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European Central Bank: (Un)Conventional policy measures

SUMMARY On 6 September 2012, the European Central Bank (ECB) announced its Outright Monetary Transactions (OMT) programme. The ECB has taken a series of standard and non-standard measures throughout the financial turmoil, the global financial crisis and the Eurozone debt crisis. This is now the second action under which the central bank has entered the sovereign-debt market. In the course of the three intertwined crises, the ECB has extended the duration and amount of its loans to eurozone banks, accepted a wider range of collateral in exchange, and lowered its reserve requirements.

The ECB's earlier measures took some pressure off financial markets but doubts have been cast on the debtor status of the central bank and on the existence of moral hazard which might discourage Member States and banks from carrying out necessary reforms. Whilst received with cheer, the long-term effects of ECB President Mario Draghi's latest initiative to "preserve the euro" are still unclear. Sceptics question the politicisation of the ECB, the persistence of the moral hazard dilemma and the riskiness of an inflated ECB balance sheet. Additional efforts, such as the newly foreseen role of the ECB as eurozone-wide supervisor of banks, are likely to stir up the debate even further.

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In this briefing:

Glossary

Monetary policy transmission Mechanism used to effect central bank policy changes (e.g. lowered interest rates) in the real economy.

Eurosystem The monetary authority of the eurozone, composed of the ECB and the eurozone Member States' national central banks (NCBs) that apply the monetary policy laid down.

Yield spread The difference in return of two distinct investments.

Money market An exchange where financial institutions borrow from each other to finance their short-term funding needs. The interbank segment of the money market indicates bank-to-bank transactions and its activity (measured by the Euro Overnight Index Average, Eonia) can be used as an indicator of their confidence in each other.

Covered bonds Bonds that are directly connected to the asset in which the money is invested and thus offer investors extra security in case of bankruptcy of the issuer. The "collateral pool" often includes residential mortgages or public debt.

The ECB as crisis manager

The eurozone crisis has highlighted the dual role of the European Central Bank (ECB) as both guardian of price stability and crisis manager. As Jörg Asmussen, one of the six members of the ECB's Executive Board, put

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it, "there cannot be stability without adequately managing the crisis." Measures taken by the ECB throughout the crisis show a corresponding shift from standard monetary policy tools towards measures aiming to break feedback loops between financial markets and the real economy. When functioning properly, financial markets are effectively part of the monetary policy transmission mechanism as they translate the official ECB interest rates into rates on other financial markets. These rates influence private-sector investment and savings decisions, ultimately leading back to price stability. However, when confidence between market actors and in states' public finances evaporated, financial markets became illiquid and the ECB had to undertake non-standard, also called unconventional, measures to attain its primary objective.

Monetary toolkit

Financial turmoil: standard measures (2007-2008)

In the early stages of the crisis, the policy instruments the ECB used were similar to those of major central banks outside the Eurosystem such as the US Federal Reserve System (Fed) and the Bank of Japan:

- In early August 2007, when US sub-prime tensions first spilled over to eurozone money markets, the ECB responded to financial market turmoil during which the interbank money market froze. To reassure market participants about their ability to access liquidity to finance their day-to-day operations, the central bank provided unlimited overnight credit to eurozone banks through its Standing Facilities in a series of so-called fine-tuning operations (ECB short-term liquidity operations).
- On 6 September 2007, the ECB lengthened the average maturity of its open-market operations, transactions in which banks provide collateral in return for cash loans from the ECB. The supplementary refinancing operations had a maturity of three to six months and the ECB also addressed US-dollar liquidity shortage by borrowing dollars from the Fed and making them available to eurozone banks (swap lines).
- However, the ECB did not use its third standard monetary policy tool, the minimum reserve requirement of one percent of deposits which banks are obliged to hold at NCBs, until late 2011.

Global financial crisis: non-standard measures (2008-2010)

Under what the ECB has called "enhanced credit support", the Bank took a set of measures to revitalise financial markets after the collapse of investment bank Lehman Brothers. The measures included the following:

- The ECB first followed other central banks by cutting its policy rate progressively throughout the crises, reaching a then-record low of 1% on 13 May 2009.
- As for non-standard measures, to boost liquidity and in reaction to the growing tendency of banks to store their liquidity as central-bank deposits, the ECB decided in mid-October 2008 to extend the provision of liquidity by temporarily rendering its long-term loans unlimited.
- Allowing banks to make greater use of their balance sheet through the ECB, the central bank extended (first temporarily, then permanently) the list of accepted collateral for loans and further offered banks access to US dollars through foreign exchange swaps.
- Following a decision in early July 2009, the ECB started its Covered Bond Purchase Programme (CBPP1) under which NCBs bought covered bonds (a major source of funding for eurozone banks) both directly from issuers (primary market) and from other investors and banks (secondary market) to ease

funding conditions and improve market liquidity.

Eurozone sovereign debt crisis: more unconventional measures (2010-2012)

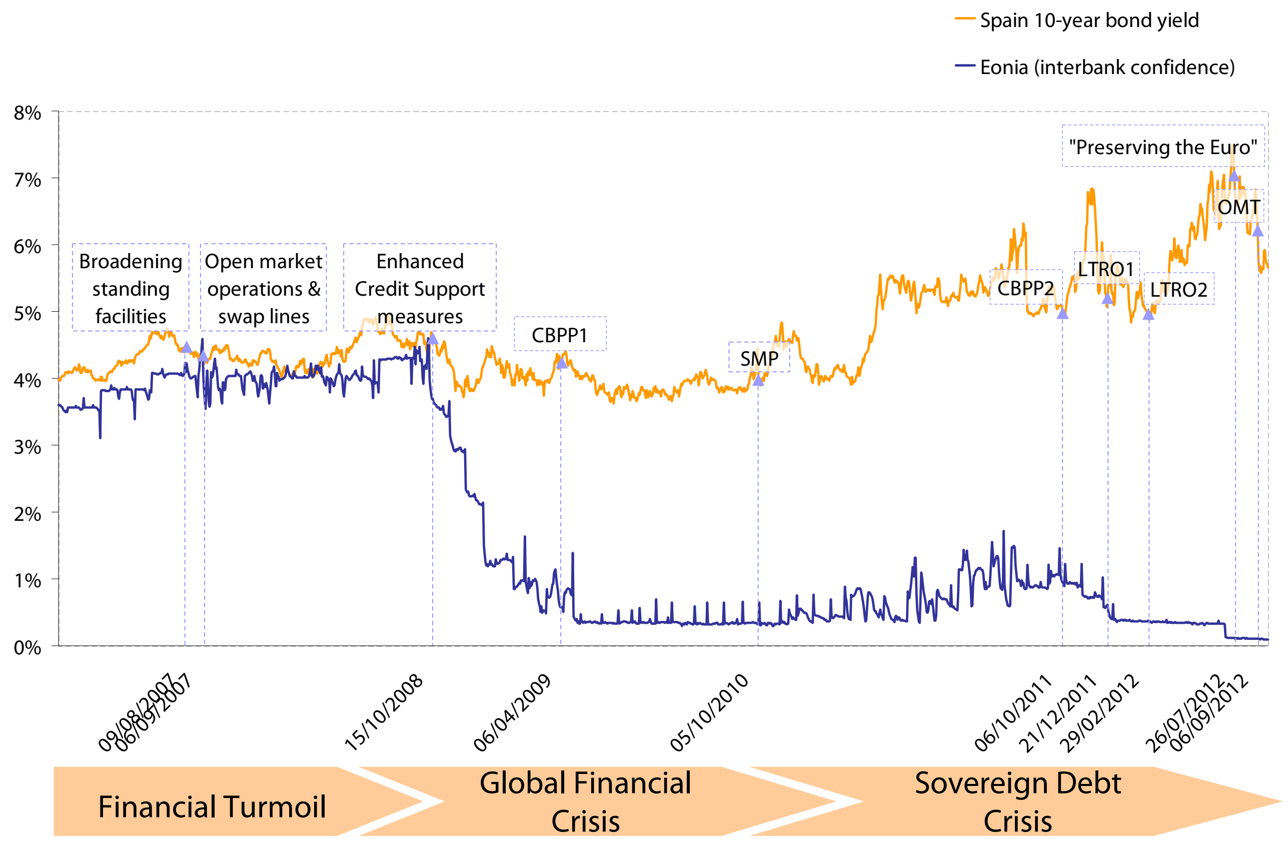
Influenced by financial market developments and initiatives from governments to boost economic growth, the sustainability of public finances came under pressure and the ECB engaged in another set of unconventional measures:

- On 10 May 2010, when markets started to panic regarding Greece's public finances, the ECB announced further outright purchases. Through its Securities Market Programme (SMP), it acquired sovereign debt securities held by other investors and banks and launched a second covered bond purchase programme (CBPP2) in early October 2010.
- In addition to further easing collateral rules and reducing reserve requirements, the ECB announced two Longer-Term Financing Operations (LTROs). In total, the ECB provided some 800 eurozone banks with one trillion euros in loans on 21 December 2011 and 29 February 2012. In doing so, the central bank hoped to stop the banking crisis from escalating and to ease the sovereign debt crisis by enabling banks to put forward a broader range of sovereign bonds as collateral. As Mario Draghi suggested indirectly, the loans could also ease governments' funding problems through banks investing the new funds in government debt.

Deepening eurozone crisis

Whilst the ECB measures above are said to have taken some pressure off the interbank market, in the real economy, banks' lending standards tightened and the debt crisis escalated further. Investor confidence in certain states (such as Greece) hit new lows, amid euro-exit speculation, and yield

Figure 1 - Timeline of ECB (un)conventional measures



Data source: European Central Bank, Forex (yields), National Bank of Belgium (Eonia) spreads with non-peripheral countries (such as Germany) grew. The SMP provoked fierce debate on the preferred status (seniority) of the ECB to other investors. LTROs high-lighted the ECB's role in replacing the interbank lending market and gave room for critics to point to the increased reliance of some banks on central-bank financing without addressing their longer term solvency or funding problems.

Confronted with these developments, Mario Draghi declared on 26 July 2012 that he was prepared to do "whatever it takes to preserve the euro".

Preserving the euro

On 6 September 2012, the ECB announced a further loosening of collateral rules for banks and the introduction of Outright Monetary Transactions (OMT) to repair distortions on the sovereign-debt market. It ended the criticised SMP (although it would continue to hold the government bonds acquired until maturity). It also re-established the "unlimited" possibility to buy bonds of peripheral states from other investors and banks.

This time the ECB will have the same status as other investors. However, a necessary condition for OMT is that the ECB will only buy bonds of Member States engaged in one of the macroeconomic adjustment programmes of the European Financial Stability Facility (EFSF) or the future European Stability Mechanism (ESM). This includes the more flexible Enhanced Conditions Credit Lines for Member States with lesser financial difficulties. As such, the OMT encourages governments to apply for these programmes. The ECB also seeks involvement of the International Monetary Fund to design country-specific conditions and monitoring.

Transactions, whose average duration details and country breakdown will be published monthly, are to focus on sovereign bonds with a maturity of one to three years. OMT is thus more restricted than the SMP which did not specify maturities. By focusing on short-term risks, the ECB strives to counter investor fears of a eurozone break-up and hopes to limit the central bank's own default risks.

A new role for the ECB

To reinforce the EU's financial architecture, the European Commission presented on 12 September 2012 its plans for a European banking supervisory authority. Whilst the plans are still to be agreed by the Council, which some believe will not be easy given all 27 Member States hold a veto, the Single Supervisory Mechanism (SSM) would be one of the key components (together with capital requirements, deposit protection schemes and a crisis management framework) in setting up a "banking union". The ECB would, involving national supervisory authorities, start supervising selected eurozone banks in January 2013, systemic banks in July 2013, and finally up to 6 000 eurozone banks by January 2014. A supervisory board of the ECB, distinct from its Governing Council, would have the final say on closing down weak banks.

ECB scepticism

Mario Draghi's last measures were received with optimism, for their clarity and precision. On the sovereign market, bond yields of Spain and Italy dropped in response to the new bond-buying plan. The initiative dampened fears of countries leaving the eurozone whilst also enabling governments to buy time for more thorough solutions. However, the long-term effects of ECB intervention have been subject to criticism.

ECB politicisation

The central banks of advanced economies are expected to act with a clear mandate and independence. Some claim the latter has been put in peril now that the new initiative links ECB decisions directly to policy actions by governments. Conditions imposed may continue the debate on the benefits of fiscal austerity. Jens Weidmann, head of Germany's Bundesbank and member of the ECB's Governing Council, voted against the OMT initiative. He has

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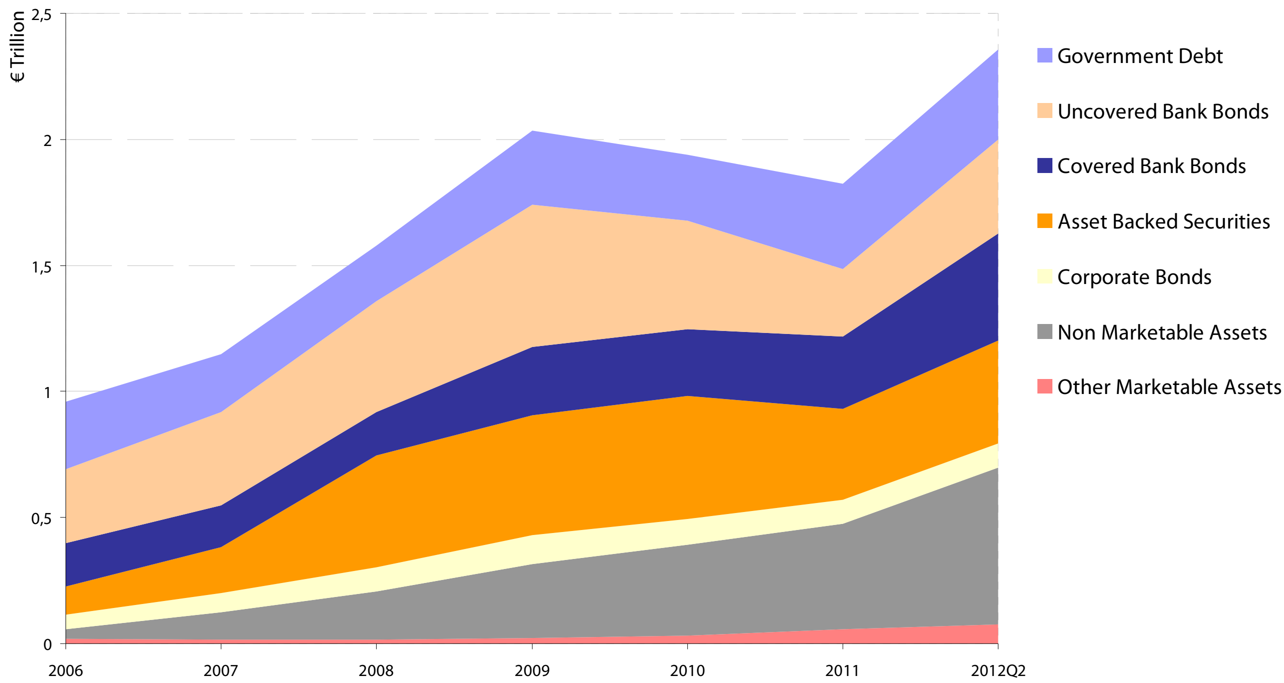
Figure 2 - Collateral held by the ECB



Data source: European Central Bank (collateral data)

openly criticised the purchase of sovereign bonds because "solving political problems" would threaten ECB independence and Eurozone price stability. Weidmann feels the ECB should not decide on pooling taxpayers' risks from different Member States. To make his point, he referred to Goethe's tragedy, *Faust*, in which printing new paper money ultimately leads to inflation and a destruction of the monetary system.

Moral hazard

Whilst the introduction of a link with EFSF programmes calmed some critics, the more relentless claim there remains room for countries to behave as, what banks call, "free riders". Now that the ECB has stepped forward to replace private investors to some extent, there could be a tendency for governments to reduce their own efforts to improve the attractiveness of their bonds. Moreover, it will remain difficult for the ECB to retire from a country when conditionality agreements are not met in order to avoid new fears of eurozone fragmentation.

Balance sheet risks

With a balance sheet above 30% of eurozone GDP (compared to approximately 20% for both the Fed and the Bank of England), JP Morgan estimates the ECB's balance sheet could easily grow by another trillion euros. Along with the extension of its measures, the ECB has more than doubled its balance sheet since 2007 and it accepted a wide range of collateral (see figure 2) from banks that had difficulties finding capital elsewhere. Although the ECB applies valuation "haircuts" – holding assets below their market value, reflecting their perceived risk – it still holds the credit risk on the collateral assets it accepts. At best this poses a risk to the central bank's credibility but harsher critics say it jeopardises the bank's solvency or may even turn the ECB into a massive "bad bank".

Wrong solution?

Some believe the solution to the eurozone crisis lies elsewhere and claim the ECB should deviate from its primary objective – price stability – to obtain a weaker euro by keeping interest rates low and through monetary easing. Weakening the euro would then enable a rise in exports outside the eurozone and enable intra-eurozone

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balancing of current account deficits and surpluses.

Position of the European Parliament

The European Parliament supports the crisis management role the ECB took up during the crises and pointed out in its resolution on the ECB's 2010 Annual Report that the ECB's balance-sheet expansion had, thus far, not led to inflation. EP President Martin Schulz also welcomed the new bond-buying programme of the ECB. He said he shared the Bank's stance on irreversibility of the euro.

Further reading

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