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CHANGING OF THE GUARD - HUGE CHALLENGES AHEAD FOR THE NEW ECB PRESIDENT

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Highlights

- Jean-Claude Trichet deserves praise for fighting inflation and his handling of the financial crisis of 2007-2009. But his legacy is unfinished and we still have to see whether he will be the one who saved the euro. Important challenges remain for the incoming president.
- First, trust of citizens in the ECB has fallen massively according to the Euro-barometer survey in many euro area countries, including Germany and Greece. Trust needs to be regained.
- Second, the ECB's stance on Greece needs to be reversed both as regards financial sector participation and SMP. The SMP for Italy can be justified but can only be a temporary solution. The ECB will therefore have to further push for a fiscal lender-of-last-resort back-stop that can also exercise conditionality.
- Third, a rate cut should be considered at this point in time but upcoming political pressure to increase inflation needs to be resisted.

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CHANGING THE GUARDS - HUGE CHALLENGES AHEAD FOR THE NEW ECB PRESIDENT

GUNTRAM B. WOLFF, SEPTEMBER 2011

DURING THE EIGHT years of Jean Claude Trichet's presidency, the ECB has faced unprecedented challenges. Under Trichet's leadership, the ECB has become an institution with far-reaching tasks and responsibilities. History books will emphasise that Trichet's ECB fully discharged its primary mandate of maintaining price stability. The ECB under Trichet's leadership has received, and deserves, the highest praise for its handling of the financial crisis of 2007-2009, having been very quick to react and effectively avert a Great Depression and financial melt-down. But Trichet's legacy is unfinished. We still have to see whether he will be the 'man who saved the euro' and a lot will depend on whether his successor and the other key decision-makers in the euro area will rise to the remaining challenges.

In this context, this Policy Contribution focuses on three main challenges for the incoming president and the institution he will lead:

- First, the ECB will have to continue to focus on price stability. At the current juncture, a rate cut should be considered. At the same time, the ECB needs to remain credibly committed to its primary mandate and fend off rising demands for higher inflation to solve the debt crisis.
- Second, the ECB will have to rethink its role in the sovereign debt crisis. This involves reversing the policy stance on Greece and supporting a solution that shares the burden more broadly, including with the financial sector. Admitting that the Greek securities markets programme (SMP) was a mistake will also allow it to more forcefully justify the need for an SMP in the current situation concerning core euro- area countries.

  At the same time, the ECB will have to continue Trichet's legacy in advancing the formation of a true euro-area fiscal authority that can take up the lender-of-last- resort function and exer cise conditionality. The executive role of the ECB in the design of financial assistance programmes should be revisited in light of the new EFSF.
- Third, the ECB president and euro-area leaders will have to regain the trust of citizens in the ECB. Eurobarometer data document a dramatic fall-off in trust during the sovereign debt crisis.

This Policy contibution argues that trust will be regained with more democratic accountability, by addressing the second challenge related to the role of the ECB in the debt crisis and by continuing to credibly defend price stability. The European Parliament is key in reshaping the role of the different institutions in the emerging new governance structure and in holding all actors to account.

1 THE TRICHET PRESIDENCY

When Jean-Claude Trichet took office as the president of the European Central Bank on 1 November 2003, he started on what has turned out to be a long journey. Nobody at the time expected his presidency to be marked by the events that we have seen in the last eight years.

Commentators of the time were giving him credit for his uncompromising stance in keeping inflation in check. The Süddeutsche Zeitung, for example, had the headline: "Trichet's accession - new ECB president for a strong euro". Newspapers trusted that the ECB would continue to focus on price stability and German media praised Trichet's emphasis on sticking to the Stability and Growth Pact. Commentators were divided on whether he should raise or lower rates. The Spanish newspaper La Razon thought that: "Trichet, known for his pragmatism and adherence to the principle of price stability, is not expected to try to make fundamental changes in monetary policy."

How different is our view of the ECB now, and how much has happened in these eight years. Jean-Claude Trichet will be remembered as the most important person in the euro area besides Angela Merkel and Nicolas Sarkozy. He will be remembered as the person who transformed the ECB from a normal central bank into an institution whose influence extends much beyond its formal mandate.

Under Jean-Claude Trichet's leadership, the ECB successfully fulfilled its primary mandate of preserving price stability. Average annualised inflation in his eight-year term has been 2.02%. This is about as close as one can get to 'close but below 2 percent' in the circumstances. This is a major achievement for him personally as well as for the whole eurosystem.

Jean-Claude Trichet will be remembered for revolutionising ECB communication with the market and public at large. He was elected 'European Banker of the Year 2007' by the journalists' association 'The Group of 20+1' for his clarity in communication that supported the credibility of the euro. This helped markets to understand and anticipate future ECB action. Certainly, Mr Trichet managed to impose discipline over ECB communication.

Jean-Claude Trichet will also be remembered for calling for strong structural reforms and strict adherence to the Stability and Growth Pact from the outset of his presidency. In the early years, his analysis of problems may sometimes have underestimated the relevance of intra-euro-area divergences and the consequences this may have for monetary policy. But he was clearly among the loudest and most vocal defenders of structural reforms and fiscal rigour. At the latest as of 2007, he and the ECB were very vocal in asking for the divergence in unit labour costs in the euro area to be addressed. In these warnings, he was clearly ahead of other institutions such as the European Commission in its outside communication, for example in the Eurogroup. Also in the recent discussion on the governance reform of the euro area, the ECB played a prominent role[1].

The ECB under Jean-Claude Trichet's leadership will be remembered for addressing the financial crisis of 2007-2009 forcefully and avoiding major damage to the euro-area and global economy. When the fall-out of the financial crisis appeared, the ECB did not hesitate to do what was necessary to safeguard the stability of the financial system. On 9 August 2007, the Dow Jones Industrial Average fell by nearly 400 points due to credit worries. Canadian and European stocks also fell. The European Central Bank, United States Federal Reserve and Bank of Canada all injected money into their credit markets to ease concerns. In fact, the ECB provided liquidity to banks even before the Fed acted. Together with the Federal Reserve, the ECB was the key player in preventing a global great depression. Jim O'Neill, at the time head of global economic research at Goldman Sachs judged that: "The speed at which the ECB responded and its steady tone [...] have been quite impressive."[2] Only the July 2008 rate hike was a monetary policy mistake in this period, even though it is of comparatively minor significance. Overall, the ECB fully rose to the exceptional challenge of the financial crisis and fulfilled its lender-of-last-resort function to the financial system.

Under Trichet's leadership, the ECB became an institution with far-reaching competencies and broad executive authority. The ECB was initially conceived as a purely monetary policy institution. Some people even perceived the institution as only deciding on the interest rate. The ECB has taken on a leading role in assuring financial stability in the euro area. In the new financial supervisory architecture, the ECB president plays a leading role in assuring systemic financial stability by heading the European Systemic Risk Board (ESRB)[3] . In discussions in the Eurogroup and Euro Working Group, the ECB has become the central actor with its voice in many instances carrying great weight even in areas that are the primary responsibility of the European Commission, such

1. See for example the speech by Jean-Claude Trichet in Helsinki, at the Bank of Finland 200th Anniversary Conference (5th May 2011).

2. Quote taken from Financial Times article 'Trichet navigates choppy waters', published 24 December 2007 00:58 ﬂ Last updated: 24 December 2007 00:58

3. For a description of the ESRB, see Wolff and Merler (2011)

as the Stability and Growth Pact. Jean-Claude Trichet and his board have plugged a huge gap in the discussions about the future governance of the euro area. They have developed ideas about how to design the macroeconomic and fiscal surveillance of the euro area in a different way, and Jean-Claude Trichet has sketched a vision of a common European finance minster.

Jean-Claude Trichet's true legacy is about how he has transformed the ECB as an institution in the overall set-up of EMU. However, the jury is necessarily still out on whether Jean-Claude Trichet will be the man who saved the euro. Certainly, history books will remember him as the man who took extraordinary, strong, courageous and sometimes controversial steps to save the euro in the sovereign debt crisis – the most controversial certainly being the Securities Markets Programme (SMP). But unfortunately the crisis is not over. Whether he will go down history as the 'man who saved the euro' or as 'the central banker who went too far'[4] is therefore not yet decided. It will depend on whether Mario Draghi and euro-area policymakers will be up to the task of solving a number of important challenges which still hang over the euro. In the next section, I want to focus on three of these challenges faced by the euro area as Mario Draghi prepares to assume the presidency of the ECB at this crucial time.

2 CHALLENGES AHEAD FOR THE NEW ECB PRESIDENT

2.1 Defining the right monetary policy stance and keeping inflation expectations well anchored

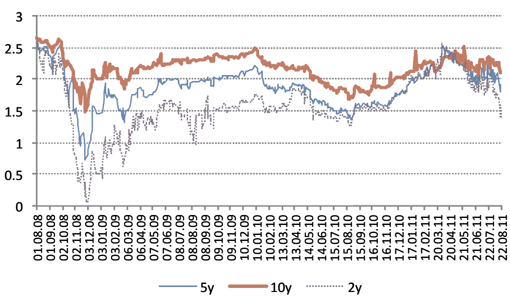
The core mandate of the ECB is to maintain price stability. Therefore, the new President will have to continue to keep a clear and vigilant eye on any risk of missing the inflation target. The ECB governing council has decided to increase the main interest rate twice this year. The first rate hike on 13 April by 0.25 percentage points to 1.25 was fully justified. Inflation expectations as derived from inflation swaps had been increasing since August 2010, and 2, 5, and 10-year expectations had clearly exceeded the definition of price stability by the ECB of close but below 2 percent (see Figure 1). Also other measures of inflation expectations such as the consensus forecast had been on an increasing path.

It is more difficult, however, to follow the logic of the second rate hike to 1.5 percent on 13 July. One and two year inflation expectations had already been below 2 percent before the meeting, and five-year inflation expectations were standing at 2.01 percent before the meeting on 11 July . Only 10-year inflation expectations were standing above the medium-term inflation target. In addition, at the time of the July meeting, it had already become clear that economic data for Germany showed a significant weakening of activity, and activity in other major euro-area economies had been weak for some time already.

Policymakers have, however, been caught by surprise by the massive fall in stock markets in recent weeks. This decline in asset prices further contributes to a weakening in activity as it constitutes a fall in wealth, thus dampening consumption and investment. I would therefore advise to consider afresh the case for a gradual reduction in the interest rate.

A reduction in the main ECB rate (main refinancing operations - fixed rate tenders) would also bring the monetary policy stance into line with liquidity provision of the ECB to the euro-area banking system. Since the beginning of the crisis, liquidity provision of the ECB has been too large compared to the monetary policy stance (see Figure

Figure 1: Euro Inflation Swap (2 yr, 5 yr, 10 yr)



Source: Datastream

4. Ralph Atkins, 'Trichet's legacy: keeping the show on the road', Financial Times, 22 August, 2011.

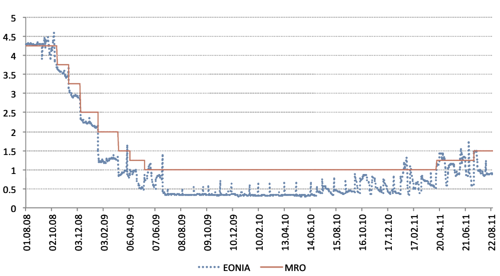
'It is difficult to justify SMPs for insolvent governments in assistance programmes such as Greece. In the case of Italy, the SMP can be justified both for monetary policy reasons and lender-of-last-resort functions.'

2). De facto, there has thus been a more accommodative stance.[5] The increase in the main ECB rate was clearly meant to signal a normalisation of monetary policy conditions. The simultaneous decline in the EONIA, however, indicates that the ECB rate decision was in disconnect with the liquidity needs to the financial system.

All in all, given the weak economic activity data, the recent global slowdown as well as the clear downward trend in inflation expectations, a clear case can be made to carefully consider the case for a rate reduction. At the same time, the ECB president and the governing council will need to keep a close eye on the medium- to long-term inflation expectations and the rising debate about inflation as the best way to address the euro-area debt crisis. If market participants start to believe that ECB independence and commitment to that goal may be weakened, inflation expectations will pick up very quickly, putting the economic system under heavy stress.

The ECB will also need to step up its communication effort so that economic actors better understand that a credible inflation commitment does not imply that inflation rates will be equal in all euro-area countries. In fact, inflation rates in German and the core euro-area countries will have to exceed two percent in the coming years. In turn, inflation rates in the southern European countries with competitiveness adjustment needs will need to be below two percent. This logic is still not widely understood.

Figure 2: EONIA and Main Refinancing Operation Rate (MRO)



Source: Datastrea, ECB

2.2 Revisit the role of the ECB in the debt crisis

The new ECB president will need to carefully reconsider the role the ECB should play in the debt crisis. This task has various dimensions.

A) The ECB has taken a strong stance in the question of burden-sharing for insolvent governments. In the case of Greece, the ECB initially argued that all the burden of adjustment should be placed on the Greek taxpayer. I know of only very few economists who believed that this would be a strategy that would work.[6]

From the outset, Greek debt sustainability was questioned by independent economists as well as by the IMF. Very soon after the details of the first Greek programme were announced (10 May 2010), most economists agreed that there was a high probability that the programme would not work, especially given the high interest rates charged on the assistance loans. The IMF entered into the programme with Greece despite considerable uncertainty as regards the solvency of Greece. The IMF considered the risks to the programme to be high (IMF staff report, 'Request for Stand-By Arrangement', 5 May, 2010). It nevertheless entered into the programme with the purpose of "safeguarding financial sector stability and reducing the risk of international systemic spillovers."

The policy community including the ECB continued to act as if in denial of the Greek facts for more than one year, thereby contributing to uncertainty. Only on 21 July, 2011 did the European Council accept that the programme would not work and came up with a new programme.[7] This long period

5.It is questionable whether liquidity provision and the monetary stance can be fully separated, suggesting that the monetary policy stance was also more accommodative.

6. A nice summary is given in for example Münchau, 'Greece's bail-out only delays the inevitable', 18 April, 2010, Financial Times. http://www.ft.com/intl/cms/s/0/da5b9516-4b1f-11df-a7ff-00144feab49a,s01=1.html#axzz1W0sqAb0z

7. While the fundamental mistakes of charging very high interests rate without any debt reduction was acknowledged, the new programme also still falls short of what is needed.

of denial of reality is remarkable. In the eyes of many, it undermined trust in euro-area policy-making. Moreover, the looming uncertainty about the eventual course of action given the inevitable also contributed to market stress.

The most convincing argument for having entered into the Greek programme was that this would give time for the market and for policymakers to prepare for the inevitable. In particular, it was hoped that delaying necessary restructuring would help the banking system to regain strength. However, euro-area policymakers did not prepare for a restructuring. They also did not do enough to force the banking system to recapitalise.

In preparation for the 21 July summit this year, which aimed at solving the Greek problem, the ECB again took a strong position. It refused to contribute to a solution that would involve private investors. It is unprecedented that a technocratic institution could play such a role. De facto, the ECB committed taxpayers' money without the consent of national parliaments. Unfortunately, the deal for Greece is unfinished with two still unresolved issues: the extent of involvement of the private sector and the guarantees creditor countries will get in exchange for further loans.

While certainly financial stability considerations are an important argument for reducing private sector involvement in the Greek deal, the ECB should have provided compelling evidence to convince policymakers and the national sovereigns that the euro-area financial system would not be able to withstand a loss in the order of magnitude of 1% of euro area GDP.[8] Another argument advanced was that a debt restructuring in one country would lead to the exit of that country. However, Darvas (2011) convincingly shows that this is a very far-fetched assumption. Finally, the argument was made that preventing a Greek debt restructuring would avoid any increase in spreads in other euro-area economies. This strategy obviously did not work. Markets re-assessed sovereign bonds all across Europe in the face of the lingering uncertainty created by euro-area policy-making and in light of structural news from other economies, including of course political instability in Italy recently.

The incoming president should consider carefully whether such a strong role is appropriate for a non-elected technocratic institution and whether it may undermine the legitimacy of the ECB and its ability to take unpopular monetary policy decisions.

B) The ECB has become a very strong player in designing the nuts and bolts of the programmes and the associated conditionality. This is a remarkable increase in power and scope of what a typical central bank does. This increase in scope of action is certainly also the result of the interest of a number of member states. The new ECB president should nevertheless carefully consider whether such a strong executive role is desirable in the new framework. Certainly, an EFSF/ESM with enlarged powers and staff could take over many of the tasks currently performed by the ECB. The European Parliament should ask for a re-consideration of the respective roles of the Commission, ECB and ESRB in this regard.

C) Opinions on the Security Market Programme (SMP) of the ECB are divided across Europe. This division of opinion by itself has become a problem for the ECB as I will show below (section 2.3).

Any discussion of the SMP needs to take into account the incomplete institutional set-up of the euro area, which led the ECB into taking responsibilities for which it was not originally designed. In fact, the euro-area crisis has exposed deep deficiencies in the governance of Economic and Monetary Union. It took several months – after the start of what was initially the Greek crisis – for the euro area to put in place instruments which, although useful, are still proving insufficient to extinguish the fire. To date, the euro area still does not have a full, unified lender of last resort. Irrespective of what one thinks of the wisdom of the SMP itself, one has to acknowledge that only the ECB has the technical capability to do this. If a decision had been taken to buy Greek government bonds, only the ECB could have done it. Obviously

8. Of course, other reasons may explain the ECB position on Greek debt restructuring. The ECB itself always argued that such a restructuring would have had negative consequences for financial stability and lead to a second 'Lehman Brothers'. However, if that had been the main motive of the ECB, it should have provided much clearer evidence in this regard. Within the ESRB as well it failed to advance the discussion sufficiently in this direction.

the ECB could have used its independence and refused such purchases. It would then, however, have known that no other institution could have played this role.

Buying government bonds of the insolvent Greek government constitutes a significant risk to the balance-sheet of the ECB and may have undermined the independence of the ECB. For a government that is fully taken off the market by a financial assistance programme, the buying of its bonds on the secondary market, as done by the ECB, has no fiscal implications.[9] The ECB always argued that it entered into the SMP to improve monetary policy transmission. However, there is only very limited evidence of why the SMP would have mattered for monetary policy transmission in Greece. Certainly Greek banks continued to get access to ECB liquidity at generous terms. The programme also foresaw a significant amount of capital to recapitalise the Greek banking system if needed. Greek banks therefore had the liquidity needed to conduct their normal banking business. It is also clear that fiddling around with the price of Greek bonds in the secondary market helped little to change market assessments of other euro-area bonds. It is therefore very difficult to understand the rationale for buying Greek bonds. The Greek SMP came at a price: it contributed to the ECB's balance-sheet exposure to Greece. This may have undermined the independence of the ECB and may explain the tragic role played by the ECB in the subsequent discussions on Greece. I therefore argue that the Greek SMP was a mistake not only with the benefit of hindsight.

On the other hand, the ECB in the current incomplete euro-area architecture has to perform a lender-of-last-resort role in order to avoid liquidity crises becoming self-fulfilling solvency crises. This is needed to avoid bad equilibria from happening. The current European set-up does not have any institution besides the ECB that is in a position to provide the liquidity needed to credibly deter betting against solvent governments .[10]

The Italian situation is different from the Greek one, both in terms of debt sustainability and in terms of the banking sector. A malfunctioning sovereign bond market in Italy seriously undermines the proper functioning of monetary policy as it affects the banking system of the third largest economy of the euro area. This should remain the main argument of the ECB for its SMP programme in Italy. The ECB should make an effort to explain why and how the SMP helped to stabilise the monetary transmission mechanism in Italy. In addition, an Italian SMP comes with lower risks. Most economists agree that Italy is solvent at the interest rate it had to pay before the recent increase in spreads. Assuming that this is a correct assessment, a credible commitment by the ECB to buy Italian bonds to an unlimited extent if needed would fend off all market speculation against Italy immediately (again: assuming solvency).

After basically having suspended the SMP programme since January 2011, the ECB decided to enter into a new SMP programme in August 2011. It bought €22 bn of government bonds followed by €14 bn, then another €5.3 bn in August. While the ECB does not disclose which government bonds it buys, there is a general agreement that most of these purchases went to Italy and to some extent to Spain. As in the previous SMP, the effect of the SMP on aggregate liquidity was offset by fixed-term deposit operations.

Was it necessary to take up the SMP for Italy at this particular point in time? There was certainly considerable concern that the widening spreads would seriously undermine the stability of the Italian banking sector. The ECB therefore had to act. Fiscally, there was no immediate urgency. Italian debt is long-term debt and refinancing needs for Italy up to the end of the year amount to €170bn. The fiscal implications of a spread of four percentage points are therefore very limited, not exceeding €8 billion a year.[11] This is money that certainly matters but that does not fundamentally change the solvency equation for Italy. On the other hand, in the current recessionary environment, an additional fiscal tightening of the order of €8 bn certainly would have had negative consequences on growth.[12] The ECB therefore decided to go ahead with the SMP and help Italy to fend off market

9. Suppose that policymakers actually believed in Greek solvency. In that case, it would have been inconsistent to ask for high interest rates on official loans while at the same time trying to lower rates on the secondary market via SMP. Such a policy is not suited to fending off liquidity crises. Irrespective of who was the main driver of the penalty interest rate on assistance loans, once this was known, no SMP programme could have changed the insolvency equation as all maturing debt was rolled over under the conditions of the programme anyway.

10. For a recent discussion see De Grauwe (2011)

11. Assuming €30 bn deficit financing needs.

12. The fiscal advantage of ECB action is difficult to quantify. Assuming that spreads would have widened in the absence of ECB action, the potential gains could be in the order of magnitude of 2%-4%*200bn=4-8bn.

doubt early on. In exchange, there was apparently a secret letter by the current and incoming ECB presidents to the Italian prime minister. This letter reportedly set out the conditions attached to the Italian SMP, and Italy moved quickly to pass a budget law and enact structural reforms.

On balance, the SMP deal with Italy therefore is more sensible than in the case of Greece. There is a clearer case as regards monetary policy transmission. Moreover, the SMP was connected with ECB-imposed conditionality and in exchange provided budget relief. However, without a true euro area fiscal backstop, the ECB can only temporarily pursue such a policy as it would accumulate too much risk and lose its independence. Moreover, ECB- imposed conditionality in exchange for SMP can only be a temporary solution. The European Parliament should demand democratic accountability in any future deal of this kind.

In the long run, the new ECB president will have to find a way of solving the tension between being the only institution with the necessary fir-power to fend of liquidity crises while on the other hand avoiding to be forced to buy large amounts of bonds over a long period. Continuing with the SMP at the current rate for a prolonged period of time will not be possible. It would imply a massive increase of the holding of Italian debt, thereby leading to a substantial increase of risk for the balance-sheet of the ECB. In addition, sterilising such large amounts of liquidity from the banking system will not be possible without frictions and possible distortions in the distribution of liquidity in the banking system. Ultimately, the new ECB president will therefore have to push European governments to finally form a fiscal mechanism that can serve as the European lender of last resort. This mechanism would need to have far-reaching executive authority as regards national fiscal policy. The outgoing president has rightly identified the need to develop a vision of a European finance minister.[13]

The agreement of the European Council of 21 July can be seen as a first step in this direction. An enlarged EFSF will take over some of the functions currently performed by the ECB, including the buying of sovereign bonds on the secondary market. It is also planned that the EFSF will get some additional staff, potentially in order to have a greater executive role. But the agreement of 21 July is unfinished business.

2.3 Regain the trust of the general public in the ECB and the euro

One of the most serious challenges the ECB and European policymakers in general face is the rising mistrust in the euro project itself by both financial markets and the wider public. The mistrust of financial markets is in the daily news: interest rate spreads between national sovereign bonds have been considerable for some time now, and financial markets do not believe that a solution has been found to the problems in Greece in particular. I refrain from further discussion of financial market trust.

Instead, I want to focus on the mistrust of the general public in the euro and the ECB. The latest available data from the Eurobarometer[14] shown in Figures 1 and 2 in the annex document that support for the euro has been falling in the last couple of years in all countries except Greece. The most dramatic fall can be seen in France, Germany and Portugal. The drop is significant, and beyond the typical volatility observed in the survey (as can be seen from the last column giving the standard deviation in the table in annex).

This decline in the support for the euro has been matched by an even more worrying decline in the trust in the institution responsible for the euro, the ECB. In only 5 of the 12 euro member states does a majority of the population trust the ECB. The most dramatic decline can be seen in Germany, the Netherlands, but also Greece, Belgium, Ireland and Spain. In France, trust in the ECB is the lowest of all the 12 euro-area countries in the sample: less than one third of the French population trusts the ECB, and more people distrust rather than trust the ECB.[15]

The time profile of net trust in the ECB is interest-

13. See Trichet's speech 'Building Europe, Building Institutions' in receiving the Karlspreis (Aachen, 2 June 2011)

14. The standard Eurobarometer is a survey consisting of approximately 1000 face-to-face interviews per EU country. It is published twice a year (Spring and Autumn) and data can also be retrieved from the Interactive Search System online.

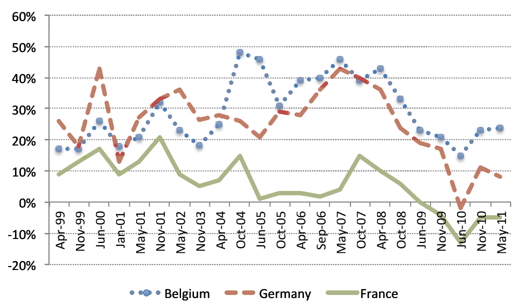
15. French absolute figures may be distorted by the fact that the ECB is called a bank and public opinion about banks is not very favourable. In France there is of course also a long tradition of scepticism towards an independent central bank with an exclusive focus on fighting inflation There was already back in 2007 a lot of public criticism towards the ECB on both sides of the political spectrum that the strong euro was allegedly destroying French industry and that there was no need to keep pushing rates up. However, it is theerefore all the more surprising to see that support for the ECB dropped when it expanded its mandate beyond inflation fighting.

'Falling trust in the ECB and the euro by citizens undermines the foundations of the common currency.'

ing. In particular in Germany, but also in France, the Netherlands, Austria, Finland and even Belgium, a particularly strong drop is visible in the June 2010 data. This is of course the month right after the first Greek programme. These data suggest that the Greek programme was not popular. These figures are worrying as ultimately, the euro can only be successful if the population supports the euro and the ECB. Unfortunately, the Eurobarometer has no further question giving an indication of why trust has gone down and so it is up to me to hypothesise on this. I would argue that the ECB and the euro have lost support in the different countries for different reasons:

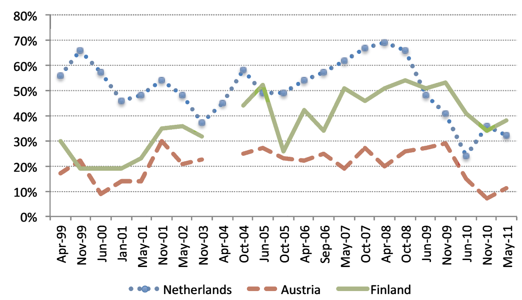
In Germany, Austria, Finland and the Netherlands,

Figure 3: Trust in the ECB: Belgium, Germany, France



Source: Eurobarometer

Figure 4: Trust in the ECB: Netherlands, Austria, Finland

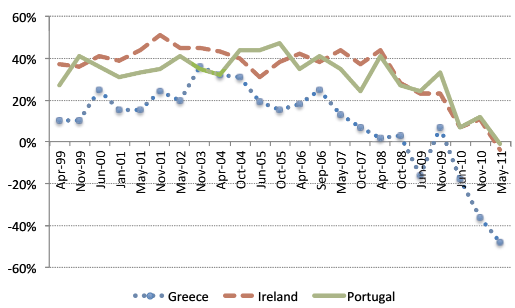


Source: Eurobarometer

Note: Data were obtained by the Eurobarometer Interactive System. The Section is "Trust in European Institutions" and the relevant question is QA18.4 "And, for each of them [i.e. European Bodies] , please tell me if you tend to trust it or tend not to trust it? - The European Central Bank"

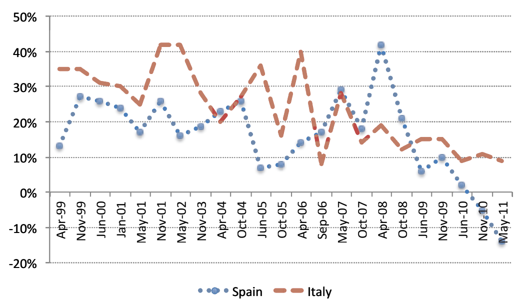
The numbers are computed as the difference between the percentage of respondents who "Tend to Trust in the ECB" and those who "Tend not to trust"

Figure 5: Trust in the ECB : Greece, Portugal, Ireland



Source: Eurobarometer

Figure 6: Trust in the ECB: Spain, Italy



Source: Eurobarometer

Note: Data were obtained by the Eurobarometer Interactive System. The Section is "Trust in European Institutions" and the relevant question is QA18.4 "And, for each of them [i.e. European Bodies] , please tell me if you tend to trust it or tend not to trust it? - The European Central Bank"

The numbers are computed as the difference between the percentage of respondents who "Tend to Trust in the ECB" and those who "Tend not to trust" there is growing fear that the ECB is misusing its independence to carry out fiscal policy operations in favour of southern Europe. The particularly steep decline in Germany in June 2010 may be explained by the effect of the SMP programme and the subsequent public debate, with Axel Weber heavily opposing such a programme. A further indication that the controversial SMP discussion played a role in Germany is the fact that there was a much steeper drop in net trust in the ECB than in support for the euro. It appears that German public opinion felt particularly betrayed by the ECB. Also now, there is a growing group of politicians that claim that the ECB is exceeding its mandate and monetising government debt. These politicians fear that this ECB policy will become inflationary.[16]

Such public debate by high-ranking state representatives, national central bankers and commentators at large is harmful to the ECB. In order to avoid this criticism, the new ECB president will have to make a significant communication effort to justify the SMP programme with monetary policy operations. Clearly, the current statement that the transmission of monetary policy is not functioning properly when spreads are high is not perceived to be sufficient. Instead, I recommend that the ECB is pro-active in using its intellectual fire-power to convince academics, journalists and other stakeholders that large spreads are a serious issue for monetary policy. With such a pro-active strategy, the ECB may be able to regain the lead in the debate and thereby regain trust in this group of countries.

In the three countries under financial assistance programmes, the public view of the ECB is certainly heavily influenced by the role the ECB played in the design and implementation of programmes. The public perception is that the IMF has become the good 'cop', understanding the real problems, while the ECB has become the 'bad cop'. The most obvious evidence in this regard is the strong disconnect between support for the euro, which has dramatically increased in Greece since 2008 and the trust in the ECB, which has fallen dramatically in Greece since the start of the programme. Also in Ireland, trust in the ECB has fallen dramatically despite a continuously strong support for the euro. The ECB has played a role in preventing a larger participation of the financial sector while at the same time shifting the burden onto local taxpayers. This strong interference in national sovereignty has not been popular. The ECB may have been right in its policy but again it has not done enough to convince citizens and informed observers of this.

In all fairness, it needs to be admitted that not only trust in the ECB has declined considerably, but other European institutions and national governments are also affected. Similar declines in trust in the European Commission and also national governments can be observed, while trust in the European and national parliaments has kept up comparatively well. It is beyond the scope of this paper to further discuss this.

3 CONCLUSIONS AND POLICY RECOMENDATIONS

The European Central Bank has been transformed into an institution with far-reaching executive authority and competencies. This has been the result of a combination of factors, the lack of strong political leadership in the euro area and the absence of alternatives being among the most important ones. But this strong increase in executive powers has come at a price, and the role of the ECB needs to be re-calibrated in the future.

1 I have shown that popular trust in the ECB has fallen dramatically in programme countries. The ECB should reconsider whether its strong involvement in the design of financial assistance programmes is desirable. It should also consider softening its stance on sovereign-debt restructuring and burden-sharing, thus yielding to the primacy of taxpayers and supporting those. In the case of Greece, the ECB should become an advocate of a clear debt cut at the expense of the financial sector, thereby finally ending uncertainty.
2 The Securities Markets Programmes have been very controversial in Germany and other creditor countries and it is difficult to justify SMPs

16. The most prominent example is certainly the speech by German President Christian Wulff in Lindau, http://www.bundespraesident.de/SharedDocs/Reden/DE/Christian-Wulff/Reden/2011/08/110824-Wirtschaftsnobelpreistraeger.html;jsessionid=00337775E370574E9F069EE120A03B99.2_cid030. But there are several politicians in a number of countries that openly criticise the ECB.

for insolvent governments in assistance programmes such as Greece. This has seriously undermined trust in the ECB. In the case of Italy, the SMP can be justified both for monetary policy reasons and lender-of-last-resort functions. The ECB needs to make a much greater effort to justify this policy action, in particular when the order of magnitude is reaching the current levels of €10-20 bn per week. In addition, the ECB president needs to continue arguing for a viable fiscal solution to replace the lender-of-last-resort function.3 The third is quantitative easing by the Federal Reserve, the Bank of England and the Bank of Japan.

3 The most important task for the ECB will be to credibly continue to anchor inflation expectations. We will see very strong calls for higher inflation targets to solve the debt crisis[17]. It will therefore be important that market participants as well as the population at large continue to trust the ECB to fulfill its primary mandate.

4 I have not discussed the changes in monetary policy strategy implied by the new emphasis on financial stability. To what extent should the ECB lean against the wind with monetary policy when it sees asset market bubbles emerging? How would its greater financial stability responsibility shape its monetary policy strategy? What should be done in case of a trade-off between inflation and stability? What role should the EP have in holding the ECB to account? Pisani-Ferry and Weizsäcker (2009) as well as Setzer, van den Noord and Wolff (2011) offer some thoughts on this.

Overall, the ECB's role will likely be reduced in the future and the roles exercised will have to be matched by an increase in democratic accountability.

17. See for example Eichengreen, 'The big Cannoli', Eurointelligence, 17 August 2011, for a discussion.

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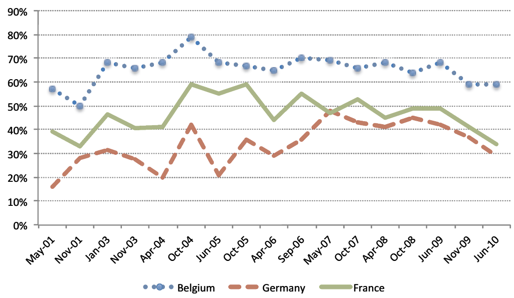
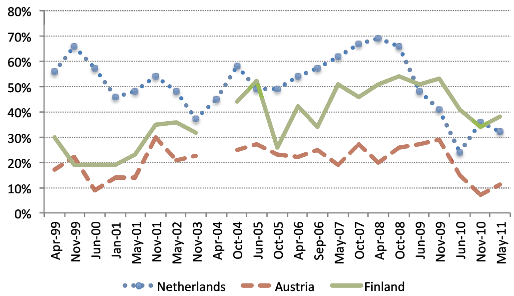
ANNEX

Figure 1: Support for the EMU: Belgium, Germany, France



Source: Eurobarometer

Figure 1: Support for the EMU: Netherlands, Austria, Finland

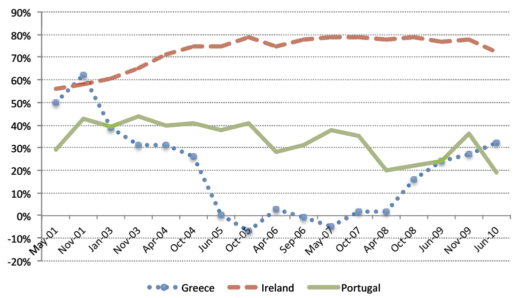


Source: Eurobarometer

Note: Data were obtained by the Eurobarometer Interactive System. The Section is "Trust in European Institutions" and the relevant question is QA20.1 "What is your opinion on each of the following statements? Please tell me for each statement, whether you are for it or against it. A European economic and monetary union with one single currency, the euro"

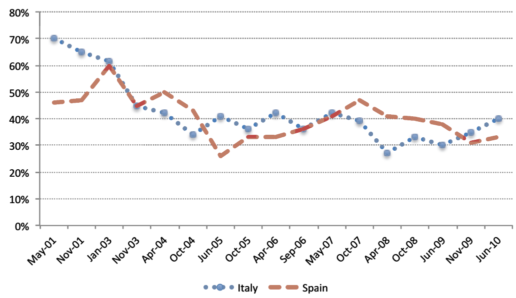
The numbers are computed as the difference between the percentage of respondents who are "For" and those who are "Against"

Figure 2: Support for the EMU: Greece, Ireland, Portugal



Source: Eurobarometer

Figure 2: Support for the EMU: Italy, Spain



Source: Eurobarometer

Note: Data were obtained by the Eurobarometer Interactive System. The Section is "Trust in European Institutions" and the relevant question is QA20.1 "What is your opinion on each of the following statements? Please tell me for each statement, whether you are for it or against it. A European economic and monetary union with one single currency, the euro"

The numbers are computed as the difference between the percentage of respondents who are "For" and those who are "Against"

TRUST IN EUROPEAN AND NATIONAL INSTITUTIONS

	ECB			EC			EP			National Gov.ment			National Parl.			EU		
	Oct. 2004	*May 2007*	*June 2010*	*Oct. 2004*	*May 2007*	*June 2010*	*Oct. 2004*	*May 2007*	*June 2010*	*Oct. 2004*	*May 2007*	*June 2010*	*Oct. 2004*	*May 2007*	*June 2010*	*Oct. 2004*	*May 2007*	*June 2010*
BE	48%	46%	15%	43%	41%	24%	47%	41%	27%	-19%	26%	-54%	3%	-35%	42%	32%	48%	17%
DE	26%	43%	-2%	6%	17%	-2%	22%	28%	0%	-28%	2%	-32%	15%	-7%	15%	5%	20%	-17%
GR	31%	13%	-18%	39%	24%	-13%	45%	30%	-2%	5%	-18%	-48%	-25%	-6%	53%	32%	26%	-14%
ES	26%	29%	2%	36%	34%	10%	45%	33%	10%	10%	13%	-56%	-5%	-16%	50%	34%	42%	-1%
FR	15%	4%	-13%	28%	15%	1%	33%	23%	8%	-36%	-21%	-46%	15%	5%	21%	10%	10%	-12%
IE	40%	44%	7%	56%	45%	20%	60%	50%	23%	-13%	-8%	-54%	8%	1%	49%	38%	29%	1%
IT	27%	28%	9%	41%	33%	20%	43%	39%	22%	-34%	-16%	-39%	28%	12%	36%	29%	30%	1%
NET	58%	62%	24%	30%	32%	29%	35%	30%	23%	-21%	49%	-3%	-2%	-56%	-12%	8%	44%	14%
AU	25%	19%	15%	3%	5%	3%	26%	13%	16%	1%	22%	13%	-18%	-22%	-10%	6%	3%	-11%
PT	44%	35%	7%	45%	41%	15%	47%	40%	17%	-39%	-3%	-56%	6%	-5%	39%	41%	41%	-2%
FI	44%	51%	41%	33%	17%	28%	47%	21%	33%	36%	54%	1%	-38%	-57%	-13%	-5%	26%	6%

Note: Data were obtained by the Eurobarometer Interactive System.
For the Section "Trust in European Institutions" the relevant question is *"And, for each of them [i.e. European Bodies] , please tell me if you tend to trust it or tend not to trust it? - The European Central Bank (The European Commission; The European Parliament".* For the Section "Trust in Institutions" the relevant question is *"For each of the following institutions, please tell me if you tend to trust it or tend not to trust it? – TheEuropean Union (the [NATIONALITY] Parliament; the [NATIONALITY] government)"*

The numbers are computed as the difference between the percentage of respondents who "Tend to Trust in the ECB" and those who "Tend not to trust"