A SYMPOSIUM OF VIEWS

Is the European Central Bank Losing Credibility?

Or are recent criticisms overblown?

To what extent, if any, has European central banking in general, and the ECB in particular, compromised its credibility to stabilize the sovereign debt market?

Critics suggest that the ECB's flooding the market with liquidity has raised questions about 1) the quality of the securities used in repo operations; 2) the length of time the liquidity is being made available; and 3) the indiscriminate way in which funding has been allowed to include those institutions with no need of additional liquidity. Critics add that the ECB's Target2 program, which credits bank transfers within the ECB, has compromised all eurozone national central banks. Does it matter that the ECB's leverage ratio is now eight times the leverage ratio of Lehman Brothers just before that Wall Street firm collapsed?

Defenders counter that the Target2 imbalances are simply the reflection of the current account imbalances in the eurozone caused by Germany's large current account surpluses. And if the credibility of European central banking were at risk, why hasn't the euro collapsed? However, others argue that the imbalances reflect subsidized capital flight to the stronger countries in the euro system.

Does European central banking have a credibility problem? Or are these criticisms overblown?

Fourteen noted observers offer their views.

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The ECB's actions will not have a good ending.

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During the financial crisis, the European Central Bank has progressively reduced its rating requirements for the collateral that banks have to provide for refinancing credit, from A- to BBB-. It accepted Greek, Portuguese, and Irish government bonds regardless of their ratings. It allowed the national central banks to provide emergency liquidity assistance credit, guaranteed only by the national central banks themselves. It allowed commercial banks to construct asset-backed securities composed from dubious ingredients. It prolonged the maturity of its refinancing operations from a maximum of three months to first one year and, recently, even three years. And it now plans to accept even company credit titles as collateral.

With this policy, it has helped the troubled countries of the eurozone to (electronically) print about €800 billion worth of central bank money beyond what they needed for their internal circulation, allowing them to redeem their foreign debt and to buy foreign assets or goods, in net terms, using the printing press. This is measured by the so-called TARGET credits. In a letter to ECB President Mario Draghi, Bundesbank President Jens Weidmann recently complained about the risk that the TARGET balances imposed on the Bundesbank, asking for guarantees.

The ECB argues that its policy was first aid, merely stepping in for the seized-up interbank market that was not providing enough credit to the periphery countries. However, this is only one interpretation. Another one is that the ECB itself helped to destroy the interbank market by establishing the money-printing press as a competitor to commercial banks. While commercial banks from the capital-exporting countries demand a substantial risk premium in the form of interest rates, the ECB has been offering its credit at a rate of only 1 percent, far undercutting the credit market. Small wonder that the periphery banks have preferred to borrow the printing press, taking the opportunity to relieve themselves of their foreign debt burden.

The policy has reduced the periphery countries' pressure to restructure and lessened the pain that the austerity measures necessary to regain international competitiveness would have inflicted on the population. But for this very reason it also has undermined the allocative function of the capital markets. After years of excessive capital flows to the periphery, the savers of Europe's core countries and their financial institutions ultimately realized their mistake and preferred to stay in their home harbor, redirecting the scarce investment capital to safer and ultimately more profitable uses, which would also result in more growth and prosperity for Europe as a whole. Even though the redirection may have been too hasty, it was a necessary and useful correction of previous mistakes, potentially ending a period of excessive capital flows and current account deficits. However, the Club Med's 70 percent majority in the ECB Council did not like this correction and has therefore made sure that the savings capital of the core countries continued to flow to the periphery despite its new-found aversion to doing so. This is an allocative distortion, since the investment risks are now being socialized via the ECB system and are, in fact, now largely borne by those same savers who no longer dare send their money abroad. After all, losses in the ECB system are socialized among the participating member central banks, and their losses are borne by the national taxpayers, which are largely identical with national savers.

These policies mean that Europe is moving away from the rules of a market economy towards a system with centrally planned capital flows. This will not have a good ending.

Lost credibility? Yes, but eurozone governments are to blame.

HEINER FLASSBECK
Director, Division on Globalization and Development Strategies, United Nations Conference on Trade and Development

The simple answer is yes. But the European Central Bank's diminished credibility is a derivative. It is more the result of flawed attempts by governments to tackle

the core of the problem in the eurozone than original failure of the ECB. The first failure of politicians to develop a solution is their unwillingness to allow direct intervention by the ECB in the bond market. Instead, they have forced the central bank into an extremely expensive indirect operation to achieve that goal. Flooding fragile banks with an enormous amount of cheap liquidity may stabilize the banks temporarily, but comes without any guarantee that these banks will buy enough government bonds and of the right kind to bring rates in southern Europe back into sustainable territory, and without guarantee that these banks' balance sheets will recover in this process.

The second and lasting failure of European politicians is their unwillingness or inability to see the systemic nature of the external imbalances inside the monetary union and the closely related obsession with a reduction of budget deficits in the midst of a recession. Germany's policy ignored the commonly agreed inflation target for ten years in its fight for higher market shares and current account surpluses. As long as this is not high on the agenda, most other activities are in vain. But even now, when Germany's mercantilism comes home to roost in a recession, the European Union is prescribing the German drug to all the other countries instead of prohibiting what has proved to be so damaging to Germany's neighbors and the European Union as a whole.

As people are smarter than politicians and have a sense of all this, many began some time ago to deposit their savings in countries where the danger of waking up one morning with pesos instead of euros in their bank accounts is small. Consequently, banks in the south need much more liquidity from the ECB to finance their businesses than banks in the safe havens of the north. This has resulted in the fact that most of the liquidity the ECB is providing is created by the national central banks in the south, which means in terms of central bank accounting to debit the south and credit the north. That fact—reflected in the famous TARGET balances—is no problem as such but it is the symptom of a deep crisis of confidence. As long as German politicians and the central bank continue to speak of a crisis of "government debt in southern Europe" and continue to ignore the systemic crisis resulting from the gap in competitiveness, confidence will not come back.

Only the full circle back to normal economic relationships between Germany and the south, based on the explicit acknowledgment that trade can never be a one-way road, can restore confidence, including confidence in the ECB. The ECB cannot win back its credibility by the kind of fire-fighting it has had to engage in during the last few months. But it could contribute to the real solution by removing some of its own ideological hurdles and explaining to the biggest member country what it means to have a monetary union with a common inflation target.

On the contrary, the ECB's credibility has been strengthened.

AGUSTÍN CARSTENS
Governor, Bank of Mexico

During the second half of 2011, the intensification of the financial and fiscal problems in the eurozone led to a period of high volatility and risk aversion around financial markets, jeopardizing the survival of the euro and consequently, of this monetary area. This situation significantly aggravated the adverse feedback loop among low economic activity, weak fiscal positions, and the fragility of the banking system. In this setting, there was a considerable increase in counterparty risk, which led to extremely restrictive conditions in the interbank market. In such an adverse environment and given the observed deterioration in market participants' confidence, the lack of a decisive policy response by the European Central Bank may have ultimately led to a speculative attack against the euro.

Within this scenario, the ECB, acting according to its mandate as it has operated since its origin, adopted unprecedented measures to stabilize the interbank funding and sovereign debt markets, thereby contributing to the reestablishment of the monetary policy transmission mechanism in the eurozone. In particular, the ECB implemented two unlimited longer-term refinancing operations and relaxed collateral eligibility criteria.

The results of the ECB's measures have been outstanding. Such actions eased the liquidity shortage of eurozone banks, and consequently reduced the probability of a funding crisis in the region. Moreover, they contributed toward improving investor confidence, which in turn translated into positive developments in the interbank funding and sovereign debt markets.

In this context, it can be argued that the actions of the ECB did not diminish its credibility, but instead strengthened it even more. Moreover, such actions have created a window of opportunity for euro area policymakers to make progress on the sovereign debt and other problems in a number of countries that lie behind the recent episode of global financial stress.

However, despite the success of the ECB measures and in the light of structural problems in some euro countries, authorities must make additional efforts to consoli-

date fiscal positions, recapitalize troubled financial institutions, and implement structural reforms to boost productivity, such as flexibilization of labor markets. Moreover, although the referred policy actions implemented by the ECB have raised some understandable concerns among a number of analysts and policymakers, mainly related to the risk of having granted long-term loans and the potential inflationary outlook for the eurozone, one must be confident that the ECB will be able to successfully tackle the challenges to come. In this context, it would be convenient to design and announce a credible exit strategy in order to guarantee an orderly unwinding of the implemented actions.

In sum, the measures adopted by the ECB have served to increase the market's faith in this institution even more. Nevertheless, in order to take advantage of the opportunities created by these actions, eurozone authorities must implement economic reforms that guarantee the long-term stability of this important economic and monetary area.

The ECB has risked its credibility in a good cause.

JOHN WILLIAMSON
Senior Fellow, Peterson Institute for International Economics

No central bank ever lost its credibility by refusing to take expansionary action, no matter how much it was needed by the economy for which it was responsible. Yet credibility is a good thing: it enables any agent to act with a greater expectation of achieving the desired result. So for about half the time central banks are confronted by a trade-off between maintaining credibility and doing what is in the short-term interest of their countries. The actions of the European Central Bank should be judged in that context. Yes, its actions have probably eroded its credibility: the mere fact that we are posed this question is proof of that. But it did so in a situation where a failure to act would have guaranteed a severe, possibly fatal, attack on the eurosystem. It risked its credibility in a good cause. To have remained a sound institution in a collapsing system might be counted a badge of honor by some, but it would not have commended itself to sensible people.

No, particularly if the ECB is successful in the winding down of policy interventions.

E. GERALD CORRIGAN
Managing Director, Goldman Sachs, and former President, Federal Reserve Bank of New York

In some circles, recent actions of the European Central Bank have raised questions about the credibility of the ECB, particularly with regard to its commitment to price stability. The primary point of concern relates to the ECB's "longer-term refinancing operation" which was announced on December 8, 2011. Following that announcement there have been two LTRO auctions which provided about €1 trillion of gross extensions of collateralized three-year liquidity to European banks at interest rates starting at 1 percent. Taking account of reductions of other forms of central bank liquidity, the net increase in central bank liquidity into the European banking system by virtue of the LTRO has been about €525 billion, which has elevated the ECB's balance sheet to about €3 trillion.

The announcement of these actions in early December occurred in the context of sharply escalated risks of a financial and economic crisis across Europe with global contagion implications. Of particular concern was the threat of an acute credit crunch centered in the interbank markets. In these circumstances, I believe that the actions taken by the ECB were necessary and entirely appropriate.

That is not to say that actions of this nature and scale—whether by the ECB, the U.S. Federal Reserve, or other central banks—are risk free. To the contrary, decisions relating to such extraordinary interventions involve highly complex judgments as to their benefits relative to their potential costs—including the potential costs associated with any misjudgements as to the timing and pace at which such interventions will be reversed. Indeed, even the relatively short-term, massive liquidity injections at very low interest rates entail risks of a renewal of the "reach for yield" phenomenon that was so pervasive in the years leading to the crisis. There is also the risk that such actions might temper the political will for badly needed fiscal adjustments. Finally, and perhaps most importantly, there is the risk that a failure to wind down such policies in a timely fashion could trigger a rise in inflationary expectations.

Clearly the ECB, the Fed, and other central banks are mindful of these risks. However, the planning and execution of the gradual wind-down of such policy interventions is a complex and delicate matter which, among other things, will depend on the ability of central banks to anticipate emerging economic, financial, and inflationary conditions. I am highly confident that, even now, the ECB and other central banks are devoting careful deliberations and planning to these issues.

Looking ahead, we can draw some comfort that contagion and systemic risks associated with the European debt crisis have been reduced—in part because of the ECB's actions. While reduced, such risks have not been eliminated and the near-term economic outlook in Europe remains distinctly sluggish, thus underscoring the rationale for the ECB's current policy stance.

Yes, the ECB has lost much credibility.

ALLAN H. MELTZER
Allan H. Meltzer Professor of Political Economy, Tepper School of Business, Carnegie Mellon University, and Visiting Scholar, American Enterprise Institute

Of course, the European Central Bank has lost much of the credibility it had when Otmar Issing retired and the sound money representatives of the Bundesbank resigned. The ECB has joined the Federal Reserve in the mistaken belief that they can flood the market with money and credit now and later prevent inflation. That's been tried before. It is irrational to expect a different outcome when policy repeats old mistakes that failed. And it shifts the troubled debt to ownership by a holder that refuses to take a haircut. Some solution! It seems to me like a stopgap that allows debt holders more time to flee.

Yes, central banks were right to respond to the financial crisis in 2008. But the Europeans and the rest of us are long past the crisis. The tragedy is that Europe will not consider a policy to end stagnation and deflation in the troubled countries. The most widely discussed policy proposals will not end the crisis nor restore growth in the over-indebted countries. The *Financial Times* and its friends tell us over and over again that Germany must agree to inflate Europe's way out of its problems. But Germany has higher productivity growth, so a European inflation will change relative prices and competitive position in the wrong direction.

The German proposals are no better. They want Greece, Portugal, Italy, and Spain to deflate. They do not want to recognize that unit labor costs are 25 percent to 30 percent higher in these southern tier countries. A deflation of that magnitude on top of the deflation that has already occurred in some of the countries repeats the worst of the Great Depression. Who can believe that wage reductions of that magnitude are politically possible? I don't and you shouldn't.

Fixed exchange rate systems often have relative price problems. If the Europeans want to save their common currency, they should let the four troubled countries in the southern tier jointly form a weak euro. The remaining members of the strong euro could then adopt the rules for fiscal stability that have been proposed. The weak euro would quickly float down against the strong euro, reducing costs of production in the troubled countries, making them more competitive and able to grow. The countries that wished to rejoin the strong euro would have to adopt the more stringent fiscal rules.

Why do Germany and France refuse to consider this solution? I cannot claim certain knowledge. But a devaluation by the weak currencies would greatly reduce the value of the debt held by commercial banks and others in Germany and France. The German and French governments would have to lend money to their banks to restore bank capital and solvency. That seems a price worth paying to restore European growth and remove or greatly reduce stagnation and deflation. And it is a solution that citizens of the troubled countries have experienced in the past.

There's been no loss in credibility at all.

HOLGER SCHMIEDING
Chief Economist, Berenberg Bank

Has the European Central Bank assumed too much risk and lost credibility? Not at all. By finally responding forcefully to the euro crisis in December 2011, the

ECB has started to rebuild its battered credibility and reduce the risks to its balance sheet and its very existence.

Early November 2011 was arguably the low point in the history of the ECB. Top European officials went cap in hand to places such as China and Russia to ask whether the central banks and reserve managers of these much poorer countries could please save the rich eurozone because the ECB was refusing to do so. With its initial reluctance to stop the vicious spiral of contagion that had pushed even the German economy from a boom that lasted until the summer of 2011 into a recession in the autumn, the ECB risked a chain reaction of cascading sovereign and bank defaults that could have threatened the very existence of the euro and the ECB itself.

Unsurprisingly, China rebutted the European requests. This sobering experience triggered a major rethink in Berlin and Frankfurt. By early December, the Bundesbank was ready to offer money to the IMF to be passed on to Italy if need be, camouflaged as a European offer to contribute to a broader increase in IMF resources. The ECB also started to contain contagion in earnest.

Since the Lehman recession, the U.S. Federal Reserve has purchased sovereign and mortgage bonds worth some 18 percent of U.S. GDP in order to keep the United States on a recovery path. The ECB bought assets worth a mere 3 percent of GDP. Had the ECB intervened with the easy abandon of the Fed, it would have purchased an extra €1.4 trillion worth of assets, an amount that dwarfs all European Financial Stability Facility or European Stability Mechanism fiscal "rescue shields." But of course, if the ECB had stepped in too eagerly, Italy and Spain might have shied away like the United States from serious fiscal repair and structural reforms.

Paying homage to the sensitivities of the Bundesbank, the ECB eventually chose the indirect route of flooding the banks with liquidity in December. Tensions started to ease immediately thereafter.

As a result of injecting a net amount of some €600 billion, the ECB now has a longer balance sheet, more exposure to eurozone banks, and claims on a larger pile of collateral of lesser quality than before. But letting the eurozone fall into an ever-deeper recession with a series of sovereign and bank defaults would have impaired the creditworthiness of ECB counterparts and the inherent quality of ECB collateral even more.

The ECB is merely the head office of the Eurosystem, which also includes the national central banks of the seventeen euro member countries. Losses from credit events as well as gains from lending more money to banks are shared across the Eurosystem. Also, the ECB has asked banks to provide collateral well beyond face value in case of dodgy collateral. That mitigates the risks. Relative to the capital base of the Eurosystem, neither the risks nor the leverage ratio look particularly threatening.

No, it is the credibility of governments that's at stake.

JULIAN CALLOW
Chief European Economist, Barclays Capital

The question of credibility should be aimed not at the European Central Bank, but rather at the euro area's member states—or, more precisely, at their individual and collective will to demonstrate beyond doubt that the euro will survive the crises and be put on a sustained footing. If the states can meet their mutually agreed responsibilities, then history will applaud the ECB's actions for having successfully bought time in the heat of the crisis via innovative measures (not least the provision of unlimited term liquidity).

The ECB has stepped up to provide a window for governments to engage in three major reform thrusts: the most aggressive pace of fiscal consolidation seen in postwar history; far-reaching structural economic reform in southern Europe; and a convergence in collective governance at least as important as that prior to the dawn of the euro. In relation to individual and collective member state credibility, ECB credibility is of secondary importance.

The key issue for the credibility of any fiat currency is the central bank's ability to deliver on its objectives for inflation and financial stability. On inflation, the ECB has done so clearly without so far compromising its integrity in the eyes of financial markets—for example, the breakeven on euro area inflation swaps continues to be stable, with the five-year rate just below 2 percent (and therefore fully consistent with the ECB's definition of price stability). Moreover, the substantial reduction of credit risk evident in the euro area financial sector since the first three-year longer-term refinancing operation, and associated rally in equity markets, also is compelling evidence that the ECB's actions have been strongly endorsed by financial markets. Underlying this, the ECB's imperative will always be to preserve the integrity of the euro. Any dissolution of the euro, however partial, would send immense shockwaves through the financial system.

By encouraging all monetary and financial institutions to participate in the LTROs, the ECB ensured that the borrowing was stigma-free and that the additional financing could permeate deep into the euro area financial sec-

tor, including to the financing arms of some non-financial firms (such as auto manufacturers).

That said, a legitimate issue for all central banks concerns the expansion in their overall balance sheets. As a share of GDP, and compared with the pre-crisis ratio at the end of 2006, the Eurosystem's balance sheet has expanded by 2.4 times, reaching 32 percent of euro area GDP at the end of February 2012. Behind this are three factors: expansion in collateralized lending to euro area banks (accounting for about 60 percent of the ratio's expansion), expansion of securities holdings (nearly one-quarter of the increase), and an increase in value of the Eurosystem's gold and foreign exchange reserves (nearly one-fifth of the increase).

While the ratio of the Eurosystem balance sheet to GDP is currently slightly higher than that of the Bank of Japan (31 percent), and significantly more than the U.S. Federal Reserve (19 percent) and Bank of England (21 percent), these differences are partly historic, and relate to the Eurosystem's standard framework for influencing market interest rates via bank refinancing operations. In fact, the ratio's expansion since the end of 2006 has been smaller than that of the Fed (up 2.9 times) and Bank of England (3.3 times).

Nonetheless, a key difference in the ECB's balance sheet expansion has been through the provision of collateralized lending to banks (rather than via securities purchases, as was the case for the Fed and Bank of England. The ECB encouraged European banks to take out term liquidity insurance without stigma or financial penalty. At the same time, it applied robust haircuts on collateral (for bank loans, the haircut is over 50 percent), and will demand more collateral if the quality deteriorates. Additionally, of the Eurosystem's €3 trillion balance sheet, its capital and reserves amount to €83 billion (3 percent of the total), but as well its revaluation account (reflecting gains in the valuation of its gold and FX holdings) is a further €394 billion (15 percent). Considering the above, the Eurosystem appears to have sufficient reserves.

Still, the size of the balance sheet also reflects significant dependency by some banking systems on the ECB. The generous nature of term liquidity provision reduces the incentive for "addicted" banks to wind down their balance sheets, restructure operations, and boost capital. Linked to this, the Eurosystem balance sheet during 2010–11 effectively became a source of balance-of-payments financing for deficit countries experiencing a net outflow of private sector capital. The result: a sharp rise of TARGET2 imbalances (the Bundesbank's net claims on the Eurosystem reached €560 billion at the end of February, up from €190 billion at the end of 2009).

TARGET2 imbalances would not be a consideration if there was just one central bank within the Eurosystem. But the possibility that one or more countries can leave the euro area represents at least a theoretical risk.

The implication of the Eurosystem's massive balance sheet is therefore twofold: first, it is vital to push countries unable to finance their balance of payment through the private sector into rapid fiscal adjustment and growth-enhancing reforms; and second, also to encourage banks dependent (or at risk of becoming so) upon ECB financing rapidly to restructure, de-leverage, and boost capital.

Assuming that those countries (mainly in southern Europe) who have run large external imbalances continue to reduce these via domestic absorption (linked to fiscal consolidation), then ultimately they should begin to attract back private capital and/or run current account surpluses, which would result in a reduction of TARGET2 imbalances. Likewise, consolidation of those national banking systems which continue to exhibit stress should result in reduced dependency on the Eurosystem for liquidity (also linked to a reduction in TARGET2 imbalances).

No, the ECB has skillfully maneuvered around disfunctional policy.

NICOLAS VÉRON

Senior Fellow, Bruegel, and Visiting Fellow, Peterson Institute for International Economics

No, the European Central Bank isn't losing credibility. On the contrary, the ECB's decisions have been reasonable, effective, and timely in a context of generally dysfunctional policymaking in the eurozone. In particular, the three-year long-term refinancing operations program announced last December has succeeded in averting a major disruption of the eurozone's economy and financial system. No doubt, this extraordinary injection of liquidity has many drawbacks in terms of moral hazard, reinforcing the unsound connection between sovereign creditworthiness and banking system conditions in individual member states, and setting the stage for further "zombification" of Europe's most fragile banks, with uncertain effects on restoring proper credit provision. But inaction would have had far worse consequences.

In the absence of consistent bank supervision at the eurozone level, and given the many gaps in the information it receives from individual member states, the ECB could not envisage more targeted interventions and was obliged

to lend similarly to all banks, solvent or otherwise. Moreover, the legal strictures of EU treaties severely limit the ECB's other options for nonconventional intervention, as it is prohibited from engaging in "monetary" financing of the member states. Europe's banking system under LTRO is surely not a pretty picture, but the ECB cannot be faulted for the abject failure of political leaders to repair it while market conditions were more favorable, particularly in the second half of 2009 when the United States had shown the way and the sovereign debt crisis had not started to hit.

Moreover, the ECB has been able to skillfully manage a highly risky leadership transition. Usually EU-level appointments are the result of arcane compromises on national and political balances that prevent the most qualified candidates from being selected. By contrast, to name only three examples, Mario Draghi has been appointed in spite of coming from "sinful" Italy; Peter Praet has been preferred to Slovakia's Elena Kohutikova on grounds of pure competence rather than the box-ticking criteria that often dominate EU-level selection processes; and both Jörg Asmussen and Benoit Coeuré have won their respective countries' backing despite having past political affiliations on the opposite side of the aisle from the current governing parties in Germany and France. Moreover, their portfolios have been allocated on the basis of experience and skills rather than national quotas: Peter Praet as chief economist (a position that many believed belonged by right to Germany), Jörg Asmussen as international negotiator, and Benoit Coeuré as liaison to the markets.

These no-nonsense decisions may look unimpressive to non-Europeans, but by EU standards they represent quite an achievement. More importantly, the ECB is able to project decisiveness, vision, and market acumen to an extent many observers had long thought it incapable of. Overall, it appears institutionally stronger than it was before the crisis. This is evidently not a guarantee of success; but if the euro saga does end in failure, the ECB is unlikely to be among the main culprits.

The issue of the ECB's credibility is secondary. Monetary union's credibility is at center stage.

BERNARD CONNOLLY
Managing Director, Connolly Global Macro Advisers

In the absence of the longer-term refinancing operations, a "sudden stop" to foreign financing would have forced current account adjustment in the externally insolvent nations (Spain, Greece, Portugal, and possibly Italy and Ireland, with France to come). That would have involved even more severe recessions in those countries: banking systems would have collapsed, the impossibility of stabilizing sovereign debt ratios within the euro area would have become apparent, and several countries would have had to leave the area. That would have been an appalling mess, a result of the EMU credit bubble in part blown by, and repeatedly praised by, such as former ECB President Jean-Claude Trichet, who claimed that monetary union would eliminate risk premiums and lauded the "*ex ante* assistance" given to external deficit euro countries by "facilitating easy external financing conditions"—in other words, through a credit bubble.

Instead of allowing this painful but ultimately unavoidable process of withdrawal, the European Central Bank has chosen to increase the risks in the financial system massively, while deferring the materialization of those risks. It has taken enormous risk onto its own balance sheet and it has, in combination with governmental arm-twisting, in effect encouraged banks to take on more risk, notably through purchases of Spanish and Italian sovereign bonds by domestic banks. This is highly unstable. Within the euro, current account adjustment via the trade balance in the deficit countries must, short of a complete trashing of the euro's exchange rate—perhaps to as low as $0.35 U.S. in the Spanish and Greek cases—mean depression, deflation, and default. To avoid such an outcome, one of two things must happen. The first would be explicit, perpetual, unrequited current account transfers, effectively from Germany to just about everyone else. That would impose an enormous burden on Germany, approaching 300 percent of its GDP on a present-value basis. Germany would be crippled financially and become unstable politically. The other is that current account positions do not adjust and transversality constraints are breached—in other words, Ponzi finance by the ECB. But for that to happen, the LTROs would also have to be perpetually renewed and indeed increased, further weakening the balance sheets of the ECB and of private banks.

In short, the LTROs have increased risk everywhere. If the LTROs continue to an extent that prevents any current account adjustment, they would amount to an expropriation of all foreign creditors of the deficit countries, as those countries' external debt ratios approached infinity asymptotically. But if the LTROs do not avoid current account adjustment, they cannot avoid the depression, deflation, and default that adjustment within the euro area must bring. The probability of a financial and, ultimately, political explosion in the euro area has been increased by the ECB's liquidity policy. Absent several euro withdrawals, the only

way out would be massive euro depreciation and rampaging inflation in Germany. Given that, the issue of ECB credibility taken by itself is totally secondary. It is the credibility of monetary union which will be destroyed as these implications become more apparent to markets.

Yes, the ECB's credibility as an inflation fighter has suffered.

ROLAND VAUBEL
Professor of Economics, University of Mannheim

Eurobarometer, the European Commission's survey institute, conducts semi-annual opinion polls on the question "Do you tend to trust the European Central Bank?" For some reason, no results have been published for the last wave in November 2011, but the May results indicate that 40 percent of respondents trust the ECB whereas 38 percent do not. However, the percentage of those trusting the ECB has strongly declined from the overall peak of 53 percent in May 2007 as well as from the pre-bailout level of 44 percent in November 2009. According to the most recent data, distrust exceeds trust in Greece (by a margin of 48 percent), the United Kingdom (24 percent), Spain (14 percent), Latvia (8 percent), France (5 percent), Ireland (4 percent), and Portugal (1 percent).

No results are reported for Germany, but there can be no doubt that the ECB's credibility has been waning there since May 2010. According to two surveys by Emnid in December and February, 51 percent of Germans take a negative view of the future of the euro (while 41 percent are optimistic), and 62 percent are opposed to the bailouts of which the ECB is an integral part.

Before 2010, the ECB's monetary policy was hardly controversial in Germany. However, when on May 10, 2010, the ECB board decided to buy Greek government bonds in the market, German public opinion decisively turned against the ECB—the more so as it became known that the two German members of the ECB board had voted against the bailout. Discontent grew further when, in February 2011, Bundesbank President Axel Weber resigned because the French government had rejected him as next governor of the ECB. (France and Italy command a blocking minority in the Euro Council.)

I have asked myself why Jean-Claude Trichet ruined his good reputation by buying Greek bonds. A former civil servant, he may have felt inclined to give in to the wishes of his president. But he also knew that he would step down in October 2011, when Sarkozy would still be president and in a position to find some interesting new posts for the retiree. As it turns out, Trichet will become chairman of the Group of Twenty and a member of the administrative board of EADS, the aerospace contractor.

Mario Draghi, his successor, has limited the bond purchases and preferred to flood the banks with central bank money so that they now buy the government bonds. When this massive increase of the monetary base affects the money supply, re-collecting it will be very expensive. The ECB will have to offer time deposits at the market rate of interest. Finally, if the eurozone economy remains weak, the majority of the ECB board is not likely to reduce the monetary base or raise the refinancing rate. The ECB's credibility as an inflation fighter has suffered considerably.

Eroding, yes. But not by much.

STEPHEN H. AXILROD
Author of **Inside the Fed: Monetary Policy and Its Management, Martin through Greenspan to Bernanke, Revised Edition** *(MIT Press, 2011)*

In the course of banking problems that have afflicted the euro area for several years, and intensified in the wake of the recent well-publicized sovereign debt problems in certain member countries, the credibility of the European Central Bank has gradually been eroding, but not by very much. Using as a benchmark the huge hit taken by the U.S. Federal Reserve's credibility after the U.S. credit crisis turned from bad to nearly catastrophic in late 2008, the ECB's credibility seems to have held up fairly well.

The Fed was hurt badly because it did not appear to realize the severity of the potential crisis until the Lehman/AIG episode in September 2008 brought the crisis's magnitude fully into public view. The ECB was caught up to a degree in the backwash of that unfavorable judgment about the astuteness of key central banks. It too seemed to have underestimated how exposed banks

and markets in the euro area were to the highly leveraged joy rides of that period (requiring, for instance, something like $500 billion in additional funds from swaps with the Fed to help support European banks and markets during the 2008–09 crisis period).

In the end, the Fed opened its credit spigot and brought the domestic crisis under control, regaining some of its lost credibility. The ECB too has recently been employing the credit spigot to allay concerns about prospects of a disastrous eurozone credit crisis. All to the good and, as it turns out so far, protective of its credibility.

In any event, ECB credibility has held up partly because the present crisis in Europe is not so much seen as caused by the ECB but as the product of EU structural issues. The recent volatility and difficulties in euro area markets, and associated threats to the banking system, have been caused mainly by the increasingly evident political problems within the European Union in the face of halting, drawn-out efforts to resolve the sovereign debt problems of a few member countries. They seemed to threaten the sustainability of the union.

The odds that Europe would hold together have been enhanced, and the crisis has eased for now, as the ECB recently began to expand its balance sheet and acquire some questionable debt either directly or as loan collateral. That would not have been practically possible in the absence of a political view among key countries that the Union was viable and desirable. A central bank traditionally can run with extraordinarily high leverage ratios (about 25:1 in the United States just before the crisis and now around 50:1; roughly 33:1 presently in the euro area) because in the end the government, the more responsible the better, in effect guarantees its viability. Unfortunately for the euro area, the definition of government for that purpose, and especially as it pertains to emergency-type activities of its independent central bank, is more complicated and unsettled for the European Union than for the United States.

Yes, the risks taken are huge. The ECB's credibility could be impaired.

GERHARD HOFMANN
Member of the Board, National Association of German Cooperative Banks

The European Central Bank has been the only institution in Europe able to effectively mitigate systemic risk and calm down Italian, Spanish, and other sovereign bond markets. Yet the ECB's recent actions represent a risky and controversial experiment regarding its mandate. This could seriously impair the ECB's credibility in the future.

By offering longer-term refinancing operations (three-year LTROs at the very low rate of 1 percent) in December 2011 and February 2012, the ECB traded monetary stability in the medium term against (relative) financial stability in the present. Inflation expectations are currently low, but may rise once the eurozone economies pick up again. The monetary transmission mechanism is still not functioning, and bank willingness to extend loans to the real sector of the economy remains very limited.

At the same time, ample ECB liquidity at the cheapest price ever has created distortions in the behavior of financial markets, banks, and governments. The capital markets' ability to discriminate according to risk and return has been compromised by the ECB's actions, as more or less all asset prices have been pushed up substantially. Moreover, banks without a viable business model ("zombie banks") were not forced to leave the market. On the contrary, they enjoy the blessings of the ECB's extremely cheap LTROs. Governments operating under considerable political and market pressure may slow down their fiscal adjustment efforts as interest rates on sovereign debt seem affordable. Some politicians have already declared that the crisis may soon be over.

However, there are no free lunches here for the banks, the ECB, or the governments. The ECB has taken on enormous risks by leveraging its balance sheet beyond imagination as well as by accepting weak counterparties and questionable collateral for its loans. Bagehot's rule—lend freely against good collateral at high interest rates—is clearly violated, and the timing of LTRO 2 was probably wrong. LTRO 2 was offered at the end of February 2012, when financial markets were calm. At that time the ECB could have acted in constructive ambiguity to keep its powder dry. As this option was not chosen, the ECB may have committed itself to engaging in the next LTRO if yields on European sovereign bonds rise again.

Although the ECB is certainly aware that monetary tightening will be unavoidable at some point, it has so far refused to discuss an exit strategy for its jumbo LTROs. Withdrawing €1 trillion of liquidity from the market will create a big challenge for the ECB; it has never been done before. Further, there are issues of redistribution of risk (and thus potential losses) within the Eurosystem. Most of the liquidity provided through LTROs has ended up in southern European countries, whereas the related counterparty and collateral risks are

allocated to all seventeen euro countries according to their capital share in the ECB. How long members in the northern European region will accept this asymmetry between the benefits and burdens of the ECB's policy remains an open question.

Failure to act boldly would have risked our future well-being and social stability.

HANNES ANDROSCH
Former Finance Minister and Vice-Chancellor of Austria

Religion is built on faith, politics on trust, and the banking system on confidence. The question of credibility addresses the fundamental role of a central bank, that is, to implement policies which coherently and credibly ensure the stability of the intermediation system and the integrity of the currency.

Driven by globalization in world trade and innovation in finance, the period before the collapse of Lehman Brothers in 2008 witnessed many changes that amplified the ensuing global financial panic. Innovation had begun to pose threats to the soundness of the financial system, because risk management and supervisory procedures for financial institutions had not kept pace.

Finance had acquired an aura of decadence whereby personal enrichment via financial speculation was more important than facilitating trade and investment.

The European Central Bank clearly failed in its whistle-blowing function, but so did just about every other central bank as well. As the stability of the financial system has the characteristics of a public good, this failure has serious implications for productivity growth, employment, and economic prosperity. In future, financial innovation must not be ranked above regulation and stability, even at the risk of slowing down desirable change. The financial system must return to its core business of intermediation.

But the response of the ECB to the crisis has displayed sensitivity to structural features of the European economy. In particular, the corporate sector of the eurozone is much more dependent on bank finance, as opposed to market-based debt finance, than is the case in the United States. This is partly due to the preponderance of small- and medium-sized enterprises in the eurozone. Consequently, relieving liquidity blockages must proceed by repairing the banking system, its balance sheet, and its capital base.

When comparing the liquidity-augmenting strategies of the ECB and the Fed, one must recognize that the former has relatively many more partner institutions, accepts a wider range of securities as collateral for funding, and has a more complex policy interest rate structure. These are institutional data, not indications of risk. In addition, the ECB pays close attention to the effects of policy along the entire yield curve and is less preoccupied with the level of the policy interest rate.

Governments in the eurozone were also remiss in the run-up to the crisis. The Greek sovereign debt problem was allowed to develop, not out of ignorance of the true situation, but from the mistaken belief that Greek debt didn't matter. And many eurozone governments could not afford to throw the first stone as they had structural budgetary deficits of their own.

European states bear a double responsibility for the current crisis, first for failing to regulate the financial sector adequately, and then for failing to curtail the stellar growth of public sector debt. Far from investing in the future, they mortgaged the future to finance current consumption. Nonetheless, a policy of generalized austerity is not now called for; instead, we need a more discriminating mix of cuts where possible combined with investment where necessary.

With a large debt overhang, economic growth is the only way forward, and monetary policy also has an important supportive role to play. Dissenting voices can be heard—if potential GDP declines in a recession and structural unemployment increases, flooding the system with liquidity contains a medium-term, upside risk of inflation. True, but we have no real alternative. Failure to act boldly, but astutely, may carry even greater risk to our future well-being and to social stability.