



DIRECTORATE GENERAL FOR INTERNAL POLICIES  
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

# ECB's Outright Monetary Transactions

NOTE

## Abstract

The creation of the EFSF has allowed the crisis to fester and spread. It made sense under the belief that the crisis would be circumscribed to a small number of small countries. This belief was mistaken in the first place and has now been proven wrong. The EFSF/ESM now threatens to delay the unavoidable acceptance by the ECB that is the euro area's lender of last resort. For the crisis to be brought under control, all public debts will have to be partially but explicitly guaranteed. This can be done by the ECB directly or by the ECB via the EFSF/ESM, once it has been granted a banking license.

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## EXECUTIVE SUMMARY

The Outright Monetary Transaction (OMT) programme constitutes a turning point. It is one of several necessary conditions required to bring the euro area crisis to an end.

By breaking the no-bailout clause, all euro area governments have created a new situation, hopefully a temporary one, for which there is no good solution. The chosen response, the creation of the EFSF and then the ESM, is mistaken. It rests on the view that we only need to plug the flows of financing gap while financial markets hold the stocks of public debts. What needs to be dealt with now is the legacy of EUR 8750 billion of accumulated debts. No other institution in the world but the ECB has the means to backstop this stock.

The OMT strategy fundamentally differs from the Securities Markets Programme (SMP) strategy. By committing to guarantee a maximum spread (cap on spreads), or equivalently a minimum price (floor for bond prices), through unlimited purchases, the ECB now deals with debt stocks. The SMP strategy, however, was in the nature of acting on flows because it was explicitly temporary and limited in size. This is why it failed.

In spite of being a most needed and long awaited step, the OMT programme suffers from a number of unwelcome and potentially counter-productive restrictions. This implies that further improvements will be needed. These restrictions may be due to the fact that the OMT programme creates a severe moral hazard problem that the ECB cannot deal with. The first restriction is that OMT will only backstop debts of governments that have beforehand signed a Memorandum of Understanding (MoU). The second restriction is that the ECB retains an *'exit option'* in the event that a government does not fulfil its commitment. The third restriction is that the ECB has not announced how the spread caps will be chosen. The final restriction is that it will only purchase debts of less than three years of maturity.

While the OMT programme represents a significant step forward, alone it will not stop the crisis. Governments must also challenge the policies that they have adopted so far. The banking union is necessary for the ECB to be able to act as lender of last resort to governments. This requires a single regulator, a single supervisor and a single resolution authority. With OMT, the ECB is becoming lender of last resort, a source of moral hazard that requires full treatment. The objective is to make sure that the debt build-up of the last decades will not occur ever again. Like OMT, The Fiscal Compact stands to represent a major step forward, but it must be improved.

## 1. INTRODUCTION: A LOGICAL ERROR

The May 2010 decision to bail Greece out, presented as a *'special and unique'* case, has deeply transformed the monetary union. Since then, more countries have had to be bailed out (Ireland, Portugal, Cyprus) and the list is set to expand. Recognising that they had opened a Pandora box, the political leaders first created the *'strictly temporary'* European Financial Stability Facility (EFSF) with a lending capacity of EUR 250 billion. Then they realized that the EFSF was far too temporary and they created the permanent European Stability Mechanism (ESM) whose lending capacity is set to rise to EUR 500 billion.

As long as the crisis only affects small countries, the EFSF/ESM approach may have been seen as realistic. The somewhat outdated Table 1, which presents the latest Commission forecasts, shows that the cumulated debts of the countries officially in programmes already exceeds the hoped-for future resources of the ESM. Adding Spain and Italy, the potential amount of debts in crisis exceeds EUR 3500 billion.

**Table 1: Public debts (EUR billion) – Forecasts of May 2012**

	National debt	Cumulated crisis countries	Cumulated potential crisis countries
Estonia	2		
Malta	5		
Luxembourg	9		
Cyprus	14	14	14
Slovenia	19	33	33
Slovakia	36		
Finland	100		
Ireland	185	218	218
Portugal	190	408	408
Austria	230		
Greece	327	734	734
Belgium	379		
Netherlands	425		
Spain	862		1596
France	1846		
Italy	1964		3560
Germany	2161		
Euro area total	8751		

**Source:** AMECO on line, European Commission.

It is essential to understand why these numbers matter. Officials often claim to deal with the financing needs of crisis governments over the next year or two – this is what the IMF calls the *'financing gap'*. The reasoning is that a government is safe as long as it has secured the corresponding resources, including from official lenders. This is a mistaken and misleading way of reasoning because it ignores how financial markets operate.

**Financial markets** – broadly defined as all investors, including financial institutions and individual savers – **hold debt stocks**, i.e. the public debts that have not been purchased by official institutions. As a result, the value of each government debt must be such that markets are willing to hold all of the existing stock. If markets are concerned that the debt will not be repaid in full, demand diminishes and the price has to decline to bring the value of the debt stock down to demand. Another principle of finance is that when prices decline

below the par value (the nominal value of the debt when it was issued), the interest rate must increase to compensate debt holders for the expected reduction on the value of the debt stock. The relentless increases in interest rate spreads simply mirror the declining value of debt stocks as estimated by the markets.

Why, then, is the **official reasoning focused** on the **flow** of refinancing needs **flawed**? Because official lending designed to match the gap for a few years do not reduce the stock; in fact official lending increases the stock. Official lending only helps, therefore, if markets regain confidence that the stock will be repaid some time in the future. For that to be the case, the markets need to be reassured that the deficits will become surpluses. If they are not, plugging the financing gap does not provide any relief, and may actually worsen market expectations. This is why large-scale purchases of public debts by the EFSF and the ECB have constantly failed to reduce the interest rate spreads. This is also why the financial markets constantly ask for economic growth because they know that deficits cannot be closed when the economy is in recession. Put differently, plugging the financing gap prolongs or deepens the crisis and invariably leads to the loss of market access.

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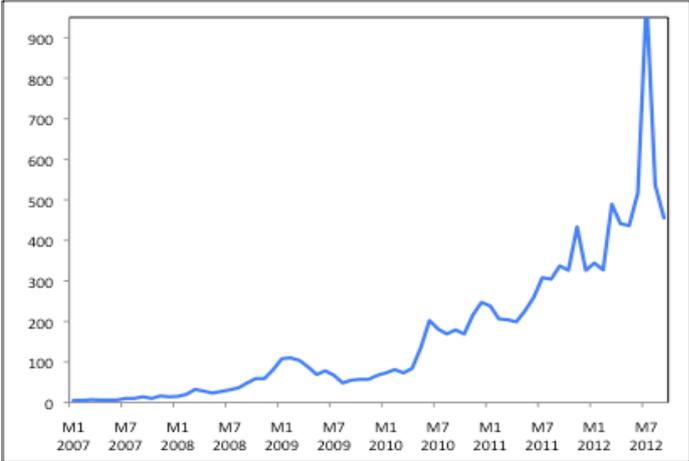
## 2. RATIONALE FOR OMT

The only way to eliminate the spreads is to eliminate the threat of default or, at least, to set a credible ceiling to the size of an eventual default. Such an objective can only be achieved by **guaranteeing**, entirely or partially, the **whole stock of debt**. The numbers displayed in Table 1 imply that the EFSF/ESM solution is totally illusory, even before we worry about big debt countries such as Spain and Italy, not to mention France. Worse, as a dwindling number of *'healthy'* countries undertake to bail out a rising number of crisis countries, their own fiscal health becomes increasingly dubious. If the crisis is allowed to linger, it is bound to spread all the way to the last, healthiest country. Proper crisis management must recognize the worst case scenario: it is the total of euro area public debts that have to be guaranteed, i.e. close to EUR 9000 billion, which amounts to more than four times the GDP of Germany.

At this stage, it becomes obvious that policy responses cannot be based on the EFSF/ESM approach. Even with IMF's help – whose total lending capacity is some USD 250 billion –, the euro area countries simply do not have the resources to prevent the crisis from spreading and engulfing the whole monetary union. The only place in the world where thousands of millions of euros can be found is the ECB. This is why the ECB holds the crucial key to the end.

One could object that previous ECB actions under the Securities Markets Programme (SMP), totalling more than the EFSF purchases, have failed to quiet things down. In fact, the SMP serves as an illustration of the logical error described above. Each intervention under the SMP has been explicitly presented as *'temporary and unique'*. In other words, the ECB has framed its interventions within the flow view of debt financing. This error has had predictable effects. Given their sizes, these interventions have provided a temporary lull in market pressure because it allowed worried debt-holders to offload to the ECB the bonds that they wanted to get rid of. Since the SMP ruled out a stock guarantee, however, the markets did not change their assessment of the ability of governments to honour their debts. Worse, the senior creditor status claimed by the ECB implied that private debt-holders would bear the whole burden of an eventual default. This is why every SMP intervention has been followed by a temporary easing of interest spreads, itself followed by a strong increase in spreads as soon as the intervention stopped, as seen from Figure 1. In short, the SMP strategy was self-defeating.

**Figure 1: Ten-year spreads on Spanish bonds (basis points)**



Source: *International Financial Statistics*, IMF and *Financial Times*.

The logic of the new **Outright Monetary Transactions (OMTs)** is **in conformity with the stock view of financial markets**. The ECB now addresses its interventions to the price (or interest rate level) and commits to unlimited interventions. This means that it stands ready to partially guarantee all the corresponding public debt. In addition, by **dropping its claim as senior creditor**, the ECB has made it clear that it intends to protect the private the debt-holders. The markets perfectly well understand that the EBC has the means to backstop public debts. The result of the August 2012 announcement is unmistakable in Figure 1.

### 3. WEAK ASPECTS OF THE OMT PROGRAMME

The **OMT programme** represents a **major turning point** in the on-going crisis. The ECB has abandoned the flow approach of the SMP and adopted the correct stock approach. Yet, as announced, the programme suffers from a number of weaknesses, which imply that further improvements will be needed. Clearly, the paradigm change is facing political difficulties fed by a misunderstanding of the nature of the crisis. This may be the reason for these limits. At the same time, OMT create a severe moral hazard problem that the ECB cannot deal with, which may be another reason why it is imposing a number of restrictions to the programme.

#### 3.1. Conditionality

The OMT will only backstop debts of governments that have beforehand signed a Memorandum of Understanding (MoU), either for a Troika programme or for the lighter flexible lending programme. In addition, the ECB retains an *'exit option'*, by stating that it will remove its guarantee in the event that a government does not fulfil its commitment. The idea is that ECB support does not easily can be seen as essential to ensure that in the future member governments will not come to see monetary financing as a normal procedure. Indeed, critics are right to stress this procedure entails a massive moral hazard. This fundamental issue is examined below and appropriate policy responses are suggested. Here, conditionality is considered as a contribution to the effectiveness of the OMT programme.

The success of the programme will depend on whether governments regain – or maintain – market access. As noted above, markets assess the ability of a government to honour its debt. Key to this evaluation is economic growth. The current Troika programmes heavily emphasize fiscal austerity and much of the spreading recession can be directly caused by these programmes or to self-imposed austerity misguidedly adopted to avoid having to sign a MoU. By making OMT conditional on a MoU, the ECB undermines the effectiveness of its interventions.

In addition, the **exit option** may well turn out to be a **double-hedged sword**. As a country gets deeper into recession, its chances of fulfilling its commitments drastically decline. This has been the case so far for every single Troika programme. What will happen in the nearly certain event that a government under OMT support is unable to live to its (imposed) commitments? Withdrawing support will put the country in an extremely severe situation; the ECB is likely to want to avoid bearing partial responsibility for such an action. One solution is that it will mellow down its conditions, which will then lose all credibility. Another option is to insist within the Troika that the MoU conditions be made more growth friendly, as the IMF has been arguing for. This would be a welcome development, but one fraught with political risks. Either way, conditionality stands to lock the ECB in an untenable position while reinforcing the austerity bias established in early 2010 with disastrous implications that have now become highly visible.

#### 3.2. Unknown caps

Setting a limit on interest rate spreads – which is equivalent to setting a floor to bond prices – is an essential step to curb the crisis. Should the cap be the same for each country? At all maturities? Should it change over time? More importantly even, where should it be set? These are extraordinarily complex questions, both because it has not been done before and because the implications are massive. Apparently, the **ECB has decided**

**not to reveal its choices.** This can be seen as a prudent response but it also stands to undermine the programme.

The markets will undoubtedly endeavour to discover the caps. They will do so by selling large amounts of public debts, until the spreads stabilize. This will force the ECB to absorb a lot of bonds. In contrast, were the ECB to announce a cap, the markets would merely test the central bank's resolve and promptly stop bond sales (unless they consider the cap as unrealistic, of which more later). Either way, the markets will end up knowing the cap so the only difference between the two strategies is the amount of bond purchases by the ECB.

Does it matter? In a benign scenario where there will be no sovereign debt restructuring, the difference between the two strategies is largely irrelevant. However if, as is likely, a number of countries eventually have to restructure their debts, the ECB stands to suffer large losses under the **'secret cap' strategy**. The issue is not that the ECB may suffer heavy losses; central banks are not profit making institutions and can suffer large losses without any serious consequence. The issue is that large bond sales followed by a debt restructuring will have resulted in the socialization of private losses. This is what happened with the unfortunate Private Sector Involvement (PSI) organized for the Greek debt and it should not be repeated for many obvious reasons.

One answer is that a fixed cap can force the ECB to absorb *'unlimited'* amounts of bonds if a debt restructuring comes to be expected, correctly or not. The fear then is that the ECB would want to argue for a debt restructuring, which may not be fully justified. This is a deep issue. In theory, only insolvent countries should restructure their debts. In practice, however, it is impossible to decide whether a country is insolvent (Wyplosz, 2011) if only because it is impossible to predict future spending and tax revenue. What is left is market judgement, which can be erroneous, and therefore market access.<sup>1</sup> In that case, every government will deny the need for debt restructuring for as long as it can. Meanwhile the debt will continue to grow and the eventual debt restructuring will be larger and more painful to both the country and its debtors; this is precisely what happened, and will happen again, with Greece. Having the ECB in the camp of those who push for prompt corrective action, including debt restructuring, is therefore highly desirable.

### 3.3. Short term bonds

In fact, by announcing a **cap on spreads**, the ECB will announce a **floor for bond prices**. Imagine, for instance, that the price floor for country is 70 percent of the face value of the debt. The markets will observe that 30% of the debt value is not guaranteed and therefore up for default. This reasoning provides a guide to the ECB for the questions raised before. The caps should be different for each country and chosen such that it corresponds to the likely size of the restructuring. The ECB would not just be an advocate of early restructuring, it would be the restructuring agent. This is of course politically difficult and one reason why the ECB has announced that it will only intervene on short maturities.

Indeed, backing only relatively short-maturity debts largely leaves the ECB off the position of preparing a restructuring. Indeed, an implied price discount of 30% at a two-year maturity will encourage bond-holders to keep their bonds – beyond selling for testing or price discovery – and simply wait for redemption at par in two year's time. A promise to continuously roll-over bond purchases at short maturities allows the ECB to indefinitely

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<sup>1</sup> One can make a strong case that no euro area country – including Greece – has been insolvent. Yet, once markets concluded differently and set large spreads and/or shut market access down, the country effectively became insolvent.

postpone debt restructuring. In this way, the **OMT programme** becomes a **powerful engine to avoid debt restructuring**.

This may well be the ECB's intention. The question, however, is whether this is wise. An opposite view is that several countries have accumulated public debts so large that sustained growth will be impossible, as has been the Italian experience over the last 15 years. Reinhart and Rogoff (2009), among others, have found that public debts in excess of 90% of GDP stunt economic growth. The 90% threshold is only indicative, of course, but several euro area countries exhibit clearly excessive debt levels, and others will pass the threshold. If the conclusion is that some debt restructurings are desirable, the ECB's decision to only buy bonds of less than three-year maturities is misguided.

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## 4. THE ECB SHOULD NOT BE ALONE

The OMT programme is one of the conditions necessary to bring the euro area crisis to an end but alone it is not sufficient. If, as argued above, several countries have to restructure their debts, a number of banks will fail. In addition, **OMT open up massive moral hazard issues** that the ECB cannot deal with. Governments must do their part.

### 4.1. Moral hazard

The current crisis should not have happened. Adequate fiscal discipline and bank supervision should have prevented it from happening in the first place. The no-bailout clause should have been invoked to circumscribe the crisis to those countries that either failed to be fiscally disciplined (Greece, Portugal, Italy) or to adequately supervise their banks (Ireland, Spain). The ECB is now required to act as lender of last resort, a step that ought to have been avoided. There is no alternative to an ECB intervention, but it is a source of moral hazard. The proper way to deal with moral hazard is not to make rescues painful – the strategy followed so far – but to make sure such a situation is most unlikely to ever occur again. This is a task for governments.

### 4.2. Banking Union

With the OMT, the ECB becomes a lender of last resort to governments. It must also be prepared to act as lender of last resort to banks. The continuing deterioration of the economic situation progressively harms banks as the number of non-performing loans rises inexorably. As noted, public debt restructurings will also hurt many banks. Sooner or later, and sooner than policymakers expect, we will see important bank failures. The ECB must be ready.

There seems to be a belief that bank failures will be dealt with EFSF/ESM resources. As with public debts, the correct measure of potential needs are stocks, not flows. The assets (and liabilities) of monetary and financial institutions add up to some EUR 34,500 billion. The large banks have assets in the order of magnitude of EUR 2,000 billion. Clearly, a serious bank shake-up would quickly exhaust EFSF/ESM resources. This is why a lender of last resort is needed and why the ECB is the only institution that can play that role.

As lender of last resort, the ECB stands to inject large amount of money into failing banks. It stands to reason that the ECB will not wish to do so without a very precise knowledge of the bank situation. The arrangement proposed by the de Larosière Group organises Colleges of National Supervisors that would make the information available as needed. Leaving the task of supervision in the hands of national authorities is unlikely to work because supervisors are known to favour national champions.

This is why the ECB has asked to be given supervisory authorities. The recent Commission proposal advocates such a transfer of authority. Yet, supervision is only the first step. Once a bank fails, it is necessary that cash injections be carefully calibrated to protect taxpayers, which often requires that the bank be deeply restructured or closed down. Bank resolution, therefore, must be protected from the intense pressure that is usually exerted on the authorities. Current plans do not call for a single resolution authority. This is bound to undermine the ECB's ability to act as lender of last resort. Governments must agree to a single supervision authority and to a single resolution authority.

## 5. WHY CRITICISM OF OMT IS EMPTY

Critics of OMT advance a number of arguments that are misleading. Here is a critical review of the main criticisms.

### 5.1. Moral hazard

The argument is that lending to governments will only encourage them to be fiscally undisciplined in the future. This is correct, as argued above, but incomplete. First, what else can be done to bring the spreading crisis to an end? Because of past indiscipline, several governments are now facing a crisis because of high public debts. This is a legacy from the past that needs to be dealt with. Continuing austerity has been tried and it is now clear that it only makes things worse. Second, the response to moral hazard concerns the post crisis regime. The Fiscal Compact offers the hope of a better regime. The focus should be on making the compact operational and enforceable.

### 5.2. Costs to 'innocent' taxpayers

As the ECB buys large amounts of public debts, some of which will be restructured, losses are possible. These losses, which come on top of those that will be borne by the EFSF/ESM, will have to be absorbed by taxpayers from all euro area countries, including those that have been fiscally disciplined and where banks have provided loans with prudence. This is true, but what is the alternative. Without OMT (and further action), the crisis countries will be forced to abandon the euro. Their new currencies will be deeply devalued, which will make service of their euro-denominated debt impossible. They will have to default much more deeply than if they were to stay in the euro area. The losses on bonds already acquired by the EBC and the EFSF/ESM will be larger. 'Innocent' taxpayers will be better protected if the euro area remains intact than if countries start to leave, a process that can prove highly contagious.

In addition, there are no 'innocent taxpayers'. As argued above, the crisis has deepened and spread because euro area governments have repeatedly broken the no-bailout clause. Citizens of countries whose governments that willingly made this historical error will have to bear the consequences. In a democracy, citizens have the means to bring their governments to account.

### 5.3. Not the solution

Another argument is that OMTs, in and by themselves, will not bring the crisis to its end. This is true but disingenuous. OMT are a necessary condition to solve the crisis, not a sufficient condition. It is hard to see the wisdom of rejecting necessary conditions simply because they are not sufficient.

### 5.4. Inflation

The Eurosystem's balance sheet has already been multiplied by 2.5 since July 2007. Even though OMT are to be sterilized, the view is that the printing press has been allowed to create money in a way that is bound to lead to inflation. This view is based on the historical link between money growth and inflation, one of macroeconomics fundamental stylized facts. This link, however, has been broken because of another broken link, that which associates money growth and credit creation. In the current situation, characterized by a latent bank crisis and a deepening recession, credit growth is virtually nil. Banks absorb massive amounts of liquidity to protect themselves against a risk of illiquidity. The money

that they hold is not used to grant credit and support spending. The best proof is the total absence of any inflation impact of the Eurosystem's balance sheet massive increase over the last five years. The same applies to other country, for example the US where Fed's balance sheet has been multiplied by a factor of 3.15.

The link break is temporary. When the crisis is over, the historical regularity will reassert itself. This means that central banks around the world will have to withdraw liquidity, a step that they are keenly aware of. This also means that those who worry about the central bank balance sheet increases should distinguish between the current historical situation and the longer run.

### 5.5. Deficit financing

A related concern links monetary financing of budget deficits with inflation. Deficit financing by central banks is known to be **the** source of all big inflations. OMT, however, do not deal with future deficits but with the legacy of high debts accumulated over the past. The response to future deficit financing is fiscal discipline and the re-establishment of the no-bailout clause.

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