Accountability and the ECB[1]

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EXECUTIVE SUMMARY


- In a democracy, it is only acceptable to delegate power to an independent institution if that institution has *legitimacy*. Both formal and substantive accountability can create legitimacy. The ECB's extraordinary degree of independence precludes it from being substantively accountable; hence, to have legitimacy it must be formally accountable.

- Formal accountability is generally thought to require both transparency and an obligation to explain and justify actions that are taken. The ECB appears to believe that, while transparency may be desirable, satisfying its reporting obligations is sufficient to satisfy formal accountability.

- The ECB lacks transparency, especially procedural transparency. We do not know how decisions are reached; it appears that votes are not even taken. Press conferences are no substitute for a failure to publish minutes.

- The ECB has a responsibility to promote financial stability. This is specified, although rather vaguely, in Articles 3.3, 25.1 and 25.2 in the Protocol on the Statute of the European System of Central Banks and the ECB. The provision of financial stability is unlikely to conflict with monetary policy and there is no need to change the ECB's price stability mandate.

- In acting as lender of last resort, the ECB has the ability to redistribute income. Its current opacity with regard to this activity is unbecoming, given its independence and the political nature of the task.

- If there were no constraints on change, it might be desirable to make the central bank the lender of last resort and the supervisor of financial institutions, to remove its independence, and to make the monetary policy committee a separate and independent body. Within the confines of the current institutional framework enshrined in the Treaty and the Statute, the ECB must become more transparent about its lender-of-last resort activities and eschew further involvement in supervisory activities.


[1] Briefing paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament for the Quarterly Dialogue with the President of the ECB

## 1. Accountability and the ECB

### *1.1. Accountability and legitimacy*

Elected authorities in a democratic society delegate certain responsibilities to independent institutions. This delegation is acceptable only if the institutions have *legitimacy*. Legitimacy exists when the electorate believes that the institution has both the right to exercise the powers that it has been granted and that the institution is the most appropriate one to perform the tasks that it has been given. There are two sources of legitimacy: output legitimacy and input legitimacy. Output legitimacy occurs when the institution performs its assigned tasks in a satisfactory manner and when it does not undertake tasks that it has not been assigned, even if it can do these tasks well. Input legitimacy can arise if the citizenry approve of the way in which the delegation of the tasks to the institution occurred and if the institution is held accountable to the elected officials, and thus to the citizenry.

As regards output legitimacy, the ECB has existed for less than 11 years and this is a short period on which to base a firm conclusion. Nevertheless, most economists would probably view the ECB's performance, both in ensuring price stability and in satisfying its financial stability mandate, at least since August 2007, as being as good as that of the world's other two leading central banks, the US Federal Reserve and the Bank of Japan.

In principle, some input legitimacy for the ECB could have been derived from the manner of its birth: the ECB is a creation of the Treaties and the Treaties were confirmed unanimously by all of the EU member states. In reality, however, the Treaty was the size of novel, although far less readable than most. Covering an astonishing number of issues in bewildering detail it had to be voted either yes or no in whole by national legislatures and sometimes by citizens in referenda. Because input legitimacy by virtue of the manner of its origin is questionable for the ECB, the other source of input legitimacy, procedural legitimacy, of which accountability is the key dimension, is essential.

Schedler (1999) defines accountability as "A is accountable to B when A is obliged to inform B about A's (past or future) actions and decisions, to justify them, and to suffer punishment in the case of eventual misconduct". From this definition, it is seen that accountability has three components for the ECB: first, the public should be able to observe or be provided with the relevant information about the ECB's actions and decision-making process; second, the ECB should explain and justify its actions; third, it should be possible to reward or punish policy makers at the ECB in response to good or bad behaviour. The first two components are often referred to as *formal accountability*; the third component is often referred to as *substantive accountability*.[2]

### *1.2. The ECB's view of accountability*

The ECB's own concept of accountability is rather more restricted than the usual and accepted versions. On its website one finds the definition in Box 1 below.

[2] See Buiter (2006, 2008).

**Box 1. The ECB Definition of Accountability**

> **Accountability**
>
> To help the ECB carry out its mandate to guarantee price stability, it has been granted political independence. But this independence needs to be balanced with accountability.
>
> Accountability is the legal and political obligation of the ECB to explain and justify its decisions to the citizens of Europe and their elected representatives.
>
> Accountability is enhanced by a high degree of transparency.
>
> **Transparency**
>
> Transparency means providing the public with all relevant information on the ECB's strategy, assessments and policy decisions as well as on its procedures in an open, clear and timely manner.

Source: http://www.ecb.int/mopo/strategy/comm/html/accountability.en.html.

The ECB considers accountability to be solely the second part of what I have referred to as formal accountability: an explanation of and justification for its actions. It says that its notion of accountability is 'enhanced' by transparency, or the first part of what I have referred to as formal accountability, although this is not apparently viewed as a *necessary* component of accountability.

Substantive accountability requires that sanctions can be imposed on the ECB by society's elected officials if they do not deem the explanations and justifications offered by the ECB to be satisfactory. I argue that the ECB is highly independent and subject to little substantive accountability.

The ECB enjoys an extraordinary amount of independence. It has an unusual amount of target independence; its degree of operational independence is probably unprecedented; it almost completely financially independent; it is nearly functionally independent.

Out of the US Federal Reserve, the Bank of Japan, the Bank of England and the ECB, only the ECB has significant target independence. The Treaty mandates that the over-riding goal of the ECB is 'price stability'. But, the Treaty does not define theoretical concept of price stability in terms of observable data. Instead, the ECB is allowed to define what sort of behaviour of which price index is consistent with price stability.

The ECB also has a uniquely high measure of operational independence. This is given to it by the Treaty and in the Statute, which can be changed only with the unanimous consent of all member states. 'Neither the ECB nor the national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. Community institutions and bodies and the governments of the Member States undertake to respect this principle and not seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks.' (Treaty establishing the European Community, consolidated version, Article 111).

The ECB has financial independence: its arrangements are kept separate from the rest of the European Community. It has its own budget and its capital is subscribed to and held solely by the national central banks. Finally, the Eurosystem has a high but incomplete degree of functional independence. The ECB has been given most of the instruments necessary for the conduct of monetary policy and is authorised to decide on its own how and when to use them. The only exception is the exchange rate, which is a joint competency of the Council of Ministers and the ECB (see Treaty establishing the European Community, consolidated version, Article 111).

Members of the Executive Board serve eight-year, non-renewable terms; national central bank governors serve at least 5-year terms. Their compensation is internally decided. Governors of national central banks and members of the Executive Board have security of tenure: they can be fired only in the event of incapacity or serious misconduct; the Court of Justice of the European Communities is competent to settle any disputes.

It is clear that no one, not the European Parliament, nor the Council of Ministers, nor the European Commission can impose sanctions on the ECB. Even gross incompetence is not a firing offence. The ECB is not substantively accountable. The citizenry is forced to hope that fear of shame and embarrassment, the threat of being pilloried by the press and reputational concerns will keep ECB officials in check.

While the lack of substantive accountability is a problem for legitimacy, there is a trade-off. The independence of the ECB in making monetary policy is desirable: independence shields policy makers from politicians who might wish to influence monetary policy opportunistically. However, without substantive accountability, formal accountability becomes crucially important for legitimacy.

As previously discussed and seen in Box 1 below, the ECB appears to view accountability as merely explaining and justifying its actions, which it can do by fulfilling its reporting obligations. Unfortunately, the formal reporting obligations of the ECB are minimal. It is required to publish quarterly reports on the activities of the Eurosystem, a consolidated Weekly Financial Statement and an Annual Report on its activities and on the monetary policy of the previous and the current year.

Transparency is apparently viewed as an optional extra which might be useful in carrying out this task. A video on the ECB web site reinforces this: entitled “Independence, Accountability and International Relations,” it makes no mention about accountability other than talking about reporting obligations and keeping the European Parliament informed.

While not considering it a component of accountability, the ECB highlights the importance of transparency on its website; see Box 2, below.

**Box 2. The ECB's Statement on Transparency**

> The ECB considers a high level of transparency as crucial for the effective conduct of monetary policy for three main reasons:
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> **Credibility**: when monetary policy is well understood and a central bank is perceived as able and willing to achieve its policy mandate, price expectations are better anchored.
>
> **Self-discipline**: facilitating public scrutiny of monetary policy actions is a strong incentive for the decision-making bodies to fulfil their mandates in the best possible manner.
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> **Guidance to markets**: Market participants can better understand the response pattern and thus anticipate the broad direction of monetary policy over the medium term. This in turn can shorten the transmission process and thus make the ECB's monetary policy more effective. It also reduces the incidence of major policy surprises and thereby helps to smooth market developments.[1]

Unfortunately, despite the promising statement, the ECB is far from transparent.

The ECB continues to befuddle the markets, as well as professional economists, with its unnecessarily vague and ambiguous formulation of its quantitative definition of price stability. As de Grauwe and Gros (2009) put it, 'The ECB repeats incessantly that its definition of price stability is inflation below, but close to 2%, refusing to make explicit whether it considers 2% better than zero. Under current circumstances it would be important to clarify this point.' The reactions of some other economists are seen in Box 3, below.

**Box 3. Views of the ECB's Inflation Objective**

> 'The ECB tightened its definition of price stability, but what it really means remains very ambiguous … given the ECB's high degree of goal independence … the case for an explicit inflation target would provide greater focus for ensuring the bank's accountability in a democratic society. ' Truman (2003, p. 134)
>
> 'We are told that below 2% remains the desirable level, but also that the Eurosystem will aim to maintain inflation rates "close to 2%". This statement is unnecessarily cryptic.' Wyplosz (2003)
>
> 'Why not say what it means, and remove the remaining ambiguity of "close". What is the point of this ambiguity?' Svensson (2003)
>
> ' … the ECB's inflation-target-that-dare-not-speak-its-name … .' Buiter (2008)

Translating the abstract concept of price stability into a numerical target for a price index is a technical task that is appropriate for the ECB. The exact choice, be it 1.8 percent or 2.0 percent, is not of great importance. An explicit numerical inflation point target is simple, visible, verifiable, and easily understood and would foster accountability.

The ECB's performance with respect to procedural transparency is woeful. According to Eijffinger and Geraat's (2006) index, it ranks behind the Bank of Japan, the Reserve Bank of New Zealand, the Swedish Riksbank, the Bank of England and the US Federal Reserve.

The ECB does not publish its votes: indeed, votes are apparently not even taken. At the Q & A session of the 10 Jan 2008 press conference, President Trichet commented, ‘As you know, we do not vote and have never voted in the past.’ In this case, how are decisions reached? The ECB representative usually insists that there is consensus, but what does this mean? It is important for markets and policy makers to know. To see an example of why this is, Geraats (2008) points out that if consensus were to mean that there is no rate change unless everyone agrees, or does not object strongly, then monetary policy will be too intertial.

The ECB does not publish minutes of the meetings of the Governing Council.[3] Its press conferences, with their “introductory statements” and Q & A sessions, are no substitute. Indeed, the length and detail of the introductory statements raise the suspicion that they are prepared in advance. And, even if completely unfounded, this may raise the even worse suspicion in some observers that the outcome of the meeting might have been decided in advance. This casts further doubt on exactly how the ECB reaches a policy decision.

The Committee for Economic and Monetary Affairs (ECON) has been expressing its concerns to the ECB over its lack of procedural transparency since it first began to make monetary policy. In April 1999, Mrs Randzio-Plath pointed out that the European Parliament attaches great importance to transparency in policy making and since then, at the Committee’s quarterly dialogue with the ECB, she and her colleagues have pressed for details about the decision-making process, minutes of the meetings and the details of the votes. They have been unsuccessful, not only in producing answers, but even in engaging the ECB representative in serious conversation. Instead, the ECB uses this as an opportunity to extol its virtue: ‘Amongst the major central banks we are still the only one to hold a press conference immediately after decisions are taken. So, in terms of transparency, we are really bold and innovative.’ (Jean-Claude Trichet, September 2005). Or, they are told that further information would only ‘create more confusion’. (Wim Duisenberg, April 1999)

The ECB’s lack of transparency damages its legitimacy, but this may not be the only cost. Geraats (2008) argues that, based on the statistical evidence, the ECB has lost credibility over time and that this cannot be explained on the basis of its inflation performance. She points out that if this is true and if the ECB really does have an unwavering commitment to price stability, then it has been unsuccessful at convincing the market of this commitment and this may suggest a need to increase transparency.

## 2. ECB Accountability After the Financial Crisis

### *2.1. What the Statute says about the ECB’s role*

As well as providing low and stable inflation, modern central banks have a responsibility to promote financial stability. For the ECB this is given in Articles 3.3, 25.1 and 25.2 of the Protocol on the Statute, shown in Box 4, below.

[3] There is confusion in the policy debate about the difference between minutes and transcripts. The minutes of a monetary policy committee are generally unattributed summaries of the arguments; transcripts are verbatim reports.

**Box 4. Articles in the Protocol on the Statute of the European System of Central Banks and of the European Central Bank Relevant for Financial Supervision**

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| 3.3 In accordance with Article 105(5) of this Treaty, the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.<br><br>25.1. The ECB may offer advice to and be consulted by the Council, the Commission and the competent authorities of the Member States on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system.<br><br>25.2. In accordance with any decision of the Council under Article 105(6) of this Treaty, the ECB may perform specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings. |

Unfortunately, these articles are rather vague, failing to specify objectives, instruments or accountability mechanisms. The exclusion of insurance is strange and worrisome: think AIG (regulated by the hopelessly out of its depth New York State Department of Insurance), the AEGON Group, Swiss Re and the Fortis Group.

*2.2. Accountability and monetary policy when the ECB has a financial stability role*

The pursuit of financial stability is important in normal times and in crisis times, but this need not change how the central bank makes monetary policy. Financial stability is about preventing crises through appropriate monetary policy and macro-prudential management as well as about managing crises. During periods of low current and expected future inflation, central banks should manage their *macro-prudential* instruments, such as countercyclical capital requirements or liquidity requirements for banks, counter-cyclical changes in maximum loan-to-value ratio for household and commercial mortgages, to prevent excessively rapid growth of credit and leverage.

In a financial crisis, the central bank can inject massive liquidity without jeopardising its price stability mandate. This is because the defining characteristic of financial crises is a dramatic shift in financial institutions' preferences towards liquidity. After the crisis, the central bank must withdraw the liquidity in a time fashion or inflation will result. But, this should not be a problem for the ECB as it cannot be forced to monetise debt.

Even if a financial crisis were to create a temporary conflict between the ECB's objectives, there would be no need to change the ECB's inflation mandate. It is understood that inflation targeting means flexible medium-term inflation targeting. We would not, for example, necessarily expect the ECB to completely offset a massive transitory supply shock at the expense of volatile output and employment. I, therefore, do not support the proposal of De Grauwe and Gros (2009) that the ECB formally and practically differentiate in its policy and objectives between normal and crisis times.

### *2.3. The broadening of the scope of responsibilities of the ECB*

Since the crisis, the financial stability role of the ECB has increased and it will, no doubt, be increased further. The Treaty and the Statute focused mainly on the ECB's macroeconomic price stability objective and its official policy interest rate. During the crisis, the ECB and the Eurosystem have greatly expanded the scope of their actions and the size of their balance sheets. National central banks have officially conducted lender-of-last-resort actions for their own governments' accounts; the Eurosystem has participated in currency swaps with other governments on its own account and, through the provision of repo facilities, to non-euro area countries such as Hungary.

When the ECB engages in lending activities, it must value the collateral that it is offered and impose a proper liquidity 'haircut' or discount on this valuation. If the ECB values the collateral properly and imposes the right haircut, then the risk-adjusted expected return to the Eurosystem on its lending will equal the market risk-free rate: there will be no subsidy or tax. But, if the ECB is not sufficiently aggressive with is discounts and haircuts, then it is transferring wealth to the borrower: a political act that could threaten its legitimacy.

Is the ECB being sufficiently aggressive? We cannot tell. In a financial crisis, a security offered as collateral may not have traded recently or it may not be marketable. In this case the Eurosystem defines a 'theoretical price'. Unfortunately, the ECB refuses to divulge either the price or the method that they used to determine it. As a consequence, the ECB is not accountable in its loan operations. As the body charged with ensuring accountability, the Committee on Economic and Monetary Affairs is responsible for looking into these operations and requesting that the members of the ECB's Board and Governing Council behave in a more transparent fashion.

It is unclear exactly how the ECB's supervisory role will evolve, but it likely to be closely involved with the prudential supervision of large financial institutions in the euro zone. Supervision is inherently political as it involves telling firms what they can and cannot do, and hence, affects their income. Unfortunately, this presents a conflict. It is desirable for monetary policy committees to have substantial independence so that they cannot be influenced by politicians who might be tempted to use monetary policy opportunistically. But, independence is not consistent with tasks that are political, rather than purely technical.

A possible solution to this problem in a country or currency area where institutional change is feasible is to take away some of the central bank's independence and give it the responsibility for providing liquidity and acting as supervisor. Make the monetary policy committee a separate and independent entity and charge it solely with setting the policy rate. Within the confines of the Treaty and Statute, this is not possible and for it to be palatable for the ECB to retain its independence it must not increase its role as a supervisor and it must become far more transparent in its liquidity provision.

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