DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

The ECB's Role in the Design and Implementation of Crisis Country Programs: Ireland and Beyond

IN-DEPTH ANALYSIS

Abstract

The ECB has been an integral participant in the design and monitoring of financial assistance programs for euro area countries. This paper focuses on the role the ECB played in the Ireland program 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 program. 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 programs. 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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AUTHOR

Ajai CHOPRA, Peterson Institute for International Economics

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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DISCLAIMER

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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 programs for euro area countries. This role gives the ECB great power and influence but also generates controversy and resentment in these program 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 program 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 program 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 program, 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 program, 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 programs. 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 programs for euro area countries. Although four countries have had such programs—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 program. 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 programs. Section 4 summarizes the main conclusions.

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

[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 program 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] 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.

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 program 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.

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 program 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 program countries.

[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.

[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

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 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 program 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

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.

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.

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 program 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 program 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 program, 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 program was launched, remaining unguaranteed and unsecured senior bondholder 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 program 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 program 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 program, 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 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 program, the ECB was unwilling to make this part of any explicit agreement. Thus, when the program 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 program. 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

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

rating thresholds for Irish government debt making such paper eligible as collateral for ECB operations.

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 program 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

[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

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 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.

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

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.

3.3. The ECB in the troika

The "troika" originated during the discussions for the first EU-IMF program 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 program 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 program 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 program table, whereas the national central bank of the country sits on the other side. As such, the ECB has played a vital part in programs 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 program 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 program 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 program 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 program 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 program 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 programs 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 program, 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 program 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 program such as OMT is under way, to continue to take part in the monitoring of the financial assistance program 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 program countries.

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 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 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 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.

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

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