short contribution is thus how a similar crisis might play out in the future. A first point that one has to keep in mind is that future banking problems will be resolved under a completely different framework, which includes the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF). These elements of the (still-incomplete) Banking Union will transform the way in which financial stability is addressed and (national) banking crisis will be dealt with. Under the BRRD, bail in will be mandatory and the SRF will be able to provide substantial financing. Moreover, the Single Supervisory Mechanism (SSM) will possess the required information and expertise to deal with banking problems. This already means that the rationale for any involvement of the ECB must change.

Moreover, the term ECB is often used too loosely. From the outside the ECB constitutes one monolithic body. But in reality there are (now) two major areas of action, i.e. monetary policy and banking supervision, and three separate decision-making centres within the conglomerate ECB:

1. Governing Council (25 members, of which 16 are voting national central bank governors)
2. Executive Board (6 members)
3. Supervisory Board (25 members, of which 19 are national supervisors)

The existence of these three separate bodies poses several problems of internal coherence for the ECB, as enumerated below:

The Governing Council is in principle the supreme decision-making body. It manages monetary policy, but not directly the participation of 'the ECB' in the Troika, about which it is informed by the Executive Board. The Executive Board manages the participation in the Troika.

The Supervisory Board (of the SSM) in principle drafts decisions related to banking supervision for the Governing Council. In practice, the 'non-objection' procedure[1] ensures that decision-making on banking supervision belongs to the Single Supervisory Mechanism.

The SSM did not exist at the time the country programmes were designed and implemented. The latest Greek programme is the only exception. In future ESM programmes, there will no longer be the pressing need to involve the ECB (or, rather, its Executive Board) in detailed programme design and assessment.

In this respect the future is likely to be very different from the past. The Irish approach (namely to save banks by increasing public debt) is unlikely to return in this form. Similarly for the Italian and Spanish case. Given that the SMP has been superseded by the Outright Monetary Transaction (OMT) programme, there will be no reason for the ECB to send a letter to the Prime Minister of Italy (or any other country) with a checklist of reforms to be approved before a certain deadline in order for the central bank to continue buying government securities.

The remainder of this paper is organised as follows. Section 2 provides a brief review of the (scarce) literature on the role of the ECB in adjustment programmes. Section 3 looks briefly at the Irish case as an example of how different (and more difficult) the situation was in 2011. Section 4 then analyses the institutional framework for 'the ECB' in country adjustment programmes (discussing also briefly the implications for the current Greek programme). Section 5 concludes.

[1] As of January 2015, the Governing Council's responsibilities include, inter alia, the following; "in the context of the ECB's new responsibilities related to banking supervision, to adopt decisions relating to the general framework under which supervisory decisions are taken, and to adopt the complete draft decisions proposed by the Supervisory Board under the non-objection procedure (www.ecb.europa.eu/ecb/orga/decisions/govc/html/index.en.html).

2. LITERATURE

While the ECB was formally not part of the decision-making of the adjustment programmes, it has been reported to have played a crucial role, not only through policy advice but also for reasons associated with the fact that it had provided very large amounts of liquidity to the banking sector, modified eligibility standards for collateral and bought sovereign bonds of countries under financial pressure.

There may be an argument that the ECB had a lot at stake at that moment, ranging from the possible financial destabilisation of the entire euro area to the risk of incurring losses on controversial purchases of sovereign bonds and on large liquidity provisions. In that context, potential conflicts of interests could have materialised.

This being said, a fully fledge assessment of the ECB's participation and its degree of involvement in the various programmes is a very challenging task – even ex-post. On the one hand, it is impossible to say how markets would have reacted to different decisions, and on the other hand, due to the lack of reporting on meetings and decisions, it is impossible to assess the role played by each of the institutions within the Troika.

The only possible assessment is one based on anecdotal evidence.

Merler, Pisani_Ferry and Wolf (2012) have collected anecdotal evidence pointing to the fact that the ECB's function in the programme missions in Greece, Portugal and Ireland was mostly limited to the financial and fiscal areas and did not extend to the identification of the financing needs. It appears that the position of the ECB on the fiscal side was typically strong, and supportive of larger fiscal adjustment than warranted by the European Commission or the IMF. On the financial and banking side, it repeatedly supported a strengthening of banks' capital base, urged larger packages for banks, larger funds to protect depositors and argued against involuntary debt restructuring of unguaranteed bonds.

As regards the emergence of potential conflicts of interest, it must be recalled that the ECB had to act under very difficult circumstance, involving important trade-offs, and overall, there is a widespread perception that the ECB's role has been of crucial importance in many instances, even if it formally was only to provide 'advice'. Merler et al. (2012) conclude that there is no clear evidence of such conflict of interest. However, they note, similarly to Whelan (2012), that while the advantages of having the institution in charge of monetary and financial stability participating in the programme are clear, the rationale for it is not.

In particular, Whelan (2012) is critical of the double role played by the ECB, both as a policy maker and as policy advisor to governments in the context of conditional financial assistance received. He argues that being part of the design and monitoring of the programme implementation while not being an official provider of financial assistance confuses the public about the conditionality of the programme and raises concerns of legitimacy.

Overall, Whelan admits that Irish fundamentals in 2010 required a bailout and recognises that the assessment of the ECB in this direction turned out to be correct. Nonetheless he argues that over time the ECB has been building an "embarrassing" track record in pushing governments to request bail-out. Irish officials reported pressures to request a bail-out plan, and some believe the ECB threatened that the liquidity support to banks would be withdrawn otherwise.

Similarly, the (in)famous letter sent to the governments of Italy and Spain by the President of the ECB containing reference to "necessary policy actions" seem to reflect an awkward involvement of the ECB in national politics and fiscal affairs, and can be interpreted as an attempt to extract reforms, possibly designed in the context of a bailout programme.

3. FISCAL IMPLICATIONS OF FINANCIAL STABILITY: **THE CASE OF IRELAND AS A PRIME EXAMPLE**

The ECB had to resort to many 'unconventional' policy measures after the start of the global financial crisis in 2008. In the initial phase of the crisis, its policy actions were clearly addressed to the euro-area financial system as whole. However, this changed when the financial crisis mutated into the euro crisis and nationally differentiated risk premia arose, and some governments started to lose access to market financing.

At that point, the ECB faced a fundamental problem: it was trying to conduct a monetary policy for the entire area while financial markets were separated along national lines, which made policy ineffective. The ECB thus argued that the monetary policy transmission mechanism was broken in several countries and that this was a legitimate concern. There was a valid reason why the ECB had to be involved in individual countries, although its mandate concerned the euro area as whole. But the key difficulty in judging the role of the ECB during such turbulent times is that sometimes the indirect (or unintended) impact of decisions can be much more important than the direct one.

The Irish case illustrates this point very well. A total amount of €64 billion was injected into the Irish banks. The Government borrowed €12 billion, another €21 billion came from the National Pensions Reserve Fund (NPRF) and an additional €31 billion came in the form of Promissory Notes (PNs). This would have given Ireland a world-record budget deficit of more than 30% of GDP in 2010. However, the impact on both deficit and debt was less than the total cost of the bailout because the €21 billion of the recapitalisation that came from NPRF were in fact not borrowed and hence were not included.[2]

The debates about the decision to fully pay out unsecured bondholders of Irish banks usually focus on the amount that the Irish government would have saved if this had not been done. This amount has been estimated at around €3-4 billion by the ECB,[3] which is not insignificant relative to the Irish economy (about 2% of GDP) and total Irish public debt (the percentage is somewhat lower since public debt exceed annual GDP in Ireland). But by itself, the expenditure saved would not have decisively changed the outlook for Irish debt sustainability. Moreover, since part of the debt was held by Irish entities, including Irish pension funds, the burden of a 'private-sector involvement' (PSI) would have fallen, at least partially, on Irish citizens anyway.

At that time, the legal procedure to be followed in order to contemplate action vis-á-vis bond-holders would have been somewhat difficult as the framework for restructuring failing banks and bailing-in bond-holders had not been developed yet (the BRRD came only years later). A formal bankruptcy might have been required to achieve any PSI. But even apart from the legal uncertainties, it remains difficult to provide a definite judgment on this episode because effects on market confidence can never be anticipated with accuracy.

The ECB continues to argue that bailing in the senior unsecured bondholders would have undermined investor confidence in the Irish government and further aggravated financial market tensions throughout the entire euro area (and possibly beyond). Even with the benefit of hindsight, there is no way one can determine the validity of these arguments with any precision.

One available option at that time could have been to use collective action clauses and try to achieve a 'voluntary' private-sector contribution in the form of a restructuring of these bonds, including perhaps a small partial haircut and a substantial extension of maturities.

2 See McArdle (2012) for a comprehensive assessment of the matter.
3 See McArdle (2012, p.13).

But it is a matter of judgment whether the impact of such an approach on financial markets would have been so severe that in the end the Irish government would have been worse off. One has to defer to the ECB as the key institution responsible for financial stability.

In this perspective, the issue that should have been raised at the time is whether it was appropriate to ask the Irish government to assume the burden of safeguarding the stability of the euro-area financial system. To the extent that the 'advice' of the ECB not to bail in senior bond-holders was based on concerns for the stability of the entire euro area, one should have found a way to compensate the Irish government for its contribution.

Such a problem should not arise again in the future since the SRF would provide the financing for a restructuring, thereby avoiding a formal bankruptcy. In principle a bail-in of senior bond-holders would be decided under the BRRD only on the basis of the losses incurred and the capital required to create a viable new bank.

4. THE ROLE OF THE ECB IN COUNTRIES UNDER PROGRAMMES

4.1 The Past

The legal basis for the involvement of the ECB in adjustment programmes has changed slightly over time, from the first Greek Loan Facility, the EFSF and finally the ESM. However, the legal texts are vague and leave room for interpretation. The current legal framework is given by the ESM Treaty which calls upon the ESM Board of Governors "to give a mandate to the European Commission to negotiate, in liaison with the ECB, the economic policy conditionality attached to each financial assistance, in accordance with Article 13(3)". [4]

The key expression here is "in liaison with", which can be interpreted in a broad fashion. The central practical aspect, which made the ECB part of the Troika, was its participation in missions to programme countries. ECB staff participated apparently in most meetings, even if the subject matter was far removed from the ECB's core (and exclusive) competence, namely monetary policy and financial stability.

The justification given by the ECB is usually that price stability depends also on financial stability and that tough labour market and other reforms are necessary to regain investor confidence. However, this is clearly 'mission creep'. All economic policy actions might have some influence on investor confidence or some indirect impact on price stability.

It is of course possible to argue that the details of Greek labour laws, or the regulation on taxi drivers in Athens, have an impact on the success of the Greek adjustment programme and thus on the stability of the euro-area's financial system and thus finally on price stability. But if one follows this line of argument to its extreme, no policy domain lies outside the purview of the ECB.

The combination of 'mission creep' and the choice to decline responsibility for decisions is apparent in the reply of the ECB to the European Parliament:

> The advice provided by the troika (including on reform priorities) aims at achieving healthy public finances, financial stability, competitiveness and sound economic policies and thereby at creating the conditions for sustainable growth and job creation in the programme countries. Decisions on granting the financial assistance, the economic policy conditions attached to the assistance and quarterly disbursements are taken by the ECOFIN Council under the EFSM Regulation, by the EWG/guarantor Member States under the EFSF Agreement and by the ESM Board of Governors under the ESM Treaty.[5]

The key issue is thus that publicly the ECB has been very much part of the process, appearing to have the same footing as the other members of the Troika. The very term, troika, already suggests that its three members have equal influence and that the consent of the ECB was sought for all major decisions.

Today the ECB argues that it only gave 'advice' and that Finance Ministers took all the decisions, but during the time the programmes were running, the ECB has seldom emphasized this aspect in public. Members in the Governing Council were usually careful to use the term advice in describing the activities of the ECB, but the overall impression they

[4] http://www.esm.europa.eu/about/legal-documents/ESM%20Treaty.htm?lang=-en

[5] See www.ecb.europa.eu/pub/pdf/other/140110_ecb_response_troika_questionnaireen.pdf

were giving was that the ECB played a full part in the process and had developed views on all aspects of the overall programme design.

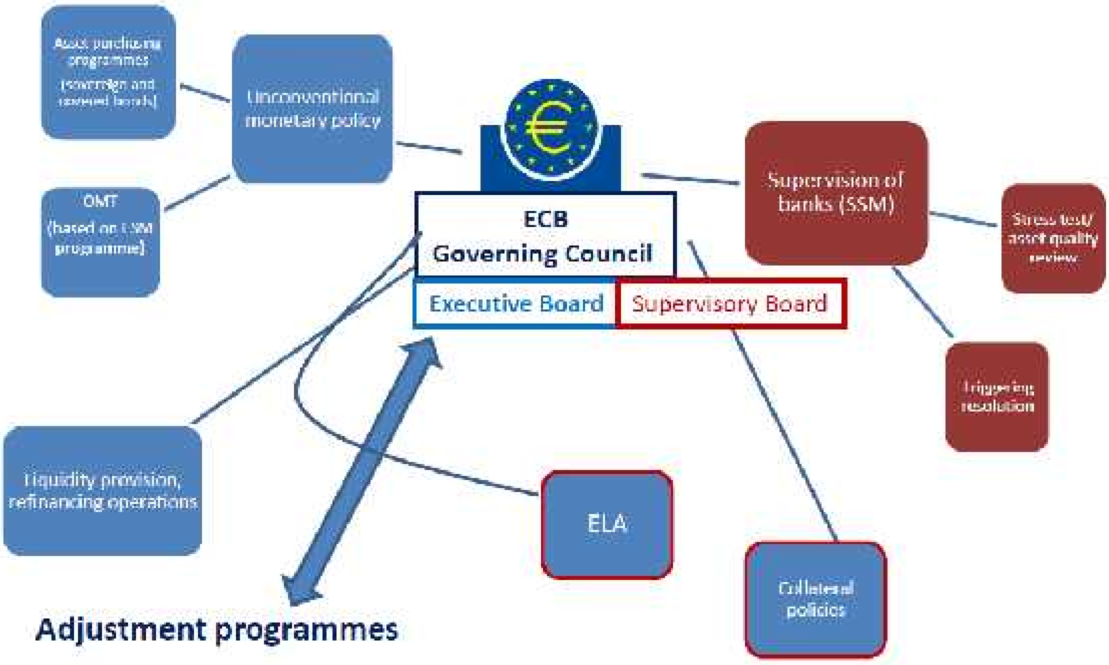
4.2 The Future

The legal framework for the involvement of the ECB in the programmes has been fixed in the ESM Treaty, but the future will be different from the past as already mentioned above. The Italian and Spanish-type letters to national authorities will no longer have any justification. The OMT requires an ESM programme (on which the ECB will provide 'advice'). The Ireland-type banking problems will also play out differently, as shown above (this also applies, of course, mutatis mutandis to the cases of Spain, Portugal and Cyprus).

But going forward, the problem of internal decision-making, and hence accountability, will become even more important.

The term ECB is often used too loosely. When a country is under financial distress, there are many areas and situations in which the ECB can be called upon to act.

Figure 1. ECB potential involvement in countries under financial stress



Source: Own elaboration.

As illustrated in Figure 1, these can belong to the two main areas of action of the bank, namely monetary policy and supervision of banks. While in principle the two are separated, in practice there are decisions that can influence both (e.g. collateral policy and ELA) and such decisions are taken within different bodies.

There are (now) three separate decision-making centres within the 'conglomerate' ECB:

1. Governing Council (25 members, of which 16 are voting national central bank governors, theoretically the supreme decision-making body)

2. Executive Board (6 members)

3. Supervisory Board (25 members, of which 19 are national supervisors)

The existence of these three separate bodies poses a problem of internal coherence for the ECB. The Governing Council is in principle the supreme decision-making body. It manages monetary policy, but not the participation of 'the ECB' in the Troika, about which it is only informed by the Executive Board. The Executive Board manages the participation in the ESM programmes.

The Supervisory Board (of the SSM) in principle only drafts decisions for the Governing Council. But in practice the 'non-objection' procedure ensures that the de facto decision-making body on banking supervision belongs to the Single Supervisory Mechanism.

The SSM did not exist at the time the country programmes were designed and implemented. Furthermore various parts of the ECB will participate in the decision-making and shaping of the Single Resolution Board. The ECB (presumably meaning the Executive Board) has to be invited as an observer to executive sessions of the Single Resolution Board (SRB) and the national supervisory bodies, which have a vote on decisions concerning banks located in their country, are also part of the Supervisory Board of the SSM. Given this highly complex set-up, it would be very difficult to hold 'the ECB' accountable for its involvement in country programmes (unless it restricts itself to giving advice).

Box 1. The role of the ECB in the third Greek adjustment programme

The current Greek programme is the first (and the only one) to take place under the new institutional framework (but not the BRRD). The role of the 'ECB' must be interpreted with care since the SSM is part of the ECB 'holding' but it is operationally separate following the construction of Chinese walls.

In Greece, the BRRD with its mandatory bailing-in provisions will apply only from January 2016. But application of the BRRD appears inopportune in this case since the bailing-in provisions would hit non-insured deposits, which are mostly the working capital of small- and medium-sized enterprises.

In compliance with Article 13 of the ESM Treaty, the European Commission, in liaison with the ECB, prepared the assessment of the Greek request for stability support in the form of an ESM loan. It foresees that the European Commission, in liaison with the ECB, will have the following tasks:

"a) to assess the existence of a risk to the financial stability of the euro area as a whole or its Member States;

b) to assess, together with the International Monetary Fund, whether public debt is sustainable; and

c) to assess the actual or potential financing needs of Greece"[6]

In the document, the reference to the role of the ECB, and its different functions, relates mostly to the assessment of the existence of a risk to the financial stability of Greece. In particular it contains reference to the role played by the Supervisory Board in the framework of the Asset Quality Review (AQR), the actions taken in relation to the ELA, such as its ceiling and the haircut on collateral for ELA, and lastly to the existence of the OMT as a tool to safeguard stability.

The Memorandum of Understanding[7] contains no specific mention of either the ECB or the Single Supervisory Mechanism.

[6] See http://ec.europa.eu/economy_finance/assistance_eu_ms/documents/2015-07-10_greece_art__13_eligibility_assessment_esm_en.pdf

5. CONCLUSIONS

It is not new that monetary policy decisions may have a fiscal element. However, at the time the Maastricht Treaty was written and ratified, it was assumed that the fiscal implications of monetary policy would be diffuse and of second-order importance. This changed with the financial crisis, forcing the ECB into a delicate position. There is little point in judging the ECB's actions on specific cases, like Ireland, with the benefit of hindsight.

In terms of future ESM programmes, the ECB should limit itself to providing general advice, refrain from going into the details of the programme and should not participate in missions to national capitals. One has to keep in mind that the ECB has three decision-making bodies. The Executive Board has managed the participation in the Troika on its own. The Governing Council, theoretically the supreme body of the ECB, has only been informed ex post. Moreover, the SSM, which if formally part of the ECB, will at any rate most probably be involved in any future ESM programme, as also will the SRB, with funding provided by the SRF.

Given that the ECB is an independent institution, it can in principle exercise broad discretion (within its mandate) in its decisions. But it might be well advised to follow the example of the Federal Reserve, which usually abstains from commenting on the general economic policy of the US government. The independence of the ECB is formally much stronger than that of Federal Reserve. Moreover, the ECB does not face one unified political actor, but many different national governments whose opinions are often at odds with one another, thus providing another, de facto, layer of protection of its independence. But the ECB was granted its full independence so that it could make its monetary-policy decisions without political interference.

The single task (price stability) combined with clear decision-making provide the conditions for the accountability of the ECB. With ambiguous tasks (and responsibilities) and multifaceted involvement in adjustment programmes, it becomes difficult to hold the ECB accountable in this respect. This provides another reason why the ECB should limit its future involvement to giving advice.

[7] http://ec.europa.eu/economy_finance/assistance_eu_ms/greek_loan_facility/pdf/01_mou_20150811_en.pdf

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NOTES

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

The ECB and financial assistance programmes: Has the ECB acted beyond its mandate?

Karl WHELAN

IN-DEPTH ANALYSIS

Abstract

This paper discusses the ECB's role in Ireland's EU-IMF programme and briefly raises some issues regarding its decisions relating to the Greek banks during this year's crisis. The absence of clear procedures for lender of last resort led to a number of key decisions being taken by the ECB in a way that fell short of the relatively transparent and accountable standards that it has set in the monetary policy area. I recommend that the ECB should no longer be involved in designing or monitoring fiscal policy or structural reform conditionality for financial assistance programmes. Some institutional changes have occurred that make some of the negative aspects of the ECB's involvement in Ireland's programme less likely to occur again. However, this year's events in Greece show that as long as the ECB's lender of last resort role remains confused, questions about whether the ECB is acting beyond its legal mandate and becoming overly involved in political developments will continue to be aired.

CONTENTS

EXECUTIVE SUMMARY

- The ECB has played a key role in determining the timing of financial assistance programmes, in setting the conditions for these programmes and in programme monitoring.

- In this paper, I discuss the ECB's role in Ireland's EU-IMF programme and briefly raise some issues regarding its decisions relating to the Greek banks during this year's crisis.

- Despite the welcome release of two letters sent by Jean-Claude Trichet to the Irish government in 2010, the circumstances surrounding the ECB's involvement in the instigation and negotiation of Ireland's programme are still unclear.

- There is now substantial circumstantial evidence that former U.S. Treasury Secretary Timothy Geithner was involved in both the ECB's decision to insist that Ireland enter an EU-IMF programme and the subsequent decision to see that all senior bondholders of Irish banks be repaid in full. The ECB should explain how these decisions were taken.

- I conclude that the absence of clear procedures in the Eurosystem for lending of last resort to banks has led to a number of key decisions being taken by the ECB in a way that fell well short of the relatively transparent and accountable standards that it has set in the monetary policy area.

- It is unclear whether the ECB's role in designing and monitoring programme conditionality relating to fiscal policy and structural reforms is consistent with its legal mandate. The ECB should explain why it was necessary for it to be a formal member of the "Troika" group.

- I recommend that the ECB should no longer be involved in designing or monitoring fiscal policy or structural reform conditionality for financial assistance programmes.

- Some institutional changes have occurred since 2010 (new state aid rules, the Bank Recovery and Resolution Directive and the appointment of the ECB as a single supervisor for the euro area's banks) that make some of the negative aspects of the ECB's involvement in Ireland's programme less likely to occur again.

- However, this year's events in Greece show that as long as the ECB's lender of last resort role remains as confused as it currently is, questions about whether the ECB is acting beyond its legal mandate and becoming overly involved in political developments will continue to be aired.

1. INTRODUCTION

The multiple crises that have affected euro area member states over the past few years exposed a significant number of gaps in the policy architecture underlying the euro as a common currency area. In its early years, the ECB focused almost solely on its monetary policy responsibilities and had relatively little role to play in banking-related financial stability areas. Indeed, responsibility for financial stability issues still lay largely with national governments and national central banks and the ECB did little to articulate how the lender of last resort function was supposed to work in the euro area.

On the fiscal policy side, the Stability and Growth Pact was supposed to prevent countries from getting into trouble but, if they did, the plan was that there would no financial assistance from other member states. The subsequent reality of ongoing fiscal and banking crisis has resulted in a huge change in the institutional structures underlying the euro. Fiscal rules have been reformed, a permanent euro area bailout fund has been put in place and the ECB has been assigned as the regulator of the euro area's largest banks.

The events of recent years have particularly highlighted the absence of a clear approach within the Eurosystem to last resort lending to banks. As a result, many of the decisions related to such lending (most notably in relation to Emergency Liquidity Assistance or ELA) were made in an ad hoc and secretive manner. A key area of uncertainty in recent years has been the role played by the ECB in the so-called “troika” of institutions that oversaw financial assistance programmes in Greece, Ireland, Spain and Portugal and the interactions between last resort lending and these programmes.

In this paper, I will mainly discuss the role the ECB played in Ireland's financial assistance programme because it is the case that I am most familiar with. Section 2 discusses the role the ECB played in the timing of the Irish programme and its role in designing the terms of the programme. Section 3 assesses the ECB's role in the Irish programme and raises some questions. Overall, I conclude that the absence of clear procedures for lender of last resort led to a number of key decisions being taken by the ECB in a way that fell well short of the relatively transparent and accountable standards that it has set in the monetary policy area. I also recommend that the ECB should no longer be involved in designing or monitoring fiscal policy or structural reform conditionality for financial assistance programmes.

A number of years have now passed since the negotiations for the Irish programme and there have been some improvements in institutional design. The ECB is no longer quite so secretive about ELA (though decisions in the area are still pretty murky). In addition, the advocate general of the European Court of Justice has argued that the ECB must not be involved in the monitoring of any European Stabilisation Mechanism financial assistance programme that would be required under an Outright Monetary Transactions (OMT) programme. The ECB is now also the official supervisor for the euro area's largest banks and has a clear mandate to deal with these banks when they are failing, a task made easier by the passing of the Bank Recovery and Resolution Directive. All of these elements are helpful in keeping the ECB's role in relation to crisis countries as transparent as possible.

That said, as I discuss in Section 4, the ECB's role in this year's Greek crisis shows that the Governing Council is still making highly politicised decisions on lending of last resort and continuing to link financial stability decisions to fiscal conditionality set by official lenders. This shows the ECB is still falling some way short of the role that it should be playing in maintaining financial stability in the euro area.

2. THE ECB AND IRELAND

2.1 Prior to the Programme

Prior to the global financial crisis, Ireland appeared to many to be a model for success among European economies. Though there has since been plenty of revisionism by international organisations, prior to the crisis Ireland was hailed as a model of fiscal and financial stability by the IMF and the European Commission.[1]

By mid-2008, it became clear that much of the economic growth Ireland had achieved in the final years of its expansion had been built on shaky grounds. A gigantic property boom had seen per capita housing completions running at four times the rate seen in the US during the peak of its housing boom and house prices quadrupling between 1996 and 2007. As the global economy began to slow down, house prices in Ireland began to slide and construction activity collapsed.

The construction bust had severe implications for Ireland's public finances. The tax base had become increasingly reliant on what turned out to be temporary revenues from the construction sector and the large increase in unemployment due to the sector's contraction put huge pressure on public spending for welfare benefits. Ireland moved swiftly from running a small budget surplus to deficits that were double-digit shares of GDP.[2]

That said, Ireland should have been well positioned to cope with a large fiscal shock. It had a gross debt-GDP ratio in 2007 of 25% and a sovereign wealth fund worth close to this amount. On its own, the large fiscal shock could possibly have been coped with without requiring official financial assistance. The aspect of Ireland's crash that pushed it over the edge was the effect of the construction bust on the banking sector.

By mid-2008, it was clear to international bond markets that Irish banks had made enormous loans to the construction sector for speculative development projects and that the losses on these loans would be substantial. These banks had relied on issuing bonds to international capital markets to finance their rapid growth and suddenly found they were unable to roll over this funding. The banks began to borrow from the Eurosystem to pay off maturing bonds. When Anglo Irish Bank ran out of Eurosystem-eligible collateral in September 2008, the Irish government choose to offer a guarantee to all depositors and the vast majority of bondholders of the domestic Irish banks.

While this guarantee temporarily stabilised the condition of the Irish banks, it became clear from late 2008 onwards that Anglo Irish Bank, which had specialised in commercial property lending, was in serious trouble. The bank was nationalised in early 2009 and was suffering from substantial deposit withdrawals when the Central Bank of Ireland agreed in March 2009 to provide it with €11.5 billion in Emergency Liquidity Assistance (ELA), i.e. loans from the Central Bank of Ireland against collateral that is not eligible for standard Eurosystem operations. While the risk associated with ELA is borne by the issuing central bank, these loans must still be approved by the ECB's Governing Council.

As the sovereign debt crisis intensified through 2010, the pace of deposit withdrawals from Anglo Irish Bank intensified and its ELA borrowings moved up sharply. Over the course of 2010, the other main Irish banks also came under pressure from deposit outflows. By mid-2010, the severity of Ireland's recession and growing international realisation of the huge

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[1] For example, the IMF (2007) reported that "Economic performance remains very strong, supported by sound policies" that "Fiscal policy has been prudent … In the past couple years, windfall property-related revenues were saved and the fiscal stance was not pro-cyclical, in line with Fund advice" and that "Banks have large exposures to the property market, but stress tests suggest that cushions are adequate to cover a range of shocks."

[2] See Whelan (2014) for a detailed discussion of Ireland's economic boom and bust and its impact on the banking sector.

size of recapitalisation costs of the banking sector (which reached 40 percent of GDP by the time the full scale of the crisis had become apparent) raised doubts about the solvency of the Irish state. These doubts then meant that the state guarantee became essentially useless to the Irish banks during 2010.

The September 2008 guarantee had been put in place for two years and the covered banks had issued a large amount of bonds that matured prior to September 2010. As September 2010 came and went, they failed to find new sources of private sector funding. Thus, these banks further increased their reliance on ECB funding and each of the banks eventually applied for ELA.[3]

As the enormous scale of the losses at Anglo Irish Bank and Irish Nationwide began to emerge during 2010, it became clear that Irish government could not borrow from financial markets to recapitalise these banks. Instead, the government issued the banks with so-called promissory notes that pay principal and interest gradually over time. In turn, these notes were used by the banks as collateral to obtain ELA from the Central Bank of Ireland.

By the end of 2010, the Irish government had issued €31 billion in promissory notes to the Irish Bank Resolution Corporation (IBRC), the institution created by merging Anglo and Irish Nationwide. The schedule for the promissory notes required the Irish government pay €3.1 billion per year, about two percent of GDP, into the IBRC, which in turn would use the money to repay ELA, which would then see the Central Bank of Ireland retire the money created to provide the ELA from money supply. While the promissory notes have since been replaced by a new series of bonds, the burden of these debts on the Irish people in the coming years will be considerable.

Figure 1 below illustrates the evolution of Eurosystem borrowing by the guaranteed Irish banks while Figure 2 shows trends in resident and non-resident deposits at these banks. By the end of October 2010, the guaranteed Irish banks were taking up €76 billion of the total €557 billion of Eurosystem refinancing credit. In addition, ELA had risen to €33 billion. Measured against Irish nominal GDP at this time of about €160 billion, these were extraordinary statistics, indicating a systemic banking crisis.

[3] See Whelan (2014) for a more detailed discussion of Ireland's banking crisis.

Figure 1: Borrowings from the Eurosystem of Guaranteed Irish Banks (Billions of Euros)

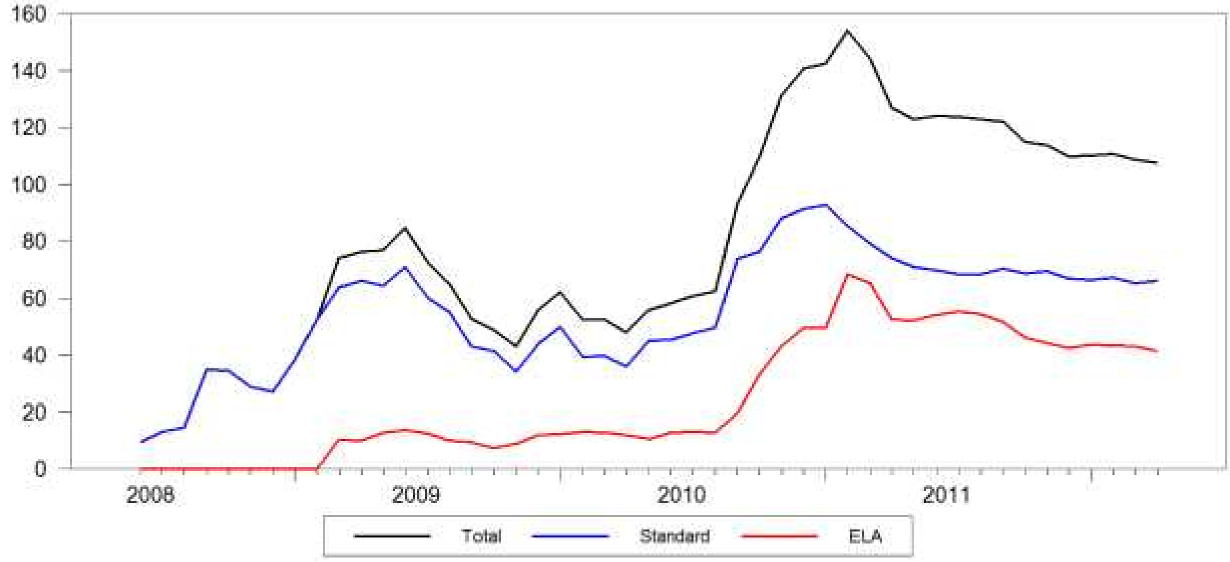
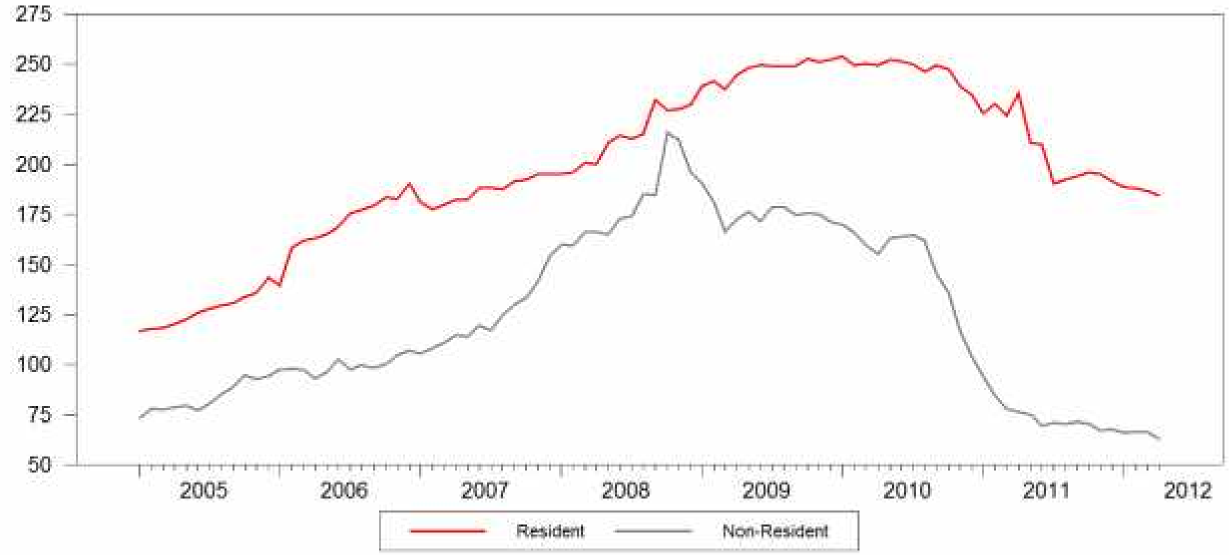


Figure 2: Resident and Non-Resident Deposits in Guaranteed Irish Banks (Billions of Euros) Source: Central Bank of Ireland, Monthly Money and Banking Statistics



Source: Central Bank of Ireland, Monthly Money and Banking Statistics

2.2 The ECB and Ireland's Application for Programme Funds

The circumstances surrounding Ireland's application for an EU-IMF programme were, for a number of years, shrouded in secrecy. We know more now than we did a few years ago, However, it is worth explaining that the actual circumstances surrounding the decision to apply for a programme are still a bit murky. What is clear, however, is that the ECB played the decisive role in the timing of the Irish government's decision to request funds from the EFSF and the IMF.

In the months leading up to Ireland's application for funds, the ECB appears to have become increasingly concerned about the extent of borrowing from Irish banks. Senior ECB officials apparently believed the financial crisis was largely over and were giving speeches about their plans for an "exit strategy" from non-standard measures (something which still has not happened). The reliance of the Irish banks on Eurosystem funding did not fit with the ECB's plans to revert to auctioning off fixed amounts of credit. ECB officials began briefing widely about their concerns about "addict banks" that were overly reliant on ECB funding.[4]

In addition to their concerns about Ireland representing a problem for executing an exit strategy from non-standard measures, it also appears that the ECB had growing fears that losses on loans to Irish banks could have an impact on the balance sheet of Eurosystem central banks: Operating procedures see losses on regular refinancing operations shared among member national central banks according to their capital key.

A more official indication that the ECB was intending to intervene in Ireland came on October 9, 2010 when they issued a statement tightening the Eurosystem's "Risk Control Framework".[5] These guidelines had already stated that "the Eurosystem may suspend or exclude counterparties' access to monetary policy instruments on the grounds of prudence" and had previously contained the line "The Eurosystem may exclude certain assets from use in its monetary policy operations." This latter statement was augmented to include "Such exclusion may also be applied to specific counterparties, in particular if the credit quality of the counterparties appears to exhibit a high correlation with the credit quality of the collateral submitted by the counterparty." Since the Irish banks had substantial assets either guaranteed or issued by the Irish government, this clause could be used to limit their access to ECB funding, which would have led to an inability to meet requests for deposit withdrawals or pay off maturing bonds.

The Official Story

In November 2014, after years of refusing to disclose correspondence from 2010 between the ECB and the Irish government, the ECB finally released two letters sent in 2010 by Jean-Claude Trichet to Brian Lenihan, Ireland's Minister for Finance at the time. The first, dated October 19 warns Mr. Lenihan about the "extraordinarily large provision of liquidity by the Eurosystem to the Irish banks" and explains that "the Governing Council cannot commit to maintaining the size of its funding to these institutions on a permanent basis." The letter warned that because Irish banks were using Irish government bonds and government-guaranteed bonds as collateral, the Governing Council would need to see progress on "fiscal consolidation, structural reforms and financial sector restructuring" if it was going to maintain the supply of liquidity.

The situation in Ireland worsened in the subsequent weeks, partly as a result of the "Deauville declaration" of Merkel and Sarkozy suggesting the need for creditors to share

4 See, for instance, this story by Ralph Atkins in the Financial Times of September 13, 2010: http://www.ft.com/intl/cms/s/0/580109dc-bf43-11df-a789-00144feab49a.html

5 Statement here: http://www.ecb.int/press/pr/date/2010/html/pr101009.en.html

losses as a condition for countries to access the European Financial Stability Fund (EFSF). Irish sovereign yields rose sharply and the deposit run intensified.

The ECB has also released a second letter from Jean-Claude Trichet to Brian Lenihan, dated November 19. This letter explicitly required the Irish government to apply to the Eurogroup for financial support as a condition for the continued provision of Eurosystem liquidity to the banks. The ECB also released a letter from Brian Lenihan to Trichet, dated November 21, indicating that Ireland intended to apply for external support.

The November 19 letter is dated one day after the Governor of the Central Bank of Ireland, Patrick Honohan, stated on Irish radio that he expected Ireland to enter a financial assistance programme. This has led some to conclude that the ECB's intervention was not a crucial one in determining the timing of the programme application because by November 19 it was clear that Ireland would already be entering a programme. The truth, however, appears to be a little different.

What Actually Happened

On Friday November 12, 2010, Reuters reported that Ireland was in talks with the EU to receive emergency funding.[6] In response, the Irish government denied that any official talks were taking place and stressed that the government could meet its budgetary needs through until the summer of 2011. My interpretation is that the ECB had briefed Reuters and other news organisations that programme negotiations were underway.

There is substantial evidence that some form of communication from the ECB to the Irish government occurred on Friday November 12. A number of Irish government officials have confirmed to me that communication of some sort from ECB occurred that day and the implication of this communication was that Ireland would be applying for a programme.

Brian Lenihan discussed the events of this period in a BBC radio documentary that is available online.[7] He described communication with the ECB as follows

> Trichet wrote to me. He raised the question about whether Ireland would be participating in a programme at that stage. I rang Mr Trichet after receipt of the letter. [...]
>
> But it was clear to me at that stage that there was a serious issue for Ireland, and I said it was important that we discuss his concerns. And we agreed that on the following Sunday there would be an official level discussion about these issues, in Brussels.

The discussion in the documentary of the various events that occurred the weekend after this communication (including ministers denying a bailout negotiation was underway) make it clear that Lenihan was talking about getting a letter either on or prior to November 12, 2010. In the documentary, Lenihan was also clear that "the major force of pressure for a bailout came from the ECB."

Another source of evidence that the letter arrived on November 12 came from an interview that Lenihan's economic adviser, Alan Ahearne, gave to the Irish Independent.[8] Here is an extract from the Irish Independent article:

> "Yeah, the letter came in on the Friday from Trichet. The ECB were getting very hostile about the amount of money that it was having to lend to Ireland's banks. The

[6] Here is a link to the Reuters story:http://uk.reuters.com/article/2010/11/12/uk-g20-ireland-idUKTRE6AB0NV20101112
[7] Bailout Boys Go to Dublin: https://www.youtube.com/watch?v=AAj7Sob3cxg
[8] See http://www.independent.ie/opinion/analysis/we-were-a-war-cabinet-and-lenihan-was-leader-26779992.html

> ECB demanded something be done about it and it mentioned Ireland going into the bailout. They were keen to get Ireland into the programme."
>
> He added: "Lenihan rang Trichet that day, and they agreed officials would meet the following day in Brussels. When they met, the ECB put huge pressure on Ireland to go into the programme."
>
> Ahearne said Lenihan was now at the centre of international chaos and Ireland's future hung in the balance.
>
> "The following Tuesday, Lenihan went to the eurozone meeting ..."

The Irish Independent story does not state the date of arrival of Trichet's letter but the reference to a Eurozone meeting on the following Tuesday seems to confirm November 12 as the date.

Another piece of evidence on this issue comes from the testimony of Governor Patrick Honohan at the Irish parliament's banking inquiry.[9]

> Deputy Eoghan Murphy: It seems clear that the ECB was in favour of Ireland entering a programme from September of 2010. But, was that ever communicated to you from Mr. Trichet or the board, that we think, the ECB, that Ireland should apply for a programme?
>
> Professor Patrick Honohan: The first time it was communicated in any, sort of, formal way was in ... what date are we talking about, I guess it was 11 November when ... no, it's Friday, 12 November, after the famous discussion in Seoul.

The reference here to Seoul refers to a side meeting that occurred at a G20 meeting. Irish journalist Sean Whelan summarised what occurred as follows:[10]

> Olli Rehn recently confirmed on the Marian Finucane show that Timothy Geithner, the then US treasury secretary and former head of the New York Fed had raised his worries that Anglo could trigger an international banking crisis at the G20 summit in Seoul on November 11 2010.
>
> Rehn said he met Geithner, Trichet and German finance minister Wolfgang Schauble in Seoul, and they had agreed that Ireland had to enter a bailout programme to stop the threat of a wider banking crisis.
>
> The following day – November 12 – Trichet reportedly phoned Lenihan and apparently told him then that the ECB could not go on funding Irish banks if the state did not enter a bailout programme.

My interpretation of these events is that after meeting with Geithner at the G20 meeting, there was some form of communication between Jean-Claude Trichet on November 12, 2010. This was perhaps a communication that a letter like the one subsequently dated November 19 would be sent if programme negotiations did not commence. Overall, the balance of evidence points to November 12 as being the crucial date for when the ECB insisted Ireland joined a programme and the November 19 letter that was kept secret for years was merely a formal restating of a message that had already been communicated a week earlier.

[9] A transcript of Honohan's testimony is available at https://inquiries.oireachtas.ie/banking/wp-content/uploads/2015/06/25062015_Honohan_vol3.pdf

[10] See http://analysis.rte.ie/business/2014/11/06/the-ecb-letters/

2.3 The ECB and Programme Negotiations

The ECB played a central role in both the negotiation and subsequent monitoring of Ireland's programme. Here, I want to flag two areas: Fiscal policy and the treatment of senior bond debts of certain Irish banks.

Fiscal Policy

The ECB did not play any role in providing money to the Irish government as part of its EU-IMF programme. Despite this, it is my understanding that the ECB still played a very active role in designing the fiscal policy conditionality associated with the programme.

The programme featured a substantially front-loaded fiscal adjustment: Fiscal adjustment of €6 billion was required in 2011 with a further €3.6 billion required in 2012 and €3.1 billion required in 2013.[11] Given the depth of the recession being experienced by Ireland at this time and factoring in that Ireland had access to non-market funding for three years, this substantial front-loading was highly questionable from a macroeconomic perspective.

This extreme front loading was, as I understand it, partly due to the ECB's insistence. Indeed, I believe the ECB's initial position in programme negotiations was that the adjustment should be even more front loaded than was required in the agreed version of the programme.

It is legitimate to ask why the ECB, rather than solely the European Commission, was involved in setting fiscal policy conditionality and whether this role meant the ECB was acting beyond its legal mandate.

One theme that emerged during the programme was that the involvement of the ECB in the programme was partly due to technocratic consideration. The European Commission did not appear to have sufficient numbers of suitably qualified staff to play the intense role required for designing and monitoring a large financial assistance programme. The ECB, on the other hand, has a large number of well-qualified economists. Whether this disparity led to ECB staff playing a larger role in the programme than perhaps they should have is an issue worth exploring.

Senior Bank Bonds

By November 2010, Ireland's original near-blanket guarantee had been replaced by a less sweeping guarantee that only covered new issues. This left outstanding a number of unguaranteed senior and subordinated bank bonds that had been issued by institutions such as Anglo Irish Bank and Irish Nationwide which were grossly insolvent and wholly reliant on Irish state assistance to pay off their liabilities.

During the negotiations of the programme, the Irish government and the IMF were in favour of putting Anglo and Irish Nationwide through bank resolution regimes that would see large haircuts on the senior bonds of these institutions. The widespread expectation that this might happen was reflected in the low prices of the bonds and their downgrades by ratings agencies. These downgrades meant that the bonds had to be off-loaded by many investment funds and banks who were not allowed to hold low-grade bonds as part of their investment portfolio. Indeed, it seems likely that by late 2010, a significant fraction of the bonds were owned by hedge funds and distressed-debt specialists.

The ECB, however, was adamant that all unguaranteed senior bonds should be paid back in full with the funds provided by the Irish state. There is now evidence that they were supported in this position by then U.S. Treasury Secretary, Timothy Geithner, but the ECB's

[11] See http://www.finance.gov.ie/sites/default/files/euimfrevised.pdf

opinion in this area was likely to be hold sway even without any intervention from Mr. Geithner.

The requirement to repay senior bond holders does not feature as an official part of the EU-IMF programme and it was not mentioned in any of the various Memoranda of Understanding relating to the programme. However, it is generally understood that the ECB argued that it would react to senior bank bond haircuts by withdrawing liquidity support for Irish banks. At the time, some commentators and politicians in Ireland argued that the ECB would never carry through on such a threat as it would lead to restrictions on deposit withdrawals and capital controls. Subsequent experience in Cyprus and Greece show there was every reason to believe the ECB's position in 2010 was a credible one. Certainly, the ECB's position on this issue was sufficient to deter any unilateral action on this front by the Irish government.

The ECB's interactions with the Irish government on this issue continued into 2011, after the election of a new government. The new Minister for Finance, Michael Noonan, has testified before the Irish parliament's banking inquiry that he had planned in March 2011 to announce write-offs for certain bonds issued by Anglo and Irish Nationwide but did not do so after an intervention from Jean-Claude Trichet. According to Mister Noonan, Trichet argued that such a default would have negative implications for the Irish financial sector and, more darkly, warned of "a bomb going off in Dublin" if any of these bonds were defaulted on.[12]

At this point, it is worth putting some context on these particular events. Given the role the banking crisis played in triggering Ireland's EU-IMF programme and given the colourful nature of some of the stories that have emerged, a tendency has emerged for people to believe that the ECB's interventions in late 2010 and early 2011 in relation to senior bank bonds played a very important role in raising the financial burden of the programme on Irish taxpayers. This is not the case.

The vast majority of the bank debts that had been covered by the September 2008 guarantee had matured prior to the ending of this guarantee in September 2010. Of the unguaranteed bonds that remained, some were secured and could not be simply defaulted on. Economist Seamus Coffey has calculated the amount that defaulting on bonds issued by Anglo Irish Bank and Irish Nationwide in late 2010 would have saved the Irish taxpayer: He puts this figure at about €4 billion.[13]

In a country with a population of about 4.5 million, the figure of €4 billion represents a substantial amount of money. In this sense, the controversy about the role played in this area by the ECB is legitimate. However, this is only a very small proportion of the total costs of the banking crisis incurred by the Irish people. The September 2008 guarantee, passed by the Irish government without threats from the ECB, should be seen as far more important in raising the costs of the crisis to Irish taxpayers than the ECB's actions of 2010 and 2011.

12 The transcript of Michael Noonan's appearance before this inquiry is available at https://inquiries.oireachtas.ie/banking/wp-content/uploads/2015/09/10092015_Noonan_vol1.pdf

13 See http://www.independent.ie/opinion/comment/seamus-coffey-so-how-much-has-been-paid-out-to-unsecured-unguaranteed-bondholders-in-the-irish-banks-26889017.html

3. THE ECB AND IRELAND: AN ASSESSMENT AND SOME QUESTIONS

In this section, I summarise the role of the ECB in the Irish programme and suggest a number of questions worth asking.

3.1 An Assessment

A Positive: A Necessary Banking Sector Restructuring

I will start with the most positive aspect. Despite the controversy over the ECB's role in Ireland's application for official funds, there is little doubt that the ECB officials were correct in their diagnosis of the health of the Irish banking sector in November 2010.

The Irish banks had lost the confidence of international investors and depositors and there was nothing in the mix of prevailing Irish government policies that was likely to undo this trend. The ECB's hope that the announcement of the availability of a large quantity of funds to recapitalise the banking system would quickly stabilise the situation did not turn out as well as might have been expected. As Figures 1 and 2 above show, even after the announcement of the EU-IMF agreement, deposits continued to flow out of the Irish banks and reliance on Eurosystem funding increased for a number of months. However, once the Financial Measures Programme was announced at the end of March 2011, combining a realistic assessment of potential loan losses with a commitment to over-capitalise the banks, the funding situation stabilised. The EU-IMF programme deserves credit for stabilising a situation that was out of control and which could have ended up inflicting even more damage on the Irish and European economies than actually occurred.

The fact that Ireland was unable to regain market access once it had stabilised its banking sector shows that claims the ECB was fully responsible for Ireland entering a programme are largely unfair. The underlying fundamentals in late 2010 were moving Ireland towards a bailout programme and while one can raise legitimate issues about the ECB's behaviour in late 2010, their advice that accessing such a programme was required turned out to be correct.

A Negative: Conditionality and Confusion of Mandates

The "Troika" as the combination of European Commission, ECB and IMF came to be known, was born during the negotiations for the Irish deal. While everyone became used to the idea of this Troika being involved in monitoring financial assistance programmes, it is worth noting that the involvement of the ECB in negotiating and monitoring of such a deal is actually something of an anomaly.

Ireland's EU-IMF programme involved borrowing of €45 billion from the EU (in the form of two different programmes, the EFSF and EFSM) and €22.5 billion from the IMF. For these reasons, it was clear the programme needed to be monitored by the IMF and also by the EU, in the form of the European Commission.

What was less clear was why the ECB is involved in programme design and monitoring. The ECB did not lend money to the Irish government as part of the programme, as such loans would be illegal. Instead, the Eurosystem was lending money to Irish banks and the terms and conditions for such loan are set by the Eurosystem's common monetary policy guidelines.

In theory, the Eurosystem monetary policy since 2007 has allowed banks to borrow as much as they wish in refinancing operations provided they have sufficient eligible collateral. In practice, however, the ECB used its risk control measures to determine which banks it was willing to lend to and how much it was willing to lend. Still, it is unclear why the ECB's risk control framework should have extended to involving them in designing and monitoring a package of fiscal measures rather than assessing each bank that it loans money to on its own merits.

As an indication of how various lines became blurred due to the ECB's involvement in programme design and monitoring, consider the following quote from Klaus Masuch, former head of the European Central Bank mission to Ireland, as spoken to the BBC:[14]

> People in Ireland were not aware of the enormous support that they get from the Eurosystem. This is a privilege, of course. The partners in the Eurozone also expect that every partner – every government in the Eurozone – is doing its own homework. This means keeping public finances stable and, of course, keeping the banking sector stable.

It is hard to imagine a representative of the Federal Reserve telling the citizens of Texas they should realise that it is a privilege that their banks can borrow from the Fed so one might ask why ECB officials believed it was a good idea to lecture Irish citizens in this manner. Moreover, the enormous "support" that was referred to in this quote (and this phrase was also repeatedly used by Jean-Claude Trichet) was largely channelled towards seeing that non-Irish bondholders and depositors were able to pull their money out of Irish banks. In linking the performance of the public finances with the privilege of "receiving support" from the Eurosystem, these kinds of statements suggested a role for the ECB in monitoring the fiscal policies of member states that I do not believe exists in the European treaties.

The ECB's approach to senior bank bonds also led to confusion in Ireland and elsewhere about the conditionality associated with the EU-IMF programme. The programme made no reference to the requirement that private unguaranteed bondholders be repaid. Indeed, such a clause would be unprecedented in an IMF programme document. However, the involvement of the ECB in the Troika monitoring of the programme and its insistence that these bonds be repaid meant that most Irish citizens believed that repayment of unguaranteed bonds was a condition of the programme. This perception undermined the popularity and legitimacy of the adjustment programme.

My conclusion is that the ECB should not be involved in designing the fiscal policy conditionality for future programmes. The ECB's role should be limited to an advisory capacity and it should focus on the role that it plays as bank supervisor and lender of last resort to banking sectors in crises. In particular, there should be no implicit linking of financial assistance programmes with requirements to repay private bank creditors.

A Negative: Confused Decision Making on Lender of Last Resort

Since the early days of banking, it is understood that a lender of last resort is required if the banking system is to avoid periodic systemic crises. Ireland's crisis is just one example of how the ECB has not yet learned to function as lender of last resort in an efficient manner.

The ECB's normal refinancing operations require collateral that is on a specified list of eligible assets. However, in recent years, banks in Ireland, Greece, Cyprus and elsewhere have all been able to borrow via Emergency Liquidity Assistance. In late 2013, the ECB published a short document outlining the procedures the Governing Council follows when approving ELA programmes.[15] However, these guidelines make clear that there is enormous room for arbitrary discretionary decisions on the part of the Council when deciding whether to start or continue ELA progammes.

[14] See http://www.thejournal.ie/the-bbc-bailout-documentary-some-choice-quotes-126048-Apr2011/
[15] See https://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf

In Ireland in 2010, there was a lot of secrecy about the procedures underling ELA and more uncertainty about how the ECB would behave. In particular, it is unclear on what basis the ECB Governing Council approved the extension of ever-increasing amounts of ELA to Anglo Irish Bank, which was becoming more and more insolvent per month. The ECB was most likely receiving assurances from the Central Bank of Ireland and the Irish government that the losses incurred by this bank would be manageable.

The months of briefing from the ECB prior to November 2010 about the temporary nature of the liquidity being provided to the Irish banking sector did the exact opposite of what we would expect a lender of last resort to do. It signalled to the market that liquidity may be pulled soon, leading to a crisis in which creditors could lose a lot of money. The secretive and ad hoc nature of the ECB's decision making process further contributed to give the market the impression that the ECB was at best a very reluctant lender of last resort. These factors further fuelled the ongoing bank run that was already underway in Ireland in late 2010.

I believe that now is a good time to develop a completely new approach for the ECB as lender of last resort. The ECB has taken over as the supervisor of the euro area's banks. This removes most of the previous arguments that were in place for the current system of ELA provision. Previously, banks were overseen by national supervisors. As such, it could be argued that those banks that got into trouble and required ELA were the responsibility of national central banks and that the risk associated with lending to these banks should be borne at a national level.

This point no longer holds. The euro area's banks have been given an official diagnosis of good health from the ECB via its comprehensive assessment proecss. If further problems arise, they should be considered the joint responsibility of all central banks in the Eurosystem.

For this reasons, I believe it is time to change the system in which lending against eligible collateral is a Eurosystem concern while ELA is a national concern. The ECB should be required to initiate and run every ELA programme and have the risk shared among the Eurosystem. As an independent regulator, the ECB should also be a position to assess whether the liquidity problems for a bank applying for ELA reflect temporary problems or else reflect deeper structural issues. This should help with speeding up the process of restructuring problem banks, via recapitalisation or bail-in. A speedier response of this sort would help to avoid a repeat of long-term ELA programmes in which Eurosystem funding is used to allow private creditors to gradually get their money safely out of insolvent banks.

A Negative: Confused Decision Making on Systemic Risk

In late 2010, the ECB made a decision that the senior bonds of highly insolvent Irish banks should be honoured on the grounds that a default on these bonds would have threatened European financial stability.

Over time, of course, the ECB's attitude to bank creditors has evolved. Events in Ireland and elsewhere contributed to the perception that there was a "vicious circle" between banks and sovereigns and the euro area's leaders committed to breaking this link in their statement of June 2012. By the time the Cyprus crisis of 2013 came around, the ECB was comfortable proposing the idea of recapitalising banks via a large haircut on deposits.

Overall, the events of recent years demonstrate that the absence of a coherent European approach to financial stability issues has left the ECB to fill the vacuum in an ad hoc manner that may or may not be consistent with its mandate. One can point to Article 3.3 of the ECB statue which says that "the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system." However, in many cases, it has been the ECB rather than any other "competent authorities" that has taken the key decisions and it has generally not been held accountable for the decisions it has taken.

Again, there are questions about whether the ECB's mandate stretches to making the protection of certain private creditors (or the absence of protection of others) to be a condition of the provision of financial assistance to countries by the EU. In my opinion, it would be better if the Eurogroup of finance ministers and\or the European Council took these decisions, albeit with the advice of the ECB. Of course, if decisions about certain creditors being protected are taken at a European political level to protect Europe-wide financial stability, then this would raise the question of whether the costs of protecting these creditors should also be shared at European level.

3.2 Some Questions

The disclosure of Jean-Claude Trichet's letters to Brian Lenihan in 2010 and the appearance of various figures involved in Ireland's programme before a banking inquiry have helped to clarify many of the questions that had lingered over Ireland's bailout programme. However, a number of questions are still worth asking.

1. Given the size of the emerging solvency problem at Anglo Irish Bank in Spring 2010, why did the Governing Council approve such a large ELA programme for the bank?
2. If the ECB were relying on the Irish state's backing for Anglo as reassurance that the bank's solvency would be maintained, at what point did doubts emerge about the state's ability to provide this assistance?
3. Was it wise for ECB staff to brief journalists from September 2010 onwards about their concerns about "addict banks"?
4. Is it correct that a meeting with Timothy Geithner at the G20 meeting in Seoul on November 11, 2010 triggered the ECB's decision to tell the Irish authorities that they should enter an EU-IMF programme?
5. What was the nature of the communication between the ECB and the Irish government on November 12, 2010?
6. Did ECB staff brief Reuters and other news agencies on November 12, 2010 that Ireland was negotiating a bailout programme?
7. What was the decision making process underlying the ECB's objections in November 2010 to haircuts being applied to bonds issued by Anglo Irish Bank and Irish Nationwide Building Society? What role did Timothy Geithner play in these decisions?
8. Given the subsequent experience with haircuts in Cyprus, does the ECB now accept that haircuts for Irish bank bonds in 2010 were unlikely to have triggered a systemic financial crisis?
9. Did Jean-Claude Trichet tell Michael Noonan in March 2011 that "a bomb would go off" in Dublin if bank bonds were defaulted on? If so, what did he mean by this?
10. Now that the ECB has taken over as regulator of the euro area's largest banks, is it time to reform its approach to the provision of Emergency Liquidity Assistance?

4. THE ECB AND GREECE'S 2015 CRISIS

While the main focus of this paper is on events in Ireland in the years up to 2011, it is worth reflecting on developments since 2011 to assess how relevant the issues raised remain today.

Some institutional changes have occurred that make some aspects of the situation in Ireland in 2010 less likely to occur again.

- State aid rules for the banking sector have been tightened in a way that would make it difficult for a government to issue the kind of blanket guarantee for banks that the Irish government introduced in September 2008.
- The ECB is now the supervisor for Europe's largest banks, so if lack of access to accurate information about the health of the Irish banks was one of the problems during 2010, this is less likely to the case in future.
- The Bank Recovery and Resolution Directive now means there are better tools available to governments and regulators to wind down failing banks and there is less concern about bail-in causing financial instability.

In addition, there are strong legal arguments against the ECB taking part in designing and monitoring financial assistance programmes that will be a condition for the ECB being willing to provide Outright Monetary Transactions. In particular, the advocate general of the European Court of Justice has argued as follows:[16]

> "if exceptional circumstances were to arise which were grounds for activating the OMT programme, it would, for that programme to retain its function as a monetary policy measure, be essential for the ECB to detach itself thenceforth from all direct involvement in the monitoring of the financial assistance programme applied to the State concerned. Nothing would prevent the ECB from being kept informed and even from being heard, but under no circumstances would it be possible for the ECB, in a situation in which a programme such as OMT is under way, to continue to take part in the monitoring of the financial assistance programme to which the Member State is subject when, at the same time, that State is the recipient of substantial assistance from the ECB on the secondary government bond market."

All of these developments are positive. However, this year's events in Greece show that the ECB still believe it is appropriate to use its lender of last resort powers to pressurise countries into signing bailout agreements with the EU and IMF.

Central to this year's crisis was the ECB's insistence that Greece needed to be signed up for an EU-IMF programme if it was to continue provide full liquidity support to Greek banks. This insistence meant the Greek government knew that a failure to agree on a new programme with the EU meant the ECB would cap liquidity support, thus leading to the imposition of capital controls. Discussions of "Grexit" were given credibility by the fact that an extended period of capital controls would possibly lead the Greek government to decide to introduce its own currency. Members of the ECB Governing Council, including Executive

[16] See http://curia.europa.eu/juris/document/document_print.jsf;jsessionid=9ea7d2dc30dd3d2fa1b9e18943c7a196a6fa90afb753.e34KaxiLc3qMb40Rch0SaxuPahz0?doclang=EN&text=&pageIndex=0&part=1&mode=DOC&docid=161370&occ=first&dir=&cid=377680

Board member Benoit Coeure, encouraged the perception that this process could end with Greece leaving the euro by freely admitting this was a possibility.[17]

Throughout the Greek crisis of earlier this year, ECB officials insisted that they were being forced by their own rules to cut off liquidity support for Greek banks. This is simply untrue.

The ECB was the supervisor of the large Greek banks and had declared them to be solvent in late 2014. Arguments about certain assets such as Greek government bonds (of which very little were held by the Greek banks) or Greek-government guaranteed bonds (which were more important) being deemed riskier in the absence of a renewed agreement with the EU may have been correct. However, these arguments did not amount to clear evidence that the Greek banks were suddenly insolvent. Moreover, the precedent set from the provision of ELA in both Ireland and Greece meant that the Eurosystem could insist on the use of a so-called “floating charge” over a bank’s assets, which allowed loans to be secured without itemising specific assets as collateral.[18] In other words, the ECB could approve an ELA programme based on its overall assessment of bank solvency rather than focusing on the eligibility of specific assets to serve as collateral.

With a focus on the solvency of the Greek banks and the need to encourage financial stability, the ECB and European governments could have handled the situation in Greece in a very different manner. For example, an alternative scenario in Greece that could have played out is as follows.

- As tension builds up in Greece prior to the Greek election in early 2015, Mario Draghi assures depositors in Greece that the ECB has fully tested the Greek banks and they do not have capital shortfalls. For this reason, their money is safe.
- Draghi announces that the ECB will thus provide full support to the Greek banks even if the government defaults on its debts, subject to those banks remaining solvent.
- Eurozone governments agree that, should Greek banks require recapitalisation to maintain solvency, the European Stabilisation Mechanism (ESM) will provide the capital in return for an ownership stake in the banks,
- Provided with assurances of liquidity and solvency support, there is no bank run because Greek citizens believe there banking system is safe even if the government’s negotiations with creditors go badly.
- The ECB stays out of the negotiations for a new creditor deal for Greece and its officials assure everyone that the integrity of the common currency is in no way at stake.

There are no legal impediments to this scenario. Supporting banks that you have deemed solvent is pretty standard central banking practice. So the ECB could have provided full and unequivocal support to the Greek banks if they wished. They just chose not to. Similarly, procedures are in place for the ESM to invest directly in banks so a credible assurance of maintaining solvency could have been offered by European governments interested in maintaining financial stability.

Why did this not happen? Ultimately, I believe these decisions reflected political realities. European governments did not want to provide assurances to Greek citizens about their

[17] See Coeure’s comments here http://www.reuters.com/article/2015/06/29/us-eurozone-greece-coeure-idUSKCN0P92P820150629

[18] Of course, we know now that Greece’s banks require an additional €14 billion to meet capital requirements under an adverse stress scenario. However, this additional capital requirement has largely been the result of the crisis triggered by capital controls and uncertainty about euro membership, a crisis that was avoidable on the part of both the ECB and the Greek government.

banking system at the same time as their government was openly discussing the possibility of not paying back existing loans they had received from euro area states. Indeed, the fact that the ECB had the ability to restrict liquidity and required the imposition of capital controls was perhaps the key bargaining chip that European governments had when negotiating with Greece.

Already under political pressure from Germany and other Northern European countries because of objections to their existing monetary policy programmes (such as OMT and the new Quantitative Easing programme) Mario Draghi and the ECB Governing Council decided it was better for them to play along with the creditor country squeeze on Greece than to stabilise the Greek banking system.

As long as the ECB's lender of last resort role remains as confused as it currently is, questions about whether the ECB is acting beyond its legal mandate and becoming overly involved in political developments will continue to be aired.

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The ECB's Role in the Design and Implementation of (Financial) Measures in Crisis-Hit Countries Monetary Dialogue November 2015

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