



**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# **Improving Monetary Dialogue with the ECB**

**NOTE**

## **Abstract**

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

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## EXECUTIVE SUMMARY

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

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

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

# 1. THE ECB

## 1.1. Looking backward

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

The first shock was the US "subprime" crisis of 2007.

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

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

The fourth shock was the euro area sovereign debt crisis of 2010 originated by the 2009 recession. The sovereign debt crisis was the result of several factors: fiscal mismanagement in some euro area Member States in good times, widening government deficits due to the working of automatic stabilisers, discretionary government spending to withstand the negative effects of the crisis, large current account imbalances in some Member States in the periphery due to lack of competitiveness. The ECB was forced to intervene for the first time with 'non-standard' monetary policy measures in order to save the monetary union and the euro. Jean Claude Trichet introduced the Securities Markets Program (SMP) in May 2010 to buy government debt of the Member States under pressure. A prolonged period of low interest rates since the early 2000s may have also exacerbated the sovereign debt crisis. ECB policy rate was cut from 4.5 % in 2001 to 2.5 % in 2002, to 2.0 % in 2003 and kept at that level until 2005 to help Germany getting out of recession as well as to spur Italy's and France's growth performance as these three Member States represent about  $\frac{3}{4}$  of the euro area GDP. However, such low policy rates translated into negative real interest rates in those Member States featuring high inflation rates (e.g. Spain, Greece, Ireland), thereby generating a boom in internal demand.

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

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

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

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

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

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

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

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## 2.1. Looking forward

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

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

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

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

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

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

At present, the viability of this Redemption Fund and the issuance of Euro bills is being analysed by a group of experts, under the Chairmanship of Gertrud Tumpel-Gugerell ex Vice Governor of the Austrian National Bank and former member of the Executive Board of

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<sup>2</sup> [www.ineteconomics.org](http://www.ineteconomics.org)

the ECB. The decision to form this group was announced by J. M. Barroso and by H. Van Rompuy, President of the European Council.

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

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## 2. MONETARY DIALOGUE

### 2.1. Looking backward

In the 7<sup>th</sup> Legislative term of the EP (2004- of 2013), the Monetary Dialogue was confronted with issues more relevant than in all the previous EP legislative terms.

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

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

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

## 2.2. Looking forward

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

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

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

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

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

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

Cross-country differentiation is also visible in the latest figures for quarterly GDP growth: In 2013Q3, the average euro area growth was 0.5 %, but some countries outperformed (Germany 1.4 %, France 0.8 %, Belgium 0.9 % and Netherlands 0.7 %), while some others underperformed markedly (Spain -0.1 %, Italy -0.8 %, Finland -1.4 %, Portugal -1.6 % and Greece -2.6 %).

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

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

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

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

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

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