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The difficult normalization of the ECB

The low-debt countries do not want to «pay for» the high-debt countries via the European Central Bank while the high-debt countries seem unable to rein in their budget deficits. A column by Charles Wyplosz.

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«In spite of considerable progress, the ECB is still not a normal central bank.»

Finally, the European Central Bank (ECB) has made its first move toward fighting inflation. Hopefully, we can now shift from endless discussions among ECB watchers about the size of the first step of this new phase to the mew monetary strategy that will unfold over the coming period.

About the author

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Whether the interest rates would rise in July by 25 or 50 basis points is immaterial, except for the investors whose private interests should not matter much for the euro area citizens, corporations and governments. How can anybody be surprised that it ended up being 50 basis points? By now, many other central banks have raised their interest rates by larger amounts because inflation has jumped to levels so far above their official targets that it would take forever to make a mark with 25 basis points steps. Coming so late in the game, the ECB had no sensible

alternative than to follow the crowd, especially as it delayed reaction has pushed the euro down, which of course further feeds inflation.

The reason why many ECB watchers were still betting on a 25 basis points increase is that the ECB had signaled such at a step at its previous meeting. This announcement did not make much sense then. The ECB should be commended for having eaten its hat and announced the end of forward guidance. Forward guidance is helpful under two conditions. First, the uncertainty is limited enough for the central bank to have a pretty clear view of what it will do over the medium term. Second, it must be understood that forward guidance is not a commitment. It is a statement of current expectations. When inflation was stuck at a very low level, forward guidance made sense, but with each new data release coming as a big surprise, this is not the case anymore. The first condition required for forward guidance is not currently met. By fulfilling the second condition, the ECB makes it possible to return to forward guidance in the future.

Interest rates of 4% to 5.5%

Still, it matters a lot how far the ECB will have to raise its interest rates. A simple calculation runs as follows. The ECB's latest forecasts (June 2022) anticipates an inflation rate of 3.5% in 2023 and about 2% in 2024. Given that the usual time lag of monetary policy effect is upward of one year, for monetary policy to be restrictive now, the ECB's deposit rate should exceed 3.5% plus the equilibrium real rate. The equilibrium rate is unknown, but estimates range from 0.5% to 2%, which calls for an interest rate of 4% to 5.5%.

Interest rates at this level stand to upset the sustainability of public debts. This has led to fears that the ECB will not dare raising interest rates enough to contain inflation. Its response is the new Transmission Protection Instrument (TPI). Beyond the jargon, this instrument makes it possible for the ECB to buy specific national public debts that come under serious market pressure. The new instrument comes on top of the existing Outright Monetary Transactions (OMT) instrument – aka «whatever it takes» – and the Pandemic Emergency Purchase Program (PEPP). With PEPP, as it conducts quantitave easing (QE), the ECB can buy larger quantities of potentially unstable debts. It is not adapted to a crisis situation, although it can be used as a signal to the markets. OMT is powerful because it allows for unlimited debt purchases, but it is subject to conditions that stand to delay action, especially the existence of a program agreed with the European Stability Mechanism. It worked in 2012 because the

countries likely to benefit had such a program. These days, the likely beneficiary, Italy, does not have a program, and is unlikely to apply for one.

Like OMT, TPI also allows for unlimited interventions, a necessary condition to deal with a crisis situation. However, it also comes with conditions, four of them in total. Two conditions refer to the Stability and Growth Pact: the beneficiary country should not be subject to an Excessive Deficit Procedure or to an Excessive Imbalance Procedure. As the pact is suspended until the end of 2023, these conditions are moot, for the time being. After 2023, TPI interventions may have to rely on the Commission's willingness to adequately twist its oversight. The third condition requires that debt sustainability analyses (DSAs) issue a green light. The purpose is to declare that the debt crisis is of a self-fulfilling nature, not driven by bad fundamentals. Since DSAs are driven by assumptions about the long run, it will always be possible to make the right assumptions to reach the right conclusion.

Potentially lethal debt crisis

Although it is driven by economic considerations, this condition is really political, since it gives the opportunity of member countries to debate these crucial assumptions. It is an astute compromise, but one that can backfire if governments start quarreling just when markets shift to a panic mode. The last condition requires compliance with the current Resilience and Recovery Facility. Clearly, this is a post-Draghi clause aimed at the next Italian government, which could be tempted to give up on the reforms promised by Super-Mario.

President Christine Lagarde has correctly indicated that the interest rate increase phase and the TPI are tightly linked. Without the TPI, the ECB could face the impossible trade-off between bringing inflation down and triggering a potentially lethal debt crisis. The TPI can do marvel but its conditionality injects some uncertainty, which is outside the ECB control. This situation reflects the fact that, in spite of considerable progress, the ECB is still not a normal central bank.

Survival of the euro at stake

In other developed countries, it is understood that the central bank will not allow the public debt to fall prey to a speculative attack. The ECB is in a different position. According to the Maastricht Treaty, it is not allowed to bail any member country out. A strict interpretation rules out any action that may be

seen as a bailout, and this is arguably why it took the ECB two years to adopt the OMT instrument, leaving in its trail a succession of highly damaging debt crises. A ruling by the European Court of Justice on the OMT has removed the strict interpretation, but the ECB still feels obliged to set conditions to stay clear of further legal proceedings, and to avoid conflicts among high-debt and low-debt member countries.

This is precisely what it just achieved with the adoption of the TPI. However, as argued above, these conditions may stand in the way of emergency interventions and make it impossible for the ECB to thwart a budding debt crisis. In that sense, the ECB is not yet a normal central bank. In addition, this risk may discourage the ECB from firmly bring inflation down. This is another way in which the ECB is not a normal central bank. Beyond legal considerations, the ECB is hindered by the lack of trust among its member countries. The low-debt countries do not want to «pay for» the high-debt countries via the ECB and the high-debt countries seem unable to rein in their budget deficits. Something mut give to ensure the smooth functioning, even the survival of the euro.