THE SEARCH FOR EUROPE
Contrasting Approaches

BBVA

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The ECB has moved from part of the problem to part of the solution. At first, it only focused on inflation, it neglected risks to financial stability, it opposed debt restructuring and it hesitated to embark on quantitative easing even when the spectre of deflation loomed. Now it recognises its lender and liquidity provider responsibilities, it has shown itself capable of pursuing unconventional policies in unusual cirucmstances, it has softened its doctrinal opposition to debt restructuring and it has assumed additional responsibilities for banking and financial supervision.

THE EUROPEAN CENTRAL BANK: FROM PROBLEM TO SOLUTION

The European Central Bank is an evolving institution. Since 2007, it has evolved from being part of the problem to being part of the solution. Prior to the outbreak of the global financial crisis, which we can conveniently date to August 9, 2007, when BNP Paribus suspended three of its funds due to problems with their investments in U.S. subprime-linked securities, the ECB focused narrowly on its price stability mandate to the exclusion of financial stability-related goals. After then taking a series of exceptional steps in 2007 and 2008, in response to problems in Europe's banks and financial markets, in 2009, it prematurely concluded that its work was done and contemplated phasing out its unconventional policies. In 2010 and 2011, it opposed all talk of a Greek

THE ECB OPPOSED ALL TALK OF DEBT RESTRUCTURING, IT RAISED INTEREST RATES TWICE AND REFUSED TO MOVE TO QUANTITATIVE EASING

debt restructuring, instead saddling the Greek sovereign with additional debt that went to pay off its French and German bank creditors. In 2011, still fixated on inflation, it raised interest rates twice, tightening the screws on the crisis countries. Even when it became clear that the real and pressing danger was deflation, the central bank refused to move to quantitative easing a l'Amérique.

Yet, in the course of the crisis, the ECB learned from experience. It embarked on a series of increasingly ambitious operations designed to address liquidity problems in Europe's banks and financial markets. In 2012, Mario Draghi issued his famous "do whatever it takes" ultimatum, signalling his and the institution's commitment to take whatever measures were needed to ensure the cohesion of the euro area. The crisis having highlighted the folly of monetary union without banking union, the central bank was designated Single Supervisor of systemically important commercial banks in 2013. And at the beginning of

2015, in response to the threat of imminent deflation, the ECB "crossed the Rubicon", to use the now standard phraseology, initiating quantitative easing.

This characterization of the ECB as evolving from part of the problem to part of the solution, while containing a kernel of truth, is of course a vast oversimplification. The ECB did not entirely abdicate its responsibility for financial stability before 2007, or for the cohesion of the Eurozone before 2012. After 2011, it did not move quickly enough

THE CENTRAL BANK WAS CRITISIZED IN ITS EARLY YEARS BECAUSE OF ITS TENDENCY TO OVERSHOOT ITS 2% INFLATION TARGET

in abandoning its opposition to a deeper Greek debt restructuring and in distancing itself from matters tangential to central bank policy, in which it became embroiled as a result of its participation in the Troika of institutions negotiating with the Greek government. Quantitative easing in 2015 was long overdue.

Still, there is ample evidence that the ECB is a learning institution. A review of what it learned in the eight years ending in 2015 may therefore provide some guidance as to what it will learn, and what kind of central bank the euro area will possess, going forward.

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The ECB was created to serve as a bulwark against inflation, reflecting German fears that inflation is always right around the corner. The Treaty on the Functioning of the European Union (Article 127, Parts 1 and 2) defines the primary objective of the ECB and the national central banks that together comprise the European System of Central Banks as "to maintain price stability." The article goes on to mention the central bank's obligation to support the general economic policies of the union, act in accordance with the principle of an open economy with free competition, and promote the smooth operation of the payment system. "Support[ing] [...] general economic policies" and "act[ing] in accordance with the principle of an open economy" can encompass many sins, but there is no question that price stability was always the institution's paramount goal. Enshrinement of such in the relevant European treaties was Germany's price for agreeing to move to monetary union.

Much criticism of the central bank in its early years centered on its tendency to overshoot its 2 percent inflation target and on the danger that currency depreciation augured even higher inflation (see for example Galí 2002). Successive ECB presidents, Wim Duisenberg, through October 2003, and Jean-Claude Trichet, thereafter, hence sought to show that they were committed to the institution's inflation target—to demonstrate, as I put it in Eichengreen (2015), that they were as Teutonic inflation fighters as any German.

The introductory statements of the president and vice president at the press conferences following the governing council's periodic monetary policy decisions contain many more references to inflation and price stability than to financial imbalances and financial instability.[1] The ECB was notably silent in this period about the financial imbalances building up as a result of massive capital flows from Northern to Southern Europe and the risks of investments by French and German banks in the bonds of Southern European countries and U.S. mortgage-linked securities. Adjustments in the central bank's policy rates were geared toward moving actual and expected rates of inflation toward target rates. Little attention was paid to differences in credit conditions in Northern and Southern Europe and what these might imply for financial stability (Micossi 2015).

The situation changed abruptly, in 2007, with BNP Paribas' fateful August 9th announcement. The resulting scramble for liquidity created serious problems for European banks and borrowers, especially those thought to have invested in the same securities held by the three BNP Paribas funds. The ECB responded with a "full allotment at policy rate" initiative, under which it committed to providing as much liquidity as the banks might require, in the form of overnight loans, at prevailing policy rates. The ECB dispersed as much as €95 billion through this channel on the Thursday in question (Trichet 2011).

This response was ambitious even by the standards of the Federal Reserve up to this point in time, though its import was minimized by Trichet, who characterized it as a "fine-tuning operation." But the episode suggests that the ECB, while still unaware of solvency problems

1 These statements are catalogued on the ECB website at https://www.ecb.europa.eu/press/pressconf/2015/html/index.en.html.press/pressconf/2015/html/index.en.html.

in Europe's banking system, was not entirely neglectful of its responsibility for the operation of the payments system and, relatedly, of the interbank market. Not that this indicated any diminished preoccupation with price stability: the ECB raised its policy rate by 25 basis points in July 2008—not exactly propitious timing—in order to "counteract the increasing upside risks to stability over the medium term," in Trichet's words in his introductory statement following the July 3rd governing board meeting.[2] Trichet specifically cited the contribution of food and fuel to the inflation overshoot, indicating an inability or unwillingness to distinguish headline from core inflation.[3] He further cited the relatively rapid growth of money and credit aggregates in an obligatory bow toward German monetarism, thereby failing to distinguish credit growth as a reflection of a healthy supply and demand for funds from credit growth as a reflection of an exceptional demand for liquidity. He emphasized, naïvely in hindsight, the absence of major imbalances in the European economy.

It is unsurprising, then, that the ECB's balance sheet showed little growth in the nine months leading up to the crisis sparked by the failure of the U.S. investment bank Lehman Bros., although the central bank did shift its repurchase (repo) operations toward longer-term securities, providing banks with liquidity longer than overnight.[4] In response to the post-Lehman liquidity squeeze, the ECB again ramped up its policy of fixed rate tenders with full allotment. This was an acknowledgement that the liquidity problem was now affecting more than just the interbank overnight market.

In addition, the ECB provided long-term refinancing operations (LTRO), also at a fixed rate and on a full-allotment basis, as always (up to this point) against good collateral, for up to three months.[5] The collateral requirements in question were eased a number of times, while the

2 https://www.ecb.europa.eu/press/pressconf/2008/html/is080703.en.html.

3 This is something I talk about more in Eichengreen (2015).

4 Nor, it should be noted, did the Fed's balance sheet grow dramatically in this period.

5 In addition, the ECB provided U.S. dollar liquidity to European banks that had funded themselves in dollars, in September providing overnight liquidity and then starting in October conducting regular auctions of dollar liquidity and offering as much as $100 billion for as long as 84 days, using its swap lines with the Federal Reserve. Again, the length of the commitment was an indication of the realization that more than overnight markets were now being affected. In addition, in 2010 liquidity swap arrangements with foreign central banks were reactivated, and the ECB again provided US dollar liquidity at fixed rates with full allotment against eligible collateral. See below.

maturity of LTROs was extended. The ECB introduced operations with a maturity of 6 months and then 1 year. In December 2011, and February 2012, it conducted two very long-term refinancing operations (VLTROs) with a maturity of 3 years and a cumulative magnitude of more than €1 trillion (although part of these operations only substituted previous borrowing at shorter maturities). The credit threshold for eligibility of collateral was lowered from A- to BBB- for marketable assets (with the exception of asset-backed securities) and non-marketable assets (which were subject to an additional haircut). 80 percent of this borrowing was by banks in the Eurozone's five troubled economies: Spain, Portugal, Italy, Greece, and Ireland.

FOLLOWING LEHMAN'S BANKRUPTCY, THE ECB ACKNOWLEDGED THAT THE LIQUIDITY PROBLEM WAS NOW AFFECTING MORE THAN JUST THE INTERBANK OVERNIGHT MARKET

The consequence was a lengthening of the maturity of assets on the ECB's balance sheet and some de facto increase in the credit risk of that portfolio. This now was liquidity provision big time, although it still failed to reflect an awareness of deeper solvency problems that mere liquidity-related operations could not help address.

LTRO and VLTRO were designed to address problems in the banks, understandably given that the interbank market was first to be hit by the BNP Paribas event, and appropriately given bank dominance of Europe's financial system. Following Lehman's bankruptcy, however, liquidity problems spread from the banks to securities markets. Buying private sector liabilities to address liquidity problems in specific segments of the securities market—engaging in what U.S. Federal Reserve Chair Bernanke referred to as "credit easing" to distinguish it, not always successfully, from "quantitative easing"—would be a significant departure for the ECB. It would also be controversial, given the tendency for credit easing and quantitative easing to overlap.

Thus, the ECB proceeded incrementally, starting with purchases of covered bonds (securities issued by the banks and packaged in such a way as to limit credit risk). Covered bonds, in the words of Trichet, "are different in nature from the various asset-backed securities that became so popular before turning sour with the financial crisis. Importantly, covered bonds do not involve the transfer of the credit risk implied by underlying assets from the issuer to the investor." Of course, if the credit risk of covered bonds was so limited, one might ask why there was such a limited appetite for them from private purchasers. Be this as it may, covered bond purchases and related operations appear to have succeeded in reducing interest rate spreads in money markets to pre-crisis levels and stimulating a higher level of activity in repo markets. On this basis, the ECB concluded that its work was done and turned its attention to phasing out its nonstandard operations.

THE COVERED BOND PURCHASES ESTABLISHED THAT THE CENTRAL BANK COULD PURCHASE PRIVATE-SECTOR LIABILITIES WITHOUT DESTABILIZING THE MONETARY AGGREGATES OR PRICE EXPECTATIONS

The central bank's covered bond purchases at least established that it could purchase private-sector liabilities without destabilizing the monetary aggregates or price expectations. Purchases of government securities, which came perilously close to direct monetary financing of governments, were another matter, or so it was thought. But such purchases became relevant, indeed imperative, with the explosion of sovereign spreads following the eruption of the Greek crisis in late 2009 and early 2010. All of a sudden, it was clear, not least to the ECB, that Europe was engulfed not just in a liquidity crisis but in a full-fledged banking and sovereign debt crisis and that, contrary to prior expectations, the central bank still had plenty to do.

The ECB addressed concerns about direct money financing of budget deficits by limiting its purchases of sovereign bonds to the secondary market, under the terms of the Security Market Programme (SMP) announced in May 2010. It justified the SMP as necessary for the smooth transmission of monetary policy, given that very large sovereign spreads, reflecting concerns over sovereign debt sustainability, were preventing its policy rates from having much impact on the market rates faced by private borrowers. To address concerns about inflation, the ECB committed to sterilizing the impact of the SMP on money aggregates, auctioning fixed term deposits as a way of sequestering commensurate amounts of credit.[6]

6 And to avoid compounding problems in secondary markets, it announced that it would hold the bonds purchased to maturity.

The ex-president of the ECB, Jean-Claude Trichet.

The SMP appears to have had some positive impact on securities markets, reducing the magnitude and volatility of sovereign spreads in the short run. But the program was limited in size: the ECB ended up purchasing just €220 billion of mainly Greek, Irish, Portuguese, Italian, and Spanish government bonds, a drop in the bucket by subsequent standards. And, in and of itself, the SMP did nothing to reassure investors about the sustainability of the public finances of the crisis countries or to significantly brighten the prospects for economic growth and price stability, where deflation now constituted the primary threat to the latter.

By mid-2011, the explosive widening of spreads was back. The ECB resorted to its now tried and true instruments, "actively" implementing the SMP, conducting a second round of covered bond purchases, providing dollar liquidity through its Fed swap lines, and cutting interest rates toward zero. At the end of the year, it extended the duration of credit provided to financial institutions to up to 36 months. These operations continued into 2012. None of them sufficed, however, to contain the mounting threat to the cohesion of the monetary union.

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That threat centered on the Greek crisis and on whether Greece's future lay within the Eurozone—a question whose implications for other crisis countries like Spain, Portugal, Ireland, and Italy was too obvious to state. The ECB had been involved in managing the Greek crisis as one of the institutions, together with the European Commission and the IMF, negotiating with the Greek government over an emergency loan and adjustment program. A number of justifications can and have been offered for its involvement, none of which is compelling. The ECB's official reply to the European Parliament on this question, in 2010, noted that negotiations with Greece might have "implications for monetary policy." But many things have implications for monetary policy, and the central bank is not involved, automatically, in all of them.[7]

It is argued that the ECB had a pecuniary interest in the Greek government's finances, given Greek government bonds acquired through the SMP and the TARGET2 system. But central banks should be motivated by larger concerns than their profits and losses as reflected in their balance-sheet statements.[8] It can be argued that only the ECB had the institutional competence to effectively represent Europe-wide interests in the Greek negotiations—for example, because other institutions lacked expertise on the operation of the Greek banking and financial system. This seems farfetched. But if it is true that other institutions, like the Commission, lacked an adequate brigade of competent financial technicians, then this was simply an argument that it should acquire them and, if necessary, that the ECB provide them on secondment to the proper political authorities. It is argued that since the ECB would be keeping the Greek banks on life support with Emergency Liquidity Assistance (ELA), the central bank had a right to be in the room when the important policy decisions were taken. But this is a rationale for keeping it informed of those decisions, not for giving it a hand in them. Finally, it is argued that the decision of whether to eject Greece from the Eurozone ultimately lay with the ECB, which could bring this about by withholding ELA. But there is a strong counterargument that the decision of whether Greece should be in or out properly lay with elected political officials, not with technocratic central bankers with a narrow monetary mandate.

Indeed, it can be argued that the ECB's participation in the Troika constituted a conflict of interest. It put an ostensibly apolitical institution in the position of negotiating fundamentally political conditions. Its

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7 See ECB (2010).

8 For more on the nature and limitations of the argument see Reis (2015).

involvement in the Troika expanded the breadth of the central bank's responsibilities beyond predominantly monetary and financial matters, what with the institutions and the Greek government negotiating over privatization, pension reform, the minimum wage, and other socially delicate matters. The broader the responsibilities of the central bank consequently became and the further it stretched its mandate, the harder it was to hold it accountable for its actions and the greater, therefore, became the threats to its independence, something whose maintenance is essential on narrow monetary policy grounds.

Finally, as the ECB acquired an interest, as a principal in the Troika, in seeing program countries carry out structural reform, economic growth became the enemy insofar as growth reduces the pressure for governments to take painful measures. The incentive to apply pressure for reform thus came into conflict with the central bank's core responsibility of promoting price stability and economic growth.

Such conflicts manifested themselves in the opposition of the ECB, in the person of its then president, Trichet, to a Greek debt restructuring. To many observers, the argument for a restructuring was compelling as early as May 2010.[9] The Troika's projections of the Greek debt/GDP ratio were so incredible as to significantly damage the credibility of the institutions. Yet the ECB continued to oppose all talk of restructuring well into 2011. In April, Trichet wrote a letter to Greek Prime Minister George Papandreou, warning of "grave risks that the Greek government would take if it were to pursue at this juncture a rescheduling of its debt, even on a voluntary basis. [...] Pursuing such a strategy would put Greece's refinancing in euro [meaning access to ECB credit] at major risk."[10] At a meeting of European finance ministers on May 16th and 17th, 2011, Trichet reportedly threatened to retaliate against any restructuring by refusing to supply the Greek banking system with further liquidity, before then storming out of the meeting.[11]

It could be that Trichet was motivated by fears of what a restructuring would do to the European banking system—in which case his fears were unfounded, since the banking system survived when a restructuring of private debt finally occurred in 2012. It could be that he was motivated by fears of what a restructuring would imply for the ECB's balance

9 There is ample documentation of the point in Blustein (2015).
10 Quoted in Xafa (2014), p.15.
11 This according to a report in FT Deutschland.

sheet—in which case his fears were inappropriate, since, to repeat, balance-sheet considerations should not be what motivate a central bank.

In the event, restructuring in 2012 focused on privately-held debt, exempting the ECB from a haircut. In talk of a second restructuring in 2015, this time of officially-held debt, there were hints that the ECB might be permitted to transfer its Greek bond portfolio to the European Stability Mechanism in return for ESM obligations. If so, this would remove the constraint, although not the fact that the ECB had no business opposing a much needed debt restructuring for years.

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The last chapter of the tale opens with the succession of Trichet by Draghi, in November 2011, and the rapid evolution in ECB policy that followed. How much of a role was played by presidential leadership and personality will be for future historians to judge; their evaluation will have to wait on the availability of the relevant archives and memoirs. But the speed and extent of the evolution are striking.

FOLLOWING THE SUCCESSION OF TRICHET BY DRAGHI, IN NOVEMBER 2011, THE ECB BEGAN EFFORTS FOR REFORMS

The changes in question began even prior to the formal handover from Trichet to Draghi. In October 2011, just days before the transition, the ECB moderated its earlier unconditional opposition to a Greek restructuring, subject still to the proviso that officially-held debt (read "ECB-held debt") would be exempt from haircuts.[12] Although it was anticipated that Greece's bonds would be downgraded to a rating of "selective default," the ECB agreed to continue to provide liquidity to the Greek banking system through its ELA window.

One can't help but think that the timing of the shift was related to the imminent retirement of the central bank's second president. The ECB's greater flexibility on the option of restructuring did not resolve the Greek crisis or take the spectre of Grexit off the table—far from it—but it was a constructive step. By demonstrating that restructuring, done

12 For details see again Xafa (2014).

right, would not destabilize the European financial system, it made it possible to contemplate further use of the instrument.

Draghi, on assuming the presidency, also inherited the problem that the Security Market Programme had only a short-term palliative effect on bond spreads. He inherited the Greek debt crisis, notwithstanding the first restructuring in March 2012. This continued to raise the spectre of not just Grexit but also the possibility that if Greece went through the door, other troubled euro area countries would be tempted or forced to follow. Bond spreads widened sharply as a result of what ECB officials, in antiseptic central-bank argot, referred to as "redenomination risk."

As Benoit Couré, member of the Executive Board, later put in it a speech:

> For example, the spreads of Spanish and Italian ten-year government bonds relative to Germany had increased by 250 basis points and 200 basis points respectively in July 2012 compared to one year before. In neither one of the two countries, fundamentals had changed so spectacularly to justify such drastic re-pricing of sovereign risk. The Italian government had taken measures which would lead to a reduction in the deficit below the reference value of 3%. The Spanish government had just embarked on a series of reforms re-dressing long-standing problems in the labour market and in the banking sector (Couré 2014).

And yet, the possibility of an investor run on public debt markets, of the sort modeled by Cole and Kehoe (1998), threatened to produce self-fulfilling results and fracture the Eurosystem.

The intensity of the pressure, which mounted over the summer of 2012, led Draghi to issue his dramatic "do whatever it takes" pledge on July 26th. This was the sort of unconditional commitment from which the Trichet ECB had shied away, suggesting that the central bank now had more muscular leadership. The impact on bond spreads was immediate. Spanish and Italian bond yields both fell to sharply lower levels, where they stayed.

Still, the policy was subject to conditions. The popular headline, in fact, came with an important preface; the full sentence read "*Within our mandate*, the ECB is ready to do whatever it takes to preserve the euro" [emphasis added].[13] Mr. Draghi's open-ended pledge was not received happily in Germany. Bundesbank President Jens Weidmann made no secret of his reservations about the commitment to do whatever it

13 <https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html>.

The president of Deutsche Bundesbank, Jens Weidmann, in a press conference.

takes, especially insofar as "whatever" might include large-scale bond purchases. The within-our-mandate clause was designed to reassure Weidmann and other like-minded skeptics.

Second, when the ECB moved in August to implement Draghi's pledge with a program of Outright Monetary Transactions (OMTs)—outright purchases of the bonds of the affected countries—it made activation conditional on the country first negotiating a program with the European Stability Mechanism (ESM).[14] This approach reflected the ECB's prior experience with buying the bonds of troubled Southern European countries. In August 2011, Italian Prime Minister Silvio Berlusconi had agreed to the terms of a letter sent to him by Trichet and Draghi (the latter then still governor of the Bank of Italy but, as such, a member of the ECB governing council), setting down the reforms that the Italian government would have to pursue in return for ECB support. But when

14 As with Draghi's July 2012 pledge, subsequent justifications for OMTs ritually invoked the ECB's mandate. To quote Couré (2014), "Why were these sovereign bond market developments relevant from an ECB perspective? In any economy, the government bond market plays a prominent role in the transmission of monetary policy and ultimately matters for the effective achievement of the central bank's objective—in our case, price stability." While OMT was announced in August, it became operational only in September, potential operations having to wait on the existence of the ESM, which was formally established only toward the end of the latter month.

the ECB began buying Italian government bonds under the SMP, Berlusconi reneged on his commitment to painful reforms. Requiring a country to negotiate either direct budgetary support or a precautionary line of credit with the ESM and to sign a memorandum of understanding was a way of limiting the risk, or raising the cost, of this kind of backsliding. It was also a way of getting the ECB out of the business of negotiating fiscal and structural conditionality, something more appropriately left to politicians and to technocrats like those of the Commission and the IMF for whom this is an explicit part of their charge.

THE FACT THAT THE ECB WAS NOW READY TO ACT AS LIQUIDITY PROVIDER OF LAST RESORT TOOK THE POSSIBILITY OF MULTIPLE EQUILIBRIA, OR SELF-FULFILLING CRISES, OFF THE TABLE

The most striking aspect of OMT was that it didn't actually have to be activated to produce the desired result. Yields on the bonds of troubled European sovereigns other than Greece, obviously a special case, remained at sharply lower levels not just through the end of 2012, but through 2013, and into 2014. Efforts at structural reform and fiscal consolidation in these countries continued. But, echoing the quotation from Coeuré above, there were no dramatic changes in the stance of policy in the countries in question.[15] Reform efforts there had been, and reform efforts there continued to be. But the fact that the ECB was now ready to act as liquidity provider of last resort took the possibility of multiple equilibria, or self-fulfilling crises, off the table. The sharp shift in conditions in Europe's sovereign debt markets thus testifies to the importance of the ECB's evolution from simple inflation targeter and faithful follower of a monetary rule to true lender of last resort.[16]

While OMT removed the specter of a self-fulfilling debt run, it did nothing to address the danger of deflation that developed in the Eurozone and throughout the advanced-economy world, starting in 2012. In

15 There were changes in national political leadership, to be sure, but again it can be questioned whether these sufficed to produce the dramatic turnaround in sovereign spreads.

16 The point had been anticipated long before by Folkerts-Landau and Garber (1992), which only serves to underscore how long it took for the relevant evolution to take place. Inspired by the events of 2012, the issue is formally modelled by Corsetti and Dedola (2014).

Europe, measures of inflation expectations based on both surveys of professional forecasters and overnight inflation swaps (OIS) had been falling since mid-year. The ECB was now alert to the deflation danger, perhaps because deviations from its 2 percent inflation target spoke of the existence of a problem in familiar terms. After some hesitancy, the central bank sent increasingly urgent signals, in the course of 2014, that it was prepared to take additional measures to combat deflation. The governing council cut the deposit rate for commercial banks, keeping funds at the central bank to zero. In June, in an unprecedented step, it moved the deposit rate into negative territory at -0.1 percent. Draghi highlighted deflation risk in his speech to a Federal Reserve conference in Jackson Hole, in August. Then, in September, the ECB cut its main refinancing rate to virtually zero—actually, to 0.05 percent, but no matter. In the spirit of the earlier covered-bond program, now extended to a second tranche, it announced the intention of purchasing asset-backed securities with investment-grade ratings.

All of this fell conspicuously short of quantitative easing—that is, of unconditional purchases of government bonds on the open market—of the sort pursued by other central banks like the Fed, the Bank of England, and the Bank of Japan. The ECB's conventional policies also visibly failed at containing deflation risk; the ECB's own survey of professional forecasters showed longer-term inflation expectations falling again between the third and fourth quarters of 2014 and as being even lower for 2015 Q1. Market-based measures like OIS continued heading down as well in late 2014 and early 2015.

The result was the central bank's "crossing the Rubicon" moment on January 22nd, when Draghi announced a program of purchases of government bonds and private sector securities of €60 billion a month, extending through at least September 2016. The early returns were positive. The euro depreciated against the dollar and on an effective basis, which was desirable from the point of view of pushing up local-currency prices of exportables. The inflation forecast implicit in five year forward swaps rose from 1.5 percent in January to 1.7 percent in June. At this point, the ECB felt comfortable about revising upward its forecasts for inflation and predicting that they would approach its 2 percent target in 2017. Economic growth accelerated modestly if visibly. In the ECB's survey of financing conditions for smaller firms published in June, it reported an improvement in the availability of bank loans. After six months, it was still too early to declare victory, but these achievements at least constituted a strong start.

This, in turn, raises the question of why adoption of the policy took so long, other major central banks having turned to QE years earlier. There were doubts about the effectiveness of security purchases, given the bank-based nature of Europe's financial system. There were questions about whether there existed an adequate stock of investment-grade securities to buy. Draghi himself worried about the Berlusconi problem—that ECB purchases of government securities might relieve the pressure

THE EBA AND THE ECB ITSELF WERE CONSIDERED FOR THE ROLE OF SINGLE SUPERVISOR OF THE BAILOUT, AND THE LATTER WAS CHOSEN

on governments to pursue fiscal and structural reforms. Therefore, he used his Jackson Hole speech in August to emphasize that the central bank by itself couldn't solve all of Europe's problems and to imply that he would be comfortable about moving to QE only with assurances that governments would stay the reformist course.

But surely the most important reason it took 2 and a half years, following the development of significant deflation risk, for the ECB to take this fateful step was that it took that long for Draghi to cultivate support for the policy within the governing board. It took overwhelming evidence that the Eurozone was at risk of deflation for the skeptics to swallow their reservations. Draghi had to convince the German members of his board that QE didn't augur runaway inflation and that it wouldn't subvert reformist effort. Only at this point, almost 17 years after it came into existence, did Europe finally have a central bank prepared to pursue its core mandate—of preventing inflation from deviating dangerously from 2 percent in either direction—by using whatever tools might be required.

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The depth of the difficulties experienced by European countries starting in 2010 highlighted the folly of monetary union without banking union. Large capital flows between Northern and Southern Europe in the period preceding the crisis had contributed to the difficulties that followed. Heavily indebted sovereigns were then hamstrung when required to recapitalize their banking systems. The institutional response had three elements: the ESM to provide emergency finance, a bail-in procedure to ensure that bank equity and bondholders shared the burden of recapitalization, and a single bank supervisor to limit the likelihood that such problems would arise in the first place.

There were questions about whether the ESM was adequately capitalized and whether the EU's bail-in protocol was workable.[17] But perhaps the most contentious issue was where to situate the single supervisor. One option was the European Banking Authority, or EBA, which was responsible for setting regulatory standards for banking practice in the European Union. But the EBA and its predecessor, the Committee of European Banking Supervisors, had not exactly covered themselves in glory in the run-up to the crisis. And it was a problem, from the standpoint of the monetary union, that the EBA was headquartered in London.

The other obvious candidate was the ECB, since money and finance were closely intertwined and central banks effectively exercise supervisory responsibility in a number of other jurisdictions. Indeed, the experience of some countries, the United Kingdom for example, had underscored the dangers of separating supervisory and lender-of-last-resort responsibilities. (Lack of coordination between the Financial Services Authority and Bank of England having been a factor in the run on the building society Northern Rock, the decision was taken subsequently to consolidate the two functions at the central bank.) It can also be argued, in favor of the current British arrangement, that knowledge of financial conditions gained through direct supervision is useful for monetary policy.

A problem was that the ECB possessed little staff with the relevant expertise. Designating the ECB as the single supervisor also raised questions about whether it should and could have responsibility for supervising the systemically important banks of European countries that were not members of the monetary union. European Commission President Barosso reportedly favored the EBA on these grounds. There were also fears that giving the central bank responsibility for bank supervision could create a conflict between functions, when, for example, inflation control dictated higher interest rates but the needs of the banking system pointed to the need for lower ones.

Clearly, there was no perfect solution to this assignment problem. In the end, the decision was taken to make the ECB the single supervisor

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17 Since many of the bondholders who would be bailed in might, in practice, be other troubled banks.

The president of the ECB, Mario Draghi, in a press conference.

and to allow EU members that had not adopted the euro to opt in to this part of the banking union. The decision reflected knowledge that other jurisdictions had been moving in the direction of consolidated supervision. It demonstrated that the ECB had shown itself as capable of growing into new responsibilities. It also showed that the ECB was an independent institution perceived as possessing, or as capable of acquiring, the relevant competencies. And it was expedient as a way of avoiding the need for a treaty change, since assigning supervisory responsibility to the Bank could be based on the existing Article 127 (6).

Finally, the assumption by the central bank of this new responsibility reflected effective lobbying by ECB officials happy to expand their domain. Chang (2015) suggests that Draghi, in particular, supported selection of the ECB, for two reasons. First, the central bank's role as lender and liquidity provider to the banks gave it a direct interest in effective supervision. Second, Draghi was a policy entrepreneur who hardly minded that his institution thereby acquired an expanded role.

The ECB subsequently embarked on a binge of hiring staff with experience in bank supervision. It sought to address potential conflicts of interests by establishing a Supervisory Board, separate from but reporting to the Governing Council, and by limiting data exchange between the two committees. The Governing Council does not have input into the decisions of the Supervisory Board but retains the power to object to those decisions and to force the board to reconsider them.

How well this arrangement will work in practice, only time will tell. But assigning significant supervisory authority over the banking and financial system to the central bank is, it increasingly appears, international best practice. And the ECB's assumption of this role is indicative of another stage of the evolution of the institution into a modern central bank.

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Skepticism about the stability and sustainability of the Eurozone is rife. The monetary union is heavily indebted. It lacks the wage flexibility, labor mobility, and federal fiscal system of other monetary unions. But an even more fundamental reason for scepticism is that a normal monetary union needs a normal central bank and that, until recently, the Eurozone lacked one. The ECB focused single-mindedly on headline inflation, raising interest rates at the worst possible time. It neglected risks to financial stability in the run-up to the crisis. It opposed debt restructuring where debt restructuring was needed. It hesitated to embark on quantitative easing even when interest rates had fallen to zero and the spectre of deflation loomed.

It is clear that the ECB has moved a considerable distance in response to the crisis and is now evolving into a normal central bank. It acknowledges its responsibilities as lender and liquidity provider of last resort. It has shown itself capable of pursuing unconventional policies in unconventional circumstances. It has softened its doctrinal opposition to debt restructuring. It has assumed additional responsibilities for banking and financial supervision.

It can thus be argued that the ECB has moved from part of the problem to part of the solution. The question for the future is whether the institution will continue to show the capacity to adapt. If the explanation for recent developments is leadership at the top, there is little reason to be reassured, since that leadership can and, eventually, will change. If, in contrast or in addition, the explanation is deep changes in the culture of the ECB, then there is more reason for optimism.

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