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Trust no more? The impact of the crisis on citizens' trust in central banks

Sébastien Wälti*

Swiss National Bank, Börsenstrasse 15, 8022 Zurich, Switzerland

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ABSTRACT

Citizens' trust in economic institutions has generally declined since the onset of the crisis. In particular, Eurobarometer surveys show that trust in the European Central Bank (ECB) has fallen significantly during the crisis. This paper studies the determinants of public trust in the ECB over the lifetime of the euro. Net trust in the ECB has decreased significantly in those countries which have experienced increasing sovereign bond yields and financial market turbulence. The finding that country-specific variables affect citizens' trust in the ECB may seem counterintuitive. However, it is consistent with strong evidence in the political science literature showing that domestic considerations play a significant role when citizens get an opportunity to express their opinion on EU matters.

> There is no doubt that in order to be successful over the longer term, the ECB will have to win and maintain the trust and support of the European public.
>
> Otmar Issing (2000)

1. Introduction

The persistence of economic institutions in a democratic society requires that its citizens trust them. The relationship between citizens and economic institutions can be understood within a principal-agent model (Ehrmann et al., 2010; Kaltenthaler et al., 2010). In such a model, citizens are the principal and economic institutions the agent. When the principal loses confidence in the ability of the

* Tel.: +41 44 6313943.
E-mail address: sebastien.waelti@snb.ch.

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agent to carry out its mandate, the principal is likely to vote for change. Therefore, economic institutions must earn the trust of citizens, they must maintain it, and they must do so on the basis of observable factors. Trust in economic institutions would be particularly important at times of crisis, when uncertainty increases markedly.

Public opinion surveys show that citizens' trust in economic institutions has actually declined since the onset of the crisis (Roth, 2009; Gros and Roth, 2009). For example, a Financial Times/Harris Poll was conducted in June 2009 across five European countries (United Kingdom, France, Italy, Spain and Germany) and the United States (Harris Interactive, 2009). This poll asked respondents the following question: "Do you feel the European Central Bank/Bank of England/Federal Reserve has responded appropriately to the challenges of the economic downturn and its consequences?" A majority answered no in each of these countries. Further evidence on trust in central banks can be obtained from Standard Eurobarometer surveys. Among other things, these surveys have asked citizens in the European Union whether they tend to trust European institutions or not. Fig. 1 depicts the cross-country average of net trust of European citizens in the European Central Bank (ECB) from Spring 1999 until Fall 2010. Net trust is defined as the difference between the share of respondents in Standard Eurobarometer surveys who say they trust the ECB, minus the share of respondents who do not trust. Net trust stood at around 40 percent before the crisis and has since then fallen markedly.

The purpose of this paper is to investigate empirically the determinants of public trust in the European Central Bank, in particular since the onset of the crisis. The crisis has manifested itself differently in different euro area countries. Thus, is the decline in trust related to large movements in inflation and unemployment, the typical arguments of social loss functions in macroeconomics, since the beginning of the crisis? Furthermore, is the fall in trust also related to other country-specific developments during the crisis, for example rising sovereign bond yields or financial market distress?

This paper contributes two innovations to the literature and includes the most recent observations coming from the Standard Eurobarometer survey carried out in Fall 2010. The first innovation of this paper is to relate the fall in net trust to the large divergence of sovereign bond yields across euro area countries. Fischer and Hahn (2008) focus only on the first five years of the euro and thus, they do not include the crisis in their analysis. Gros and Roth (2010a) focus narrowly on output growth to identify the impact of the crisis on net trust. Yet, the crisis has manifested itself in different forms in different countries. Even though output growth may capture some part of banking sector distress and rising bond yields, we control for different forms of the crisis directly by including a large set of explanatory variables in our regression analysis. Ehrmann et al. (2010) also consider banking sector distress but do not take into account sovereign bond yields.[1]

The second innovation of this paper relates to the modeling of explanatory variables. Since Standard Eurobarometer surveys are carried out at irregular intervals, the construction of explanatory variables is somewhat complicated. While Fischer and Hahn (2008) make use of annual data, Gros and Roth (2010a) adjust the survey fieldwork dates in order to be able to use quarterly data. Instead, all explanatory variables in this paper are based on data available at the monthly frequency. Indeed, crises exhibit high-frequency dynamics, meaning that monthly data are most adequate to understand the link between net trust and macroeconomic developments.

Finally, the sample period in this paper extends to the latest Standard Eurobarometer survey conducted in November 2010. Both Ehrmann et al. (2010) and Gros and Roth (2010a) use data only up to the Fall 2009 survey. Gros and Roth (2010a) conclude that "the change of net confidence seems to have come to a halt in October–November 2009". However, as Gros and Roth (2010b) and Fig. 1 in this paper show, net trust fell further by a significant amount during Spring 2010. Those observations which were gathered in 2010 are therefore important in providing time variation in net trust.

My results show that both rising sovereign bond yields and financial sector turbulence have reduced citizens' trust in the ECB. In particular, a one-percentage point increase in sovereign bond yields reduces net trust by about seven percentage points, other things equal. The finding that country-specific variables affect citizens' reported level of trust in the ECB may seem counterintuitive. However, it is

[1] Ehrmann et al. (2010) also differs from this paper on methodological grounds. Ehrmann et al. (2010) perform an individual-level analysis, while I focus on macroeconomic aggregates like in Gros and Roth (2010a).