Global Economics View

Did Summit Avoid Nadir?

- **Summit Outcome** — At the euro area (EA) and EU Summit on June 28-29, EA/EU leaders agreed on the following crisis-fighting and crisis prevention actions:
  - to sign the €120bn "*Compact for Jobs and Growth*" which includes a €10bn capital increase for the EIB, the reallocation of existing structural funds and project bonds.
  - to make a proposal for the ECB to have a central supervisory role for EA credit institutions by December.
  - for the ESM to have the possibility to recapitalise banks directly, once the ECB has assumed its central supervisory role.
  - that financial assistance to Spain for the recapitalisation of its banking sector will be provided by the EFSF and transferred to the ESM, without gaining seniority status.
  - that EFSF/ESM assistance to countries respecting their commitments under the SGP/EDP and MIP/EIP could come without additional conditionality, but would require a MoU.
  - to ask the European Council President to develop a specific, time-bound roadmap for the achievement of a genuine Economic and Monetary Union. An interim report is to be presented in October 2012 and a final report by the end the year.
- **Our preliminary assessment** — These announcements made by the Council contained some positive steps towards banking union. In our view, however, many key necessary conditions for preventing a break-up of the EA remain unfulfilled, including (among others): boosting the inadequate size of the fiscal rescue facilities; a EA-wide bank resolution regime and an associated mutually guaranteed resolution fund or bank recapitalisation fund; a mutualised EA-wide deposit guarantee scheme that would also insure against redenomination risk; providing the fiscal rescue facilities with a credible funding backstop; and enhancing the accountability and political legitimacy of the European Central Bank and the European Commission, both of which are set to gain considerable authority.

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Introduction

Refreshingly, the outcome of the June 28-29 Summit exceeded very low market expectations; however, the outcome was close to our expectations (Euro Economics Weekly - Another Underwhelming Summit Likely). Euro area (EA) and European Union (EU) leaders did not just sign off on the already-agreed 'Growth Compact', but went somewhat further than we had expected down the road towards banking union and also hinted at some measures that could provide short-term relief for the Spanish and Italian sovereign debt markets.

But although the measures are generally welcome, the positive surprise was mostly in the timing. The agreement was not a game-changer – merely a hint that the widely-shared desire among Europe's political class to save the euro may, during the months and years to come, lead to further agreements that render a collapse of the euro area significantly less likely. First, progress was reported late on Thursday night/early on Friday morning, rather than on Friday afternoon or even over the weekend, as had generally been expected. More significantly, we thought that reaching an agreement to allow the ESM to recapitalise banks directly could take more time.

Overall, the Summit decisions are mostly small steps in the right direction, notably towards 'banking union' and weakening the vicious link between vulnerable euro area sovereigns and vulnerable euro area banks. But in our view the agreed measures still fall far short of what is ultimately needed to ensure the survival of the euro area, and also short of what is needed to achieve banking union. Much work also still needs to be done to clarify not just many details but even key aspects of the decisions that were taken. Even when the exact nature of the proposals is fully fleshed out and communicated to the public and the markets, we will likely still need to jump through a number of parliamentary and Summit hoops and possibly Treaty revisions before these proposals can be ratified and implemented. Therefore it might easily take up to a year before the measures that have been agreed to in principle at the summit will be implemented.

It is noteworthy that a number of items were not mentioned explicitly at all in the Summit statements, notably any form of mutualised bank funding guarantees (for deposit and/or other funding) let alone guarantees against currency denomination risk, EA/EU wide resolution regimes and funds for banks, a funding backstop for the EA rescue facilities, and ways to enhance the legitimacy and accountability of the supranational institutions that stand to gain the additional authority and new powers under the new roadmap: the European Commission (EC) and the European Central Bank (ECB).

Some aspects of the Summit decisions may also create problems of their own in the medium term. Thus, we regard any decision to remove the preferred creditor status of the ESM – a decision undoubtedly affected by the adverse market reaction to the announcement of the Spanish bank bail-out – with considerable concern. This preferred creditor status of the ESM and the tax-payer protection that comes with it was key to obtain support in the first place from those EA countries most likely to be net creditors to the ESM in the event that one or more sovereigns or banks that become obligors of the ESM were to default. There is a material risk, should the ESM's preferred creditor status be revoked, that it would become more difficult to obtain approval for future use of already approved ESM resources to fund sovereigns or recapitalise banks. It would certainly make it more difficult to expand the upper limit on the ESM's resources, currently €500bn, without preferred creditor status for the institution.

We also doubt that taking away the preferred creditor status in the case of the Spanish funding programme will calm investors permanently. As we have learned in the Greek PSI, neither the bilateral loans from the other EA countries to Greece through the Greek Loan Facility and the EFSF, nor the Greek sovereign debt held by the Eurosystem as a result of its Securities Markets Programme (SMP) purchases (none of which benefits from preferred creditor status) were part of the Greek sovereign debt restructuring. Therefore investors probably will continue to have doubts regarding the creditor status of the ESM.

Although we regard the creation of a pan-European bank regulator and supervisor as one of the necessary conditions for the survival of the euro area, it is also likely to highlight that the increase in the powers of the European institutions, notably the European Commission, as a result of the Fiscal Compact, the Growth Compact, the Six Pack, and other reforms to come, have not come with a commensurate increase in democratic control by the European Parliament, national parliaments or by more involvement of voters in directly electing some of the protagonists of the European institutions. Should the ECB's formal and substantive accountability not be enhanced as it takes on supervisory powers (and possibly even more wide-ranging powers in the future, including for bank funding or bank resolution), concerns about the democratic deficit of European institutions are likely to rise significantly.

In the near term Italy, and in particular Spain, are likely to be the main beneficiaries of the Summit's decisions. But we continue to expect that Italy and Spain will request assistance for the sovereigns from the EFSF/ESM, possibly quite soon.

The Summit Decisions

1. Signing the "Compact for Jobs and Growth" which includes i) a EUR10bn capital increase for the EIB which should increase its lending capacity by EUR60bn (and is meant to unlock up to EUR180bn in additional investment in the EU), to be implemented by end-2012; ii) the reallocation of structural EU funds of EUR55bn towards research and innovation, SMEs, and youth employment; iii) launching project bonds with a volume of up to EUR4.5bn for pilot projects in key transport, energy and broadband infrastructure; and iv) a variety of structural initiatives to complete the Single Market (notably in Services) and to boost growth and employment.

   As noted previously (see Global Economics View - What's Next for Spain and Italy?), these measures are likely to be useful, but since the total size of the envelope is small and much of it involves reallocation of existing funds rather than 'new' money, the resulting effect on growth is likely to be very limited. There is also no clarity about how quickly the €120bn will actually be spent to generate demand for goods, services and labour, and over what period the additional resources are to be spent.

2. To present a proposal to have the ECB with a central supervisory role for euro area credit institutions by December 2012.

   We have long advocated a single regulator and supervisor for EA banks as a necessary condition for banking union and ultimately for eurozone survival. Choosing the ECB (rather than the EBA or creating an entirely new institution) appears, mostly based on practical concerns, to use existing provisions in the Treaty (and therefore potentially avoiding lengthy Treaty revisions), to build on existing organisational capacities, and to

combine bank regulation with a source of unlimited liquidity. Choosing the ECB as the single regulator for euro area banks only (rather than for all EU banks) also highlights concerns by the UK, but also some Eastern European countries, such as the Czech Republic and Poland, about centralised bank regulation. No information was available at this point on whether all euro area banks would be subjected to centralised supervision or only the SiFis.

The decision to award greater powers to the ECB is likely to highlight the lack of formal and substantive accountability of the ECB and other European institutions, a point we elaborate on below. It also creates potential conflicts of interest in the ECB. This is because the ECB's price stability mandate will now not only risk clashing with its lender-of-last-resort role (a conflict that cannot be avoided as only the central bank can be a credible lender of last resort), but also with the supervisory, macroprudential and microprodential responsibilies the EA and EU authorities have decided to impose on the ECB.

3. The EA governments also decided to allow the ESM to have the ability to recapitalise banks directly 'following a regular decision' (with appropriate conditionality formalised in a Memorandum of Understanding), once the ECB has assumed its central supervisory role. The Eurogroup explicitly referred to Ireland where it would endeavour to 'examine the situation of the Irish financial sector with the view of further improving the sustainability of the well-performing adjustment programme', but also noted that 'similar cases will be treated equally'.

   Having a centralised bank recapitalisation facility is also a necessary ingredient for banking union and therefore we welcome this decision. A number of caveats remain, however. First, the decision is explicitly contingent on the establishment of 'an effective single supervisory regime' which could take some time (no target date was established).

   Second, the implementation of centralised bank recapitalisation is far from straightforward. Open issues range from the relatively mundane question of whether the ESM or other related institutions would have the expertise to carry out the necessary assessments and transactions, to the financially and politically fraught issue of which form the capital injections would take, the financial terms of these investments, how other investors would be treated, which form monitoring would take and how decisions would be reached. In other words, a European bank recapitalisation fund should be part of a wider European bank resolution regime, in which the bank resolution fund (or bank recapitalisation fund) in general would not inject its own resources until unsecured bank creditors, both subordinated and senior, but most likely excluding depositors (even those not protected by deposit insurance) would have been bailed in, through haircuts or by mandatory conversion of unsecured debt into equity.

   Third, it is undesirable, in our view, that the facility providing liquidity support for (mostly likely) solvent but illiquid sovereigns should also provide capital injections for undercapitalised and (most likely) insolvent banks. The expertise, conditionality and accountability requirements for these two uses of public funds are quite different. Yet the ESM is supposed to perform both tasks. This undesirable convolution of distinct roles comes on top of the inadequacy of the resources available to the

ESM (point five below).

Fourth, it is not clear at this stage whether a revision to the ESM Treaty would be necessary for the changed mandate to take effect. The phrase 'following regular decision' may suggest that no change to the ESM Treaty is envisaged, but we do not yet have explicit confirmation of this, and legal challenges are likely.

Fifth, the size of the ESM remains limited to a maximum of €500bn of lending/funding capacity. This is clearly not sufficient to both recapitalise the EA's undercapitalised banks and ring-fence euro area sovereigns that are most likely solvent but at risk of illiquidity against a sudden stop in market funding.

No direct reference to Spain was made, but we consider it likely that the Spanish bank bail-out could ultimately be implemented by the European institutions injecting capital directly into Spanish banks, subject to the important proviso that the Spanish government and the EA creditors would need to reach agreement on the terms and conditions of the bank recapitalisation and consolidation – and these conditions are likely to be tougher when the ESM resources come as capital into the banks rather than as loans to the sovereign. Although fiscal and macro risks remain large in Spain, removing the 6-10% of GDP increase in general government debt that would result from the bank bail-out (assuming that the expected bank losses underlying the Spanish request for financial assistance of up to €100bn are realistic), would certainly be credit-positive for the Spanish government.

No further information on process or terms (whether capital would be injected in the form of preference shares, convertible capital, or, possibly less likely, as common equity) was available at this stage.

4. The EA government reaffirmed that financial assistance to Spain for the recapitalisation of its banking sector "will be provided by the EFSF until the ESM becomes available and that it will then be transferred to the ESM, without gaining seniority status".

   From the available statements, it is not possible to verify conclusively whether i) a revision of the ESM Treaty would be needed for this decision to take effect (it seems unlikely), ii) removing the seniority status of the ESM would be specific to the Spanish instance (likely, for now) or would be applied more broadly, or iii) whether the ESM claims on the banks would be explicitly specified as pari passu with other claims or whether it simply would not have de jure preferred creditor status.

   As noted, it is unclear whether the derogation of the preferred creditor status (seniority) of the ESM is just for the funds it will extend directly to the Spanish banks or for all future funds provided by the ESM, including loans to sovereigns or debt purchased from them. It would certainly have been complicated to assert seniority for ESM funds provided as capital to banks. If these funds are to be provided as, say, preference shares, would seniority mean that preference shares held by the ESM would be senior just to other preference shares (and of course senior also to other claims on the bank that are junior to preference shares)? Or would preference shares held by the ESM also be senior to other claims on the banks,

including instruments normally ranked as senior to preference shares, such as unsecured subordinated debt, unsecured senior debt, or perhaps even secured debt? This complication would not arise for sovereign debt or loans to the sovereign held by the ESM, so it remains unclear whether the waiver of seniority by the ESM for the Spanish bank capital injection is going to be extended to ESM funding of sovereigns.

The seniority of the ESM was widely cited as one of the reasons for the adverse market reaction to the Spanish bank bail-out. But we are inclined to see a decision to remove de facto preferred creditor status of the ESM as a potential net negative for the medium-term evolution of the euro area crisis. This is because the preferred creditor status of the ESM, and the tax-payer protection in the ESM creditor countries that comes with it, was key to obtain support from the creditor countries to create the ESM in the first place. Preferred creditor status for the ESM would likely make it easier to actually use already approved ESM resources in the future, and to possibly expand them. Conversely, a request for new assistance, or for increased assistance by the ESM to sovereigns or banks is more likely to be vetoed by the Dutch, Finnish, Austrian, Slovak, Slovene or German member of the ESM Board because of political pressures from their domestic constituencies, when the ESM is pari passu with private creditors. A fortiori, a request for an increase in the capital base of the ESM is likely to be turned down if the ESM does not have preferred creditor status.

We understand the concern that creating effectively senior debt – senior debt that may end up representing a large share of the total outstanding debt – may act as an impediment for private investors to invest in EA government bonds, but we consider a higher yield on the effectively subordinated debt to be a price worth paying for reducing the risk that bail-out fatigue in 'donor' countries could ultimately derail the rescue efforts. If the aim is to safeguard affordable funding costs or primary market yields for the respective sovereigns, the ESM funds could be treated as senior relative to debt issued prior to the ESM's involvement but pari passu with debt issued thereafter.[1]

No further information on the size of the programme, the conditionality or on the guarantor status of the Spanish government were available at this stage, but more should transpire by the time of the July 9 Eurogroup meeting.

5. The EA governments also affirmed their commitments to "using the existing EFSF/ESM instruments in a flexible and efficient manner in order to stabilise markets for Member States respecting their Country-Specific Recommendations and their other commitments including their respective timelines, under the European Semester, the Stability and Growth Pact and the Macroeconomic Imbalances Procedure. These conditions should be reflected in a Memorandum of Understanding. We welcome that the ECB has agreed to serve as an agent to EFSF/ESM in conducting market operations in an effective and efficient manner."

[1] One reason to take out the explicit preferred creditor status, but retain the possibility of differentiation between official and private creditors could also be concerns about triggering negative pledge clauses on debt issued under foreign law, or CDS. Please see Stealth subordination - Why ESM seniority will be most effective when subtle

In our view, these statements mostly clarify the procedures for the already-existing instruments for the EFSF/ESM and leave the door open to an Italian or Spanish request for EFSF/ESM support, be it through loans, or purchases in the primary or secondary market. The statement makes clear that such support would require i) a request to the Eurogroup by the respective government, and ii) an MoU with conditionality. By referring to countries respecting their commitments under the European surveillance procedures, the statement does suggest that the proposed financial support would come in the form of one of the EFSF/ESM 'precautionary programmes' rather than of the 'normal adjustment programmes' and that the conditions would not go beyond those included under the existing mechanisms. This 'lighter touch' conditionality is likely to reduce the political cost to Spain or Italy if and when they apply to the EFSF/ESM.

The involvement of the ECB is not really a new development and does not mean that the ECB will bring anything to the table other than technical assistance (its staff and systems), similar to what the Bundesbank does for the German debt agency.

6. The EU leaders also asked the European Council President to develop, in close collaboration with the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific, time-bound roadmap for the achievement of a 'genuine Economic and Monetary Union', which would include 'concrete proposals on preserving the unity and integrity of the Single Market in financial services and which will take account of the Euro Area statement and, inter alia, of the intention of the Commission to bring forward proposals under Article 127, which could be done under existing Treaties. An interim report is to be presented in October 2012 and a final report by the end the year.' This roadmap would also highlight what could be done under existing Treaties and what would require Treaty changes.

   Following the report "Towards a Genuine Economic and Monetary Union" presented by the President of the European Council, in cooperation with the Presidents of the Commission, Eurogroup and ECB, which set out the "four essential building blocks" for the future EMU (an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework and strengthened democratic legitimacy and accountability), this mandate is meant to continue the work on the longer-term configuration of EMU. It is notable the Summit was otherwise completely silent on the questions of mutualised debt issuance, and also on questions of political and fiscal integration.

EU leaders at the Summit also endorsed country-specific recommendations to guide Member States' policies and budgets (bringing the 2012 European Semester to a close) and decided to locate the Court of First Instance of the Unified Patent Court (UPC) in Paris, with thematic clusters in London and Munich. For the euro area-specific issues (centralised bank supervision, ESM bank recapitalisation possibilities, and ESM seniority), some further information is expected at the next Eurogroup meeting on July 9, even though the agenda for that meeting already looks rather crowded, with some details of the negotiations of the revised Greek MoU and first details of the Cypriot and Spanish MoUs to be discussed then.

General implications and comments

The steps taken to sever the link between national sovereigns and banks in their jurisdiction by allowing the ESM to recapitalise banks are clearly welcome, as is the designation of a single regulator and supervisor. But many issues remain unresolved.

First, regarding the announced and any additional measures, many technical details remain to be specified and once proposals are finalised approval processes are likely to be lengthy and rather noisy. The key questions as to the scope of the proposed supervisory structure and the recapitalisation of banks through the ESM remain unaddressed. As regards member state coverage, are they intended for the 17+ or for the 27- (perhaps the 25-, with both the UK and the Czech Republic not part of the Fiscal Pact and the ESM)? As regards bank coverage within a participating national jurisdiction, with it be for all banks, for SiFis only or even just for cross-border SiFis only?

Second, the absence of a number of key issues from the statements of the Summit was notable. Among those were not only Eurobonds or their close cousins, Eurobills and the Debt Redemption Fund, but also any form of bank funding guarantees (for deposits or other types of funding), the possible extension of Deposit Guarantees to include redenomination risk, the size of the rescue facilities or the question of whether, or subject to what conditions, the ESM (or some SPV created by the ESM that would be able to get around possible Treaty-based impediments to the Eurosystem lending to an entity like the ESM) would be given access to the Eurosystem's refinancing capabilities. The use by the ESM of the collateralised lending facilities of the Eurosystem could be either to increase the speed with which the ESM can mobilise resources for disbursement to sovereigns or banks, or to leverage its own resources (with the degree of leverage dependent on the haircuts imposed on its collateral by the Eurosystem) or both. The ECB's willingness to go along with such a scheme would likely be greater if speed rather than leverage were the objective. We find it hard to see the ECB agreeing to be the vehicle through which the ESM leverages its own resources, unless a joint and several guarantee/indemnity from the 17 EA member states were provided for the collateralised loans to the ESM or its designated SPV.

Although some of these omissions likely reflect the sheer impossibility of fitting the entire to-do list for keeping EMU alive into a single Summit, they also highlight that some or even all of these measures face rather large hurdles (political, legal, and financial). In our view, it is likely that the size of the rescue facilities and a potential funding backstop will need to be revisited at some point, but that progress on these issues is unlikely over the next few weeks. And although the Summit results in our view do show some resolve by the EA countries, including Germany, to take substantial measures to contain the EA sovereign debt and banking crisis, we see no reason to change our view that any form of substantial mutualised new debt issuance, or even large-scale *ex-post* mutualisation of existing debt (through, say, a European Redemption Pact and Fund along the lines proposed by the German Council of Economic Advisers), whether by the EFSF/ESM or by the ECB/Eurosystem, remain most unlikely for the duration of this crisis and the rest of this decade.

Accountability, legitimacy and democracy

Among the four essential building blocks of the future EMU highlighted in the report of the President of the European Council was strengthened democratic legitimacy and accountability. We believe that if the euro area and indeed the EU are to

survive, it is key not to underestimate the importance of Germany's demand for greater democratic accountability for the new or enhanced EA institutions that have been created, are being created or will be created to deal with the crisis.

We already have a serious issue with the new Fiscal Compact, the Growth Compact, the Six Pack, the Two Pack, the ESM, etc, because these agreements, arrangements and institutions greatly increase the power of the European Commission without a commensurate increase in democratic control, whether by the European Parliament, national parliaments or by having the President and possibly other members of the Commission elected though some process that enhances their legitimacy.

Legitimacy is the popular acceptance of an authority – a governing law, a regime or an individual ruler. Three dimensions of legitimacy can be distinguished. All are matters of degree, not binary. All are important for a governance structure to survive, let alone perform effectively. They are input legitimacy, process legitimacy and output legitimacy. Input legitimacy relates to the ultimate source of authority, e.g. the selection of the ruler(s) or the manner in which a governance institution has been established. Output legitimacy refers to legitimacy achieved by performance – the right to rule is judged by performance in office. Process legitimacy concerns the perceived validity and acceptability of a conclusion and the action(s) its leads to will depend upon the perceived validity of the method used to reach it.

In modern western societies, the absence of direct democratic input legitimacy is often seen as a serious handicap in wielding political and economic power. The fact that the ECB is the creature of a Treaty that has been ratified by 27 legitimate national political decision making processes is not necessarily sufficient for the public or even national political leaders to view its actions or its powers as legitimate. The repeated demands for an elected president of the European Commission, or of the European Union (elected, say, by the European Parliament, directly by the European citizenry or by some other mechanisms) are a reflection of the widespread perception of a democratic deficit in the EU. The ECB has emphasised output legitimacy as the foundation for its powers: its primary mandate is price stability. It has performed rather well since 1999 as regards price stability. Therefore the institution is legitimate. Of course, institutions tend to be judged not by just how they perform as regards their official objectives, but by how their actions influence outcomes of interest to the public and the political class, regardless of whether these outcomes form part of the ‘official scorecard’. Since central banks influence not just the general price level, but also real economic activity and financial stability, the ECB’s output legitimacy cannot be established just by tracking the behaviour of the general price level.

Process legitimacy, which requires accountability, which in turn requires transparency and openness, is often important for institutions perceived as lacking input or output legitimacy.

Banking union will likely create much enhanced accountability problems if the ECB becomes the only or main supervisor for the EA banking sector. It is the least accountable of the leading central banks, both as regards formal accountability and substantive accountability. Formal accountability is measured by the degree to which the agent/trustee (the ECB) provides the principals/beneficiaries (the European Parliament and the EU or EA citizens) with the information required to make an informed judgment of the agent’s/trustee’s performance. Substantive accountability refers to the extent to which payoff-relevant consequences (pain or pleasure) follow for the agent/trustee from the assessment of their performance by the principals/beneficiaries.

Despite the Treaty containing elaborate voting procedures for the Governing Council of the ECB, the ECB does not vote on interest rates. If it votes on any other aspect of monetary, liquidity or credit policy, it does not publish the voting records of the individual members of the Governing Council, thus hampering accountability. The ECB, which has increased the size of its balance sheet from €1.2 trillion in June 2007 to well over €3 trillion today, continues to refuse to provide the European Parliament or the public at large with information on the financial instruments it has bought outright (say through the SMP), the prices and other terms and conditions of these purchases or the identities of the counterparties. Likewise it refuses to provide sufficient information on its collateralised lending to determine the magnitude of any subsidy or tax element that might be contained in the loan transaction. The technical models used to price illiquid assets have not been put in the public domain, nor have the actual valuations produced by these private (to the ECB) models. We know the haircuts, but not, for illiquid assets, the valuations to which these haircuts are applied. It is clear that commercial considerations and other legitimate grounds for confidentiality may preclude the immediate release of certain types of information. But given a time lag of, say, six months, we find it hard to come up with convincing arguments for anything but full and detailed disclosure.

So, as regards formal accountability, the ECB as interest rate setter, liquidity and credit manager, lender of last resort and market maker of last resort, displays less formal accountability than any other leading central bank. It is symptomatic of the relationship between the ECB and its main European Parliamentary interlocutor, the Economic and Monetary Affairs Committee, known as ECON, that the quarterly meetings between ECON and the President of the ECB are described by the ECB not as ‘hearings’, ‘evidence sessions’ or ‘testimony’ but as ‘dialogues’. Dialogues occur between equals. Accountability is not a characteristic of a symmetric relationship. The party that is held accountable (the ECB) is not the equal of the party to whom account is given (ECON). But the ECB’s usage describes the reality of the relationship well. Successive ECB Presidents have routinely stonewalled, ignored or refused to answer pertinent questions of MEPs. And they have been able to do so with impunity.

As regards substantive accountability, the degree of operational and target independence is inversely related to the degree of substantive accountability. For the Board of the ECB to be substantively accountable, it should be possible for the European Parliament to fire Board members or to dock their pay for cause. Among the causes ought to be incompetence. However, the European Parliament cannot fire or alter the pay of Board members at all. Board members can only be removed by the European Court of Justice for ‘serious misconduct’. The pay of the Board is fixed by the Governing Council (without the Board members voting on this). We are not arguing that this very high degree of operational and target independence and the associated virtual absence of substantive accountability are a bad thing for a monetary authority without supervisory or regulatory responsibilities. However, if the ECB as banking supervisor were to have the same degree of operational and target independence that the ECB has as interest rate setter and in its other liquidity and credit operations, the legitimacy of this monetary authority cum supervisor/regulator will be undermined. Supervision and regulation are deeply political processes. They reassign property rights. They can involve the naming and shaming of institutions and individuals and they can lead to criminal prosecutions, fines and imprisonment. They cannot operate under the ‘formal accountability-lite’, ‘substantive accountability-none’ paradigm governing the ECB today. Ultimately, even the ECB’s independence in the conduct of monetary policy narrowly defined would be threatened.

Past mutterings about the democratic deficit in the European Union will be nothing compared to the angry roars we can expect if bank supervision (and later deposit guarantees, redenomination guarantees, the bank resolution regime and bank resolution fund) are institutionalised without a matching increase in democratic control over these agencies, functions and competencies.

The best technocratic solution can come to nought if it cannot be made acceptable to a sufficient plurality of the people in the EA.

Likely near-term ECB action

Unlike the other leading central banks, the ECB distinguishes sharply between on the one hand monetary policy, which amounts to setting an interest rate (the refi rate) or an interest rate corridor (refi rate, marginal lending facility rate and deposit facility rate) to pursue price stability, and on the other hand enhanced credit support or exceptional policy measures that concern the size and composition of its assets and liabilities. The ECB's interest decisions will be driven largely by whether HICP inflation is likely to be south or north of the "below but close to 2 percent per annum in the medium term" benchmark the ECB considers consistent with price stability. We therefore can expect a rate cut, probably 25 bps in July and another 25 bps cut soon afterwards (see Euro Economics Weekly - ECB to Act in July). Although there is no logical reason why the refi rate could not go all the way down to zero, with the deposit facility rate at, say, minus 75 bps, this is unlikely for historical-emotional reasons (as it has been for the Bank of England). Tracker mortgages with negative nominal rates appear to be a cognitive bridge too far for some central banks. So 50 bps is likely to be the refi rate floor for the ECB, with the deposit facility rate at or just above zero.

As regards the size and composition of its balance sheet, we expect that the willingness of the ECB to engage in further LTROs and other exceptional policy measures will have been boosted by the Summit and action is likely as early as at the July meeting. With more countries on programmes, funded at least in part by the EFSF/ESM, the pressure on the ECB to increase its exposure to the periphery governments is lower than it would otherwise have been. SMP operations in particular are unlikely to be pushed for by periphery governments. This should increase the willingness of the ECB to act as lender of last resort for banks, a task it is clearly comfortable with, unlike the job of acting as lender of last resort for governments, a task the ECB only performs reluctantly and in extremis.

Appendix A-1

Analyst Certification

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