The European Central Bank in (the) Crisis

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Introduction

Since the eruption of the sovereign debt crisis in the euro area in May 2010, the ECB (or for that matter Eurosystem) has been in the spotlight of crisis management and resolution. Less attention has been paid to the impact of the crisis on the ECB itself. It is often argued or assumed that the sovereign debt crisis is the result of flaws in the framework of the euro.

This article takes another perspective. We begin by analysing the nature of the sovereign debt crisis, then discuss how the crisis has affected the functioning of the ECB and the euro, and how the ECB was forced to respond and evaluate the choices it made in formulating a response. Finally, we focus on the future and the challenges that lie ahead.

The nature of the sovereign debt crisis

The crisis was triggered by three different developments. The first was lack of discipline in the management of government spending and revenues. This was the case in Greece. The second was a gradual and continuous erosion of competitiveness, which was again the case in Greece, but also in Portugal and Italy. That led to structurally low economic growth, which subsequently threatened the sustainability of government debt. One could also make the same point by arguing that these countries have never fully adjusted to the requirements of the Single Market. Finally, the financial crisis of 2007-2008 had a very strong impact on the banking sector in some countries. Governments offered support to their banks in order to avoid a collapse of the financial system, which weakened government budgets and increased government debt. This negative impact was reinforced by the deep recession of 2009, which caused a sharp decline in government revenues. In countries like Ireland, and to a lesser degree Spain, this became a threat to fiscal sustainability.

The fiscal sustainability crises in individual countries became a threat to financial stability in the euro area, because of high financial integration in the euro area and due to (the threat of) contagion. High financial integration was reflected in the fact that, in many cases, a high proportion of the government debt of euro area countries is held outside the country concerned. Doubts about the sustainability of debt of a certain country therefore have an immediate impact on the solvency of banks across the euro area. The discussion about private sector involvement in the case of Greece and as an element in the functioning of the European Stability Mechanism (ESM) enormously reinforced the potential and actual spillover effects between countries and between government instability and financial sector instability.

What about the euro and the ECB? The main objective of setting up the ECB was to maintain price stability in the euro area as a whole. The ECB has so far been very successful in achieving its main objective: since the introduction of the euro inflation has on average been around 2%. That is lower than the average outcome for Germany in the era of the Bundesbank, and lower than in many other advanced countries around the world. The ECB has also succeeded in becoming a very highly respected central bank in the international arena. Therefore, the euro as such and the ECB are not the problem.

It is more a question of the sovereign debt crisis affecting the euro and the ECB through two channels. The first channel (discussed above) is the creation of (potential) financial instability in the euro area. This is an issue for the ECB because one of its tasks is to contribute to the financial stability policies of the competent authorities without prejudice in terms of maintaining price stability.

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The second channel is even more fundamental from the perspective of the euro, because it affects the conditions for the existence of the euro and the ECB's capacity to maintain price stability in the euro area. The so called convergence criteria are fundamental to the existence of the euro and the possibility of running a single monetary policy for the euro area. These criteria should not only be fulfilled as a condition for introducing the euro and for entering the euro area at the moment of entry, but should be complied with on a sustainable basis. The latter means that compliance must be ensured after adopting the euro.

This is where things have gone wrong. Let us first recall that the convergence criteria relate to government finance, long term interest rates, inflation and real exchange rates. In the year before the introduction of the euro it was realised that compliance with the government finance criteria after the introduction of the euro did require additional measures and procedures, so the Stability and Growth Pact was introduced. However, it is now abundantly clear that this Pact was not complied with and that government finance criteria are still not respected by many euro area countries.

The other criteria were more or less ignored. The interest rate criterion is closely related to the government finance criterion. At the moment, a number of euro area countries no longer fulfil this criterion, which specifies that long-term rates should not deviate by more than 200 basis points from the average long term rate of the three best performing countries in terms of inflation.

The relevance of the other two criteria after adoption of the euro was contested before the euro was introduced. It was argued that after adoption of the euro they would tend to be automatically fulfilled. This was underpinned by endogenous optimal currency area literature (Frankel and Rose 1998). The assumed mechanism was that, in the absence of the exchange rate as an adjustment escape mechanism, structural reforms would be triggered that would lead to automatic convergence of inflation and competitiveness. Not everybody agreed and there were coordination mechanisms for economic policies introduced in the governance of the EU and euro area. However, they were weak and they could not prevent non-compliance with the criteria cited above over time. It can also be concluded that the endogenous optimal currency area theory has been convincingly falsified.

Consequences for the euro, the ECB and the ECB's response

All in all, the sovereign debt crisis means that the fundaments of the euro have been eroded and that the possibility for implementing a single monetary policy in the euro area has been significantly reduced in principle. In practice, this was hidden to a certain extent in a way by the deep recession that followed the financial crisis. As a result, very loose monetary policy was appropriate everywhere, although this is hopefully not a structural situation.

Nevertheless, the ECB was immediately thrown into the spotlight after the sovereign debt crisis hit in May 2010. There were three aspects to its responsibilities: future prevention, crisis resolution and crisis management. In future prevention and final crisis resolution, the ECB can only offer its analysis and views. The responsibility is in the hands of the politicians. These are not areas that put pressure on the (cohesion of) the ECB Governing Council's decision-making. All Council members have a similar interest, although they may somewhat disagree on the precise content of the measures to be taken. We will later argue that the impact on the single monetary policy of the crisis resolution may again cause strains within the Governing Council. Initially, however, resolving the crisis is a matter for the governments of the euro area. It is in the area of crisis management that the ECB and the cohesion of its Governing Council was quickly put to test. During the Greek sovereign debt crisis market turbulence increased to high levels and interest differentials against Germany went up sharply.

The ECB identified the underlying cause as excessive deficits and debts, but was also aware that there was no immediate remedy available at a government level. The EFSF (the European Financial Stability Facility, the emergency fund) had not yet been created and it was going to take time to negotiate a programme for Greece.

The Securities Markets Programme

The ECB Governing Council found itself in uncharted territory. For the first time it had to take a decision on whether and how to intervene in government debt markets. This was, of course, no ordinary monetary policy decision. It could even be debated whether the decision was indeed a monetary policy decision, or whether it was about supporting finan-

cial stability measures taken by governments. The fact that intervention could be seen as being directed against market turbulence and that reference is made to financial stability in the EFSF could have been an argument for grounding intervention in financial stability considerations. In the end, however, the monetary policy argument for intervention was used. With hindsight it can be argued that a financial stability based intervention would have had the advantage of perhaps making it easier to immediately transfer the bonds purchased in the context of the interventions to the EFSF when that fund was finally ready. A disadvantage for the ECB would have been that, according to the Maastricht Treaty, monetary policy decisions can be made in complete independence, while supporting financial stability is a secondary task.

As we have seen above, monetary policy was indeed impacted by the sovereign debt crisis. Spreads became higher in some markets than allowed by the convergence criterion on long-term interest rates. The ECB argued that the Securities Markets Programme (SMP) in the context of which it started to buy government debt in the secondary market, aimed to facilitate the homogenous transmission of monetary policy.

However, this was not a straightforward argument. The Treaty is clear on the fact that the ECB is not allowed to buy government bonds in the primary market. It does not forbid such purchases in the secondary market, but the ECB had developed the view that such buying should be limited so as not to circumvent the rule of not buying in the primary market. Was the SMP consistent with (the spirit of) the no bail out clause? Whatever the case is legally, it must be taken into account that the ECB had to decide and operate in an environment where some EMU rules had been clearly violated, i.e. the convergence criteria. So it had to operate in an environment where the foundations for the single monetary policy had been damaged. In other words, the ECB had to make choices and operate in a world where the rules of the game were not respected.

There was also a substantive argument against the SMP. By buying government bonds the ECB would relieve market pressure on the governments concerned to consolidate and adjust. This is the argument of induced moral hazard and why the ECB stressed the temporary nature of all of its so called unconventional measures and thus also of the SMP.

In the popular press there were also voices that said that the SMP would be inflationary. That is why the ECB decided to sterilise SMP purchases on a weekly basis. This was a communication devise rather than anything else. It is worth remembering that the ECB implemented full allotment by as early as the end of 2008. This meant that the monetary base was demand-determined, whether the ECB sterilised or not. Moreover, since there is no mechanical relation between the monetary base, M3 and inflation, avoiding an inflationary impact from the SMP can never be ensured by sterilising the purchases. However, in practice, there was no worrisome increase in the growth of M3, which remained very modest.

It became rapidly clear that the decision to set up the SMP was contested within the ECB Governing Council. Axel Weber made his opposition public and later it became also clear that Jürgen Stark had never been in favour. Other Council members did not say in public that they were against the SMP, although there were rumours that some other members from traditional hard currency countries started to feel very uneasy with it after a while too. In any case, this was not good for the credibility of the ECB, which until the introduction of the SMP, had built a reputation of very effectively handling the financial crisis.

The SMP was meant to be temporary, but governments did not take sufficient measures to end the market turbulence or to make it possible for the ECB to (gradually) exit the programme. There was a period beginning in spring last year when tensions in the markets became smaller. The size of the SMP more or less started to stabilise at around 70-75 billion euro and started to look like it would die quietly, until the crisis flared up again when Spain, and later Italy, came under pressure. A very rapid increase in the size of the SMP to well above 200 billion euro was the result. The SMP purchases only came down when the ECB under its new President Mario Draghi announced two three year LTROs with full allotment (see below).

The SMP not only affected the homogeneity of the Governing Council, it also strained the relations between governments and the ECB. The ECB became increasingly annoyed with governments for not taking measures that went to the root of the crisis. As of May 2010 a "muddling through" scenario developed. The ECB had to continue to operate in very challenging situations and was also forced to

write letters to governments to force them to take consolidation measures and implement structural reforms as a condition for being prepared to purchase bonds. This is a very unpleasant and undesirable position for a central bank to be in. The central bank is independent, but in the longer term that can only be the case if it has a clear and limited mandate. Setting the fiscal policy of sovereign states is clearly not part of such a mandate. On the other hand, the ECB became hostage to governments who counted on it to intervene in markets when pressures mounted due to a lack of action on their part. Although formally that does not affect the independence of monetary policy, in practice it can be (seen as) a step in the direction of less independence and of substituting fiscal for monetary dominance.

Addicted banks

As a response to the financial crisis the ECB introduced full allotment of its refinancing operations at the end of 2008. This is perhaps the most important policy measure that the ECB had introduced before the sovereign debt crisis. As a byproduct of full allotment, a number of banks addicted to ECB credit had emerged. The purpose of full allotment was to provide funding to banks that could no longer rely on the professional funding markets, and the interbank market in particular, which almost completely dried up as a consequence of high uncertainty after the collapse of Lehman Brothers.

Full allotment turned out to be an effective instrument to alleviate market turbulence. However, it has proven a blunt instrument too (see also Hoogduin and Wierts 2012). Its purpose is to provide liquidity support, but it can also be a lifeline for banks that do not have a liquidity, but an underlying solvency problem. Restructuring or resolution of such banks is postponed and they continue to exist as so called dysfunctional Zombie banks in the financial system. It should be noted that the EU Commission has accepted this type of support to banks without demanding restructuring measures like it did in the crisis of 2008/2009. This raises important level playing field questions between euro area banks. Another result of full allotment can be that some banks take on additional ECB funding to take unwarranted risk or to continue to fund loans that are not profitable. That has the potential to create new Zombie banks and flatter the solvency of some firms.

The sovereign debt crisis and (the discussion about) private sector involvement caused a resurgence of uncertainty in markets and put additional stress on balance sheets in the financial sector. The more government debt of (potential) problem countries on the balance sheet, the greater the impact. As a result the amount of ECB funding increased. This was particularly the case in (potential) problem countries, since banks in these countries generally had the biggest problem in attracting funding. This also created an incentive to invest in own country government debt to be available as collateral for ECB funding.

As a result, not only did the ECB buy government debt through the SMP, but its exposure to the banking system of (potential) problem countries also rose, as did the collateral pledged by banks from these countries. Over time the government and the financial sector became increasingly interlinked. Banks started to hold a growing amount of government debt and the risk that governments had to support their banking systems increased with the weakening of the banks' balance sheets.

Generally speaking, the Eurosystem became the hub between the banks of (potential) problem countries and the banks of the other countries. This led to an increase in the size of the balance sheet of the national central banks. In the (potential) problem countries, credits to banks increased; and on the liability side so did the so called Target 2 balances. In the other countries Target 2 balances increased on the asset side while deposits of banks in their country rose on the liability side. This reflects the fact that the euro area money market no longer functions and has been taken over by the central bank (see Sinn and Wollmershauser 2011 for a comprehensive analysis). As long as the euro area remains intact, claims via Target 2 do not pose a problem. In case of one or more countries leaving the euro area there is at least uncertainty as to whether these claims will be (fully) honoured. They can therefore be seen as a tail risk.

The main problem is the exposure of individual banks or banking systems, which is far higher than would have been possible under the normal allotment system (flexible rate tenders with a minimum bid rate). An exit from the full allotment to the normal system is not on the horizon, but has become an even trickier issue than it already was. The situation became even more serious after the adoption of new unconventional measures at the end of last year. They are the subject of the next section

The different situations of countries in the euro area makes it more difficult than in normal times for Governing Council members to strictly focus on the euro area as a whole in their decision making.

Three year LTROs and collateral measures

When problems mounted again towards the end of last year there was apparently resistance in the Governing Council to accelerating and increasing purchases of government bonds under the SMP. The new President of the Bundesbank Jens Weidmann even argued in public that this would not be compatible with the Treaty. The point was made by the Governing Council in the person of President Draghi that governments first had to adopt a so called fiscal compact, which would minimise the risk of similar problems in the future (Draghi 2011).

After governments had announced that they would negotiate such a fiscal compact in the form of an intergouvernmental treaty, the majority of the Governing Council was apparently prepared to take action. However, resistance by some against increasing the SMP further had not disappeared. It should be noted that in Germany in particular there was also broad and strong opposition outside the Bundesbank to the SMP.

The ECB then surprised everybody by announcing two long-term refinancing operations (LTROs) with a 3 year maturity and full allotment (against collateral). It also allowed seven national central banks to accept a wider range of collateral against ECB refinancing operations (Draghi 2012). These combined measures led to a liquidity injection in the banking sector of over 1000 billion Euro. The above mentioned problems of full allotment were magnified in the process. The collateral measures contributed to a further fragmentation of the euro area money market.

It is surprising that the ECB announced two LTROs. Why not just announce one and wait for the result? Why a maturity of three years and not of one, as in the past? Why did the ECB not introduce a cap to remain in control of its own balance sheet? The reason is probably that the ECB wanted to "shock and awe". That put a premium on more and on longer maturities than the market had become used to in the meantime. It worked very well since market turbulence disappeared, the spreads of Spain and Italy came down and, more generally, the prices of risky assets increased.

However, since the ECB measures in themselves do not address the underlying problems of the sovereign debt crisis, it remains to be seen how permanent this market stability and higher risk appetite will turn out to be. If turbulence returns, there will probably be further demands for either additional LTROs and/or for the ECB to increase the size of the SMP. This will put further pressure on the homogeneity of decision making in the ECB.

We also wonder whether the ECB did not act too early by only asking for a fiscal compact. It would probably have been better to also ask for a sizable increase in the EFSF/ESM with euro area guarantees or resources as a condition for considering any additional ECB measures. In the end, the underlying problems are for governments to solve. Therefore, it might also have been made clear that any ECB action should be preceded by EFSF/ESM action after the emergency funds had been first increased sufficiently. By acting earlier the ECB has reduced pressure on euro area governments to decide on a sizable increase in the emergency funds. We would also have preferred a further increase in the SMP to that of the LTROs and collateral measures. The SMP addresses the problem of sovereign debt at its roots without involving the banking system and without causing the related spill over effects.

We do not agree with the point of view that this is not in line with the Treaty. As mentioned earlier, the ECB has the task of contributing to the financial stability policies of the competent authorities, as long as this does not conflict with maintaining price stability, which is its prime objective. There are no restrictions with respect to the timeframe or size of possible measures in this context, but they can never be automatic. In the context of the sovereign debt crisis, the ECB should continuously assess whether high interest rate spreads are the result of insufficient consolidation, or of unorderly markets. If the latter is the case, it is first up to the EFSF/ESM to intervene. If tensions do not abate even after such interventions, there is also room for the ECB to take action.

The challenges ahead and conclusion

The sovereign debt crisis has forced the ECB to take far-reaching, unconventional measures. The measures have been successful in calming down markets, but by their very nature they cannot solve the crisis. They can only buy time for governments to take the necessary measures to address the underlying problems.

The ECB has been put in a difficult position. The crisis has caused strains within the Governing Council. There are different views on the appropriate response to the crisis and, since countries are in different positions, it is more difficult for Council members to adopt a euro area, rather than a more national perspective.

The unconventional measures have negative side effects. They lead to a further segmentation of euro area financial markets and can, as such, be seen as a step towards renationalisation of monetary policy. They tend to create Zombie banks and thereby run the risk of creating a financial system that is not fully functional. It is therefore of the utmost importance that the ECB makes a plan to bring these measures to an end in an orderly fashion. That will not be easy. If it moves too early, it may create serious financial instability. If it moves too late, inflation may go up significantly. It should be noted that financial stability is a necessary condition for price stability in the longer term; and that price stability is a necessary condition for financial stability.

The greatest challenge is probably due to the fact that not all countries of the euro area currently fulfil the convergence criteria; and this will probably the case for quite a number of years to come. Fiscal consolidation and restoring competitiveness in particular take time.

What is needed in the next decade or so is a renewed convergence process. Unlike the convergence process leading to the introduction of the euro, this process must be completed by countries that have already adopted the euro. Letting countries temporarily leave the euro area is an option in theory, but not one that should be pursued. It would permanently change the nature of EMU from a currency union to a system with fixed, but adjustable exchange rates. Apart from the political issues involved, we know that fixed but adjustable exchange rate regimes are unstable.

Different necessities and speeds of fiscal consolidation mean that the business cycle conditions will probably be quite different between countries that make a strong fiscal consolidation effort and the rest. Countries can restore competitiveness through different types of measures. Some of these measures are not related to the price of their goods and services (non-price competitiveness), but others put a downward pressure on the price level.

It is inevitable that the convergence efforts of the countries that have to consolidate their public finances and that have to improve competitiveness have a deflationary impact on euro area growth and inflation. This leads to an old question in a new context: should inflation below 2% in converging countries be compensated for by inflation above 2% in the rest; or should the objective be to keep inflation close to, but below 2% in the countries that meet the inflation convergence criterion?

In our view, in setting its monetary policy the ECB should not take into account the downward pressure on the euro area price level and inflation as a result of convergence efforts in a number of euro area countries. If it were to do this, countries like Germany would pay an intransparant and not democratically sanctioned compensation to the countries in convergence by accepting higher inflation. On top of that, countries like Germany would be at risk of generating asset price bubbles as a result of having excessively low interest rates for too long.

Therefore, a change in the ECB monetary policy strategy is required for the period of the convergence process. The ECB should continuously assess the impact of convergence measures on the inflation outlook for the euro area as a whole. Its objective in the years ahead should be to keep euro area inflation corrected for the impact of convergence measures below, but close to 2%.

This will definitely make monetary policy more complicated and there is also a risk of it becoming less transparent. The latter risk should be addressed by publishing the methodology for correcting the euro area inflation rate for the impact of convergence measures. Having a more complicated monetary policy (strategy) is the lesser evil. Therefore, it is urgent for the ECB Governing Council to take up this issue. It is urgent, because first signs of the current interest rate being too low for Germany are emerging. House prices, for example, have recently increased by 5.5% on an annual basis in twenty German cities.

The question of whether and how countries that go through a convergence process should be supported is a political one. It is inevitable that adjustment is costly. There are motives for the other countries to be prepared to offer support. It is also in their interest that countries convergence. It would make a single monetary policy less complicated, as we have seen. Moreover, a stable Southern Europe is also

important for the political and economic stability of the rest of the euro area. Finally, solidarity with fellow Europeans could be an argument for providing support.

If it were decided to offer support, this should not take the form of monetary policy or of expansionary budgetary policy. Support can take the form of technical assistance, financing the adjustment process for a rather long time and/or at favourable interest rates, promoting private investment from the rest of the euro area in the countries concerned, directing more EU structural funds to the countries in convergence and/or increasing the size of such funds, etc.

Finally, it should be noted that an improvement in the competitiveness of Southern European countries will have implications for other countries. In itself it will lead to an increase in imports from and a decrease in exports to these countries. This implies a fall in economic activity in these countries. Sometimes it is argued that these countries have to run more expansionary budgetary policies to compensate for this fall in activity. We do not agree and see this as a non sequitur. What it does imply is that the economies in these countries should be flexible enough to substitute other private activity for the fall in activity resulting from the convergence process in Southern Europe.

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