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ECONOMIC AND MONETARY AFFAIRS

CHANGING OF THE GUARD AT THE ECB

BRIEFING NOTE

Abstract

President Trichet's first half of mandate has run smoothly and strengthened the ECB's credibility as a dedicated inflation fighter. The second half has brought extraordinarily challenges, especially as sovereign debt crisis is spreading through the euro area. Although it has been made even more difficult as the result of poor institutions and dithering governments, the ECB's responses to the crisis have been unsatisfactory. Through its President statements, the ECB ruled out key steps that proved to be unavoidable and, more generally, failed to anticipate on market reactions. This may signal the limits of the consensus model of decision-making or a dangerous tendency toward "group think", both of which are a matter for the President to deal with. More generally, the

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EXECUTIVE SUMMARY

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

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

The ESCB has a particularly complicated decision making structure. Formally decisions are made by the Governing Council. Currently composed of 23 members, the Council is clearly too large to conduct in-depth analyses. Although details are not made public, it seems that the decisions are prepared within the 6-member Executive Committee. It is plausible that the President discusses on the side with (some) governors of National Central Banks (NCBs) to make sure that an agreement can be reached. It is also known that the President comes to the meeting with a draft of the text that will be presented at the ensuing press conference. This means that the President plays a pivotal role.

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

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

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

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

1. INTRODUCTION: DO PRESIDENTS MATTER?

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

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

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

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

It is therefore no surprise that the personality of the governor matters a lot, and there is nothing inherently wrong with this situation. At the same time, the governor must be sensitive to divergent views and criticism, both within and outside the bank. The chairmanship of Alan Greenspan offers an illustration of the dangers of a governor who becomes impervious. Formally, central bankers are subject to accountability procedures that allow elected officials to represent the "wishes of the people". In practice however, accountability can be weak, as in the case of the Eurozone, or misguided, as happens occasionally in the US. While there is no magic solution to the accountability riddle, part of the solution is open and frank debate within the policy-making committee, more generally within the central bank and with outside experts. This is the only way of combining the necessary independence – a hugely important progress achieved over the last two decades – and control over decisions that are often complex because there is often not one best answer to the issue faced by the central bank.

On these various aspects, the ECB's record is good but not perfect. Section 2 describes how the ESCB and the ECB operates. The following section provides a brief – and superficial – evaluation of the ECB performance during the eight years of Jean-Claude Trichet's presidency. The shortcomings during the crisis suggest a number of interpretations, which are presented in Section 3, and a number of suggestions, which are the object of the last section.

2. HOW THE ESCB OPERATES

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

It is not known publicly how the Governing Council functions. All we know for sure is that the Council meets twice a month, with one meeting devoted to monetary policy decisions and one meeting dedicated to internal house keeping.[1] We also know that the policy-making meeting starts with a report by the Chief Economist, namely the Executive Board member who supervises the Economics Directorate General. Beyond that, what follows is informed guesswork, a first signal that transparency is limited.

[1] Emergency videoconferences are also organized.

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

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

Like his predecessor, Wim Duisenberg, Jean-Claude Trichet has insisted on the pretence of consensus and on being the only one to present the bank's viewpoint.[2] This is in line with his role as consensus-builder. This role gives him unique power among his colleagues and the fact that consensus is achieved is the litmus test of his authority. This is a general phenomenon: dissent within policy-making committees tends to be seen as a signal that the governor is weak. This needs not be the case. For instance, the Bank of England and the Swedish Riksbank, both of which publish minutes and voting records, project the image of frank and open intellectual debates. Occasionally, the governor is seen to be in the minority. As long as these instances are infrequent, there has been no suggestion that the governor is weak. In the Fed, on the other side, there is a view that putting the Chairman, who opens FOMC meetings and states his views, in the minority would be an affront.

3. TRACK RECORD

The eight years of Jean Claude Trichet have been rich and varied. A brief evaluation, like the one that follows, is inevitably superficial and unfair. Hopefully, it can still bring up some issues of general interest. By the time the crisis hit in 2007, half way through his mandate, the EBC President was unanimously considered as highly successful, an equal to the Fed Chairman.

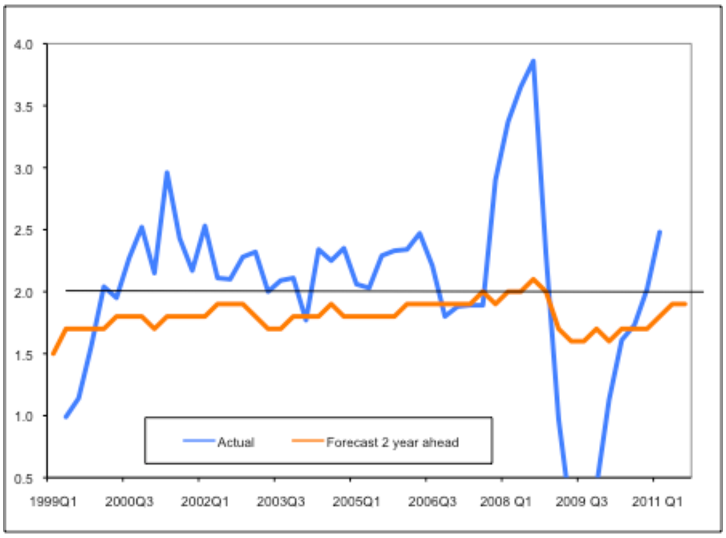
[2] At the very beginning, divergent opinions from Council members created the sense of cacophony. It took some time and much effort for President Duisenberg to restrain his colleagues.

Over the next half mandate, the challenges became formidable and it would have been extraordinary to sail through the storm without making mistakes. Of course, the situation of the ECB is uniquely difficult as it must deals with many governments that tend to disagree on important issues. It is also important to note that the ECB is caught in a governance structure of the euro area that has now been unanimously recognized as imperfect, if not dysfunctional.

First half of mandate

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

HICP inflation: actual and foreseen



Source: ECB

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

Crisis years

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

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

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

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

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

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

And now?

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

4. IMPROVING THE ECB BOARD'S EFFECTIVENESS

Group think vs. hardening positions

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

A different interpretation is that Board members were not prepared from their previous experience to face the crisis. It is often observed that most Board members have very similar profiles, coming from Treasuries and central banks. Most other central banks include in their boards former academic and market economists whose instincts are to challenge conventional wisdom and who easily recognize mistakes.[3] Within the ECB, instead, it could be that different Board members and NCB governors staked out positions and were led to harden them as the situation deteriorated and called for ever more audacious steps.

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

TRANSPARENCY

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

APPOINTMENTS[4]

One of the judicious features of the ECB statutes is that the Executive Board members cannot be reappointed. We have countless examples of highly

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

[4] Disclaimer: I have no personal interest in any position at the ECB.

successful central bank governors who are appointed over and over again. Long-serving officials become less interested in being challenged by internal and external colleagues and they tend to rely increasingly on their own judgments. The turnover at the head of the ECB has so far gone smoothly. Yet the appointment system is deeply flawed.

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

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

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

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