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The Monetary Dialogue and Accountability for the ECB

NOTE

Abstract

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

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AUTHOR

Karl WHELAN, University College Dublin

RESPONSIBLE ADMINISTRATOR

Dario PATERNOSTER
Policy Department A: Economic and Scientific Policy
European Parliament
B-1047 Brussels
E-mail: Poldep-Economy-Science@ep.europa.eu

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ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its monthly newsletter please write to:
Poldep-Economy-Science@ep.europa.eu

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EXECUTIVE SUMMARY

- The Parliament's Economic and Monetary Affairs committee has had to deal with an extraordinary number of complex events and new issues in its ongoing Monetary Dialogue with the European Central Bank.

- In particular, recent years have seen very considerable increase in the power and influence of the ECB. Its roles in deciding when to provide emergency credit to banks and when to purchase sovereign bonds have led to considerable controversy.

- The ECB's new role as the single supervisory mechanism for banks will further add to the institution's already considerable powers.

- While traditionally responsible for implementing monetary policy in a relatively straightforward manner, recent years have seen a wide range of discretionary decisions by the ECB in areas where the rationale for policy decisions are unclear and where accountability is generally lacking.

- Areas such as the use of the risk control framework to deem certain securities or counterparties ineligible for Eurosystem operations and decisions relating to the provision of Emergency Liquidity Assistance have been very important in recent years but there is very little clarity as to how these decisions are taken. The same applies to decisions to purchase sovereign bonds.

- In its current format, the Monetary Dialogue has had limited success in shedding light on the new powers that have been used by the ECB in recent years.

- The Monetary Dialogue needs to play an important role in keeping the ECB accountable for its actions to the European public but the kinds of complex issues that continue to arise are difficult to handle within the Dialogue's current format.

- I suggest that the Dialogue needs to more focused, more interactive and make greater use of outside expert advice.

1. INTRODUCTION

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

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

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

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

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

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

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

2.1. The ECB and the Provision of Credit to Banks

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

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

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

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

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

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

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

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

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

In November 2010, the ECB played a crucial role in Ireland's application for a bailout from the EU and IMF. As I have discussed elsewhere, there is strong evidence that Jean-Claude Trichet sent a letter to Irish finance minister, Brian Lenihan, on November 12, 2010 and that this letter contained suggestions that the ECB would withdraw funding from Irish banks if the government did not apply for assistance from the EU and IMF.[2] The ECB has acknowledged the existence of a letter from Trichet to Lenihan in November 2010 but has refused to release it and also insisted the letter has a different date than that suggested by other evidence.

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

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

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

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

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

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

2.2. Bond Purchases, Letters and Discretion

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

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

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

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

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

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

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

3. ACCOUNTABILITY VIA THE MONETARY DIALOGUE

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

3.1. The ECB Press Conference and the Monetary Dialogue

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

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

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

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

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

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

3.2. Recommendations

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

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

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

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

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

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