DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

THE ROLE OF THE ECB IN FISCAL ADJUSTMENT PROGRAMMES

Abstract

Under the pressure of a historical challenge, the ECB has taken a number of bold initiatives. Yet, for much of the last three years, along with government and Commission policymakers, the ECB has been "behind the curve", responding to market pressure rather than taking pre-emptive action. The poor institutional setup of the Euro Area goes a long way to explaining this mixed record. Recent moves, however, are encouraging.

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EXECUTIVE SUMMARY

Under the pressure of a historical challenge, the ECB has taken a number of bold initiatives. Yet, for much of the last three years, along with government and Commission policymakers, the ECB has been "behind the curve", responding to market pressure rather than taking pre-emptive action. Recent moves, however, are encouraging.

The creation of the Troika is unprecedented. Hitherto, the IMF has never shared the design and supervision of adjustment programmes. Its normal procedure has been to carry out these functions alone, turning to "friendly countries" for additional resources. The programmes involve precisely quantified loans to the country in difficulty, two third of which are provided by Europe and one third by the IMF. Yet, in parallel, the Eurosystem has provided amounts that are of the same order of magnitude, mostly through the SMP, which means by monetizing existing debts. As such the ECB has acted as lender of last resort, an interpretation that it fiercely denies but stating that it is merely maintaining a key channel of monetary policy.

The ECB has also provided massive liquidity to banks. Denying that this represents lending in last resort, it has again claim that its motivation is to keep up the policy transmission mechanism. All in all, the ECB has massively increased the size of its balance sheet. These interventions imply that the ECB has absorbed large amounts of securities, both public and private, which is risky but entirely justified. It remains that the ECB stands to suffer large losses that will ultimately borne by the member states. There is nothing wrong with that, except for the denial that it is lending in last resort.

Lending in last resort is a function that has fiscal policy aspects. This is the reason why the ECB is uncomfortable with this interpretation. It should be complimented to have taken these actions in the midst of a complicated institutional setup and in front of internal and external opposition. On the other hand, its continuing insistence that these actions are temporary and limited has greatly undercut their effectiveness. Indeed, the ability to muster as necessary unlimited resources is what makes central banks so uniquely powerful in crisis situations. Instead of dispelling market fears by being "ahead of the curve", the ECB has fed these fears by claiming to simply react to unique situations.

In fact, the ECB could have gone a long way in preventing the crisis from festering and spreading by acting more forcefully and presenting its actions as part of determined plan to assuage market uncertainty and fears. Fearing to be dragged into quasi-fiscal policy action, the EBC has insisted that it is for governments, and for governments only, to take action. Of course, all central banks in this kind of situation are similarly reluctant. As a result, the ECB has established the notion that the euro is in effect a foreign currency for the Euro Area member country, which is one of the reasons for contagion.

Fortunately, the "new ECB" that emerged at the end of 2011, seems to be ready to jump "ahead of the curve". It has conducted massive LTROs while pushing governments to adopt the paradigm-shifting Fiscal Compact. Currently, it seems to arrange a similar quid pro quo with reluctant governments: acting as lending of last resort for banks in exchange for the creation of a single European bank regulator, a necessary step that has been blocked since before the creation of the euro.

1. INTRODUCTION: THE ISSUE

Since the start of the sovereign debt crises, three countries (Greece, Ireland and Portugal) have requested support from the IMF and from others Euro Area countries. More countries (Spain and Italy seem to have reached the point of no return) are likely to follow. In many respects, this has been unprecedented action. It was clearly not anticipated in European treaties. Never before has the IMF shared the elaboration of adjustment programmes; in fact, it explicitly rejected such an arrangement during the Asian crisis in 1997-8. As for ECB, it has played an active role by buying public debts on the secondary market, in apparent contradiction with its own pre-crisis principles. It has also repeatedly lowered its criteria for accepting public debts instruments in its refinancing operations, additionally extending these operations and shifting to "full allotment".

At the same time, little is known of what exactly is the role of the ECB. ECB representatives join Commission and IMF staffs when drawing out adjustment programmes and during assessment visits in the relevant countries. The ECB position in these discussions is not revealed publicly. The official statements from the Troika are jointly issued. The present report is based on ECB documents, in fact on the information provided either in the *Monthly Bulletin* or in statements published on the EB website, none of which reveals the Bank's views. In fact, the ECB insists that its involvement in the adjustment programmes is not directly related to monetary policy; the Bank's view is that it only matters as it affects the effectiveness of monetary policy.

These various aspects of the ECB's role since the start of the sovereign debt crisis raise a host of new and important questions, which are taken up in the next sections. Section 2 provides a critical description of what seems to have been the ECB's role. Section 3 evokes other actions that the ECB might have been taking. Section 4 briefly explains why I believe that the strategy between early 2010 and late 2011 has been wrong, as a prelude to an evaluation of the ECB's actions. Section 5 covers the most recent period and the last section concludes.

2. THE ROLE OF THE ECB

Greece started to face mounting tensions soon after the general elections of October 2009. The financial markets, which had so far considered Greece's public debt, expected the newly elected government to tackle its huge deficits and quickly rising debt. The failure of the government to send signal that it understood the problem and was prepared to act in one way or another unnerved investors that held significant amounts of the debt. At that stage, there was no certainty that Greece could not fully pay its debt but the initial denial that some drastic action was needed – not necessarily immediately – along with the revelation that the debt was larger than previously announced convinced many investors that Greece was unable or unwilling to fully honour its financial commitment. In a few weeks market sentiment changed and Greece shifted from a manageable situation – a good equilibrium – to a full-fledged crisis – a bad equilibrium. The value of Greek debt instruments started to decline, which meant that interest rates rose. This meant increasingly high borrowing costs at a time when the public deficit stood at 16% of GDP, a huge number. The situation had become definitively unsustainable. The same self-fulfilling process repeated itself later on in Ireland and Portugal and it is under way in Spain and Italy.

For years, the EBC had expressed concern about insufficient fiscal discipline within the Euro Area. It also publicly wondered about the small size of interest rate spreads (apparently ignoring that its own acceptance of all public debts at full value was in effect pegging national interest rates to each other). It saw the mounting pressure on Greek debt as a vindication of its often-restated position. It reacted by calling upon all governments to promptly close their deficits:

"The very large government borrowing requirements carry the risk of triggering rapid changes in market sentiment, leading to less favourable medium and long-term market interest rates. […] High levels of public deficit and debt would place an additional burden on monetary policy and undermine the credibility of the provisions of both the Treaty on the Functioning of the European Union and the Stability and Growth Pact as a key pillar of Economic and Monetary Union. The Governing Council therefore calls upon governments to decide and implement in a timely fashion ambitious fiscal exit and consolidation strategies." *Monthly Bulletin*, January 2010, p. 7.

The European Commission, which has seen itself as in charge of implementing the Stability and Growth Pact, shared that view. They did not evidence any concern that Greece was in recession since 2009 and that growth was weakening in many other countries. In February, the Greek government bowed to pressure from both the Commission and the ECB and announced a set of measures (spending cuts and tax increases). The ECB applauded:

"The Governing Council of the European Central Bank (ECB) welcomes the convincing additional and permanent fiscal consolidation measures, which the Greek Government announced earlier today. We appreciate the envisaged very swift implementation of these measures, which are both necessary and appropriate to make significant progress with fiscal consolidation in 2010." Press release, 3 March 2010.

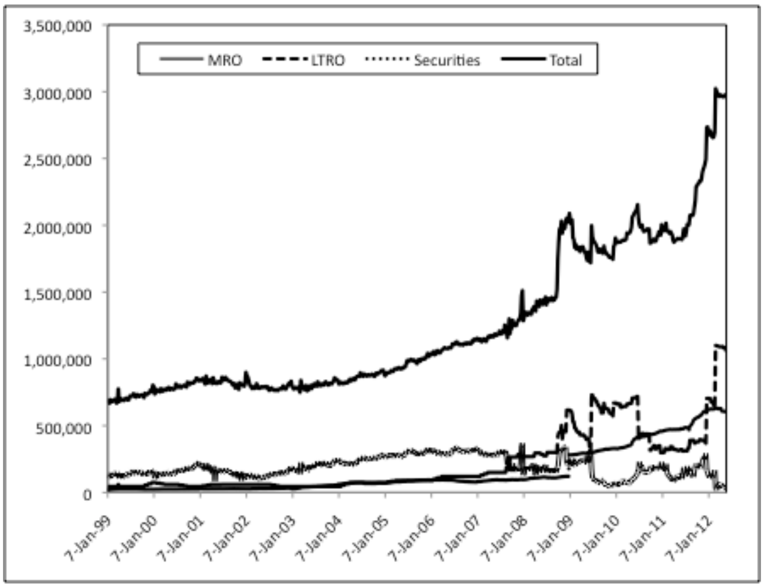
Markets were unconvinced and interest rate spreads rose to the point where the Greek authorities could not access the market anymore. This led to the May 2010 bailout and the creation of the Troika. The creation of the Troika is unprecedented. Hitherto, the IMF never shared the design and supervision of adjustment programmes. Its normal procedure has been to carry out these functions alone, turning to "friendly countries" for additional resources. The same arrangement has been applied subsequently. The IMF contributes one third of each package, the rest being provided by the Euro Area countries (using the EFSF and EFSM). These are loans, not presents. They increase the relevant country's official debt. The ECB is not part of this financing but operates the Securities Market Programme (SMP), buying public debts on the secondary market. Three aspects of the SMP are notable.

- First these purchases have been targeted both in time and in term of the debts purchased.
- Second, SMP interventions are not loans, but asset purchases. While this may be interpreted as debt monetization, the ECB systematically insists "the objective is to restore an appropriate monetary policy transmission mechanism, and thus the effective conduct of monetary policy oriented towards price stability in the medium term" (http://www.ecb.int/home/glossary/html/act4s.en.html).
- Third, these interventions are meant to be sterilized to avoid any impact on the money supply and therefore to avoid to have any monetary policy implication.

Targeting means that purchases were either following the adoption of a formal programme (Greece, Ireland and Portugal) or to defuse tensions beforehand (Italy and Spain). The amounts bought, some € 210 billion, can be compared to € 256 billion, the total amount committed by both the EU and the IMF, but not fully disbursed, to the three programme countries. Thus, so far, the EBC has been the largest contributor to the state bailouts, explicit (Greece, Ireland and Portugal) or implicit (Italy, Spain). (Not counted is the promised € 100 billion EFSF loan to Spain under negotiation.)

In addition, through various programmes, the ECB has provided massive liquidity to banks, always under the cover that the intention is "to restore an appropriate monetary policy transmission mechanism". In most cases, indeed, the ECB has stepped in to replace broken interbank linkages, including a fragmentation of liquidity circulation along national lines. Unable to find liquidity on the interbank market, frightened banks – it is the lack of access to liquidity that led to the failure of Lehman Brothers in 2008 – have undertaken to stock up huge amounts of cash. These various interventions are visible in Figure 1, which displays the evolution of the total balance sheet of the Eurosystem and some of its assets. It confirms that the ECB has taken brazen initiatives. In effect the ECB as acted as lender of last resort for both banks and governments. This is as should be, even in a monetary union.

Figure 1. Assets if the Eurosystem



Source: *Monthly Bulletin*, ECB, June 2012.

In return for these large cash injections, the ECB has absorbed (either buying outright or accepting as collateral) equally large amounts of securities, both public and private. The rule used to be that it would accept quality paper, i.e. securities rated at least A-. Initially, it indicated that it had no intention of accepting lower quality paper. As the scope of its engagement expanded, while at the same time a number of public debts were being subject to rate cuts by all the rating agencies, the ECB was forced to review its policy. It started to accept lower but investment grade securities to which it applied haircuts following a published graduated scale. This risk taking was accompanied by an increase in capital in December 2010. It remains that the ECB stands to suffer large losses in the event some countries default, possibly exhausting its capital. Central banks can operate with negative capital and some do (the central banks of Chile and Israel). This means that potential losses would not have to be immediately paid up by the Euro Area member states; the ECB could reconstruct its capital over decades without any harm. Still losses would be incurred and, one or another, borne by the member states.

Section 4 offers an evaluation of the ECB's role. The question discussed here is whether the ECB has been influential and how it has portrayed its own role. It is impossible to know from outside what has been the ECB's influence. Informal reports suggest that the Commission has taken the lead, often frustrating the IMF, which has advocated privately first, publicly next, less stringent adjustments, calling for more spread out efforts. In its public statements, for example in the *Monthly Bulletin*, the ECB has systematically adopted a line that is both hard line and improbably optimistic. For example, in mid-2011, when it was clear that the situation was seriously worsening and that the programmes' objectives were slipping away, the ECB stated:
"Euro area countries must, as a minimum, comply with their fiscal consolidation commitments for 2011 and beyond, as foreseen under the respective excessive deficit procedures. Adequate and more frontloaded adjustment should ensure that structural fiscal consolidation targets are met." *Monthly Bulletin*, July 2011, p. 7.

The ECB has portrayed the programmes as operated by "the EU in collaboration with the ECB, and the IMF". While it has become customary to refer to the Troika, in reference to the composition of the teams that negotiate and oversee the adjustment programmes, it is clear that the ECB sets its role separately.

3. OTHER POSSIBLE ACTIONS

Given that the crisis concerns public debts and banking system stability, the issue of ECB's role as lender of last resort has quickly emerged. The ECB strategy has been to ask governments to take responsibility for their debts and for their banking systems. When governments did not deliver and whenever the crisis worsened to reach a critical level, the ECB stepped in. Until late 2011, these interventions were of a stopgap nature and clearly carried reluctantly. Even though the amounts were large, as noted above, they provided only limited relief.

Another approach could have seen the ECB "ahead of the curve", which means pre-emptive. For instance, the ECB could have indicated that it would not let interest rate spreads above a given level. Its unlimited ability to absorb troubled public debts would have instantly quieted down the markets. Quite possibly, it would not have had to actually buy public debts.

Similarly, many governments have actively sought to minimize the fragility of their banks. National supervisors undermined the severity of the stress tests carried out by the newly created European Bank Authority (EBA). The facts that banks that received a clean bill health (Dexia, Bankia) had to be rescued, has gravely undermined the credibility of the EBA. The ECB has no bank supervision authority and may well have limited information of the health of individual banks. Yet, it is difficult to imagine that it was less well informed than the IMF whose Managing Director issued in October 2011 a warning that banks were being treated too leniently.

4. CRITICAL EVALUATION

The ECB was behind the curve

The fact that these crises were not foretold is extremely important to understand and evaluate the role of policymakers, both national and European. It is undoubtedly disquieting that markets may be that flimsy, but flimsiness has long been now as a characteristic of financial markets, with no known solution. Policymakers have no excuse to ignore this characteristic. Quite to the contrary, they must take it into account, both when they borrow and when they face market nervousness. In particular, because the phenomenon of self-fulfilling crises is driven by expectations, policymakers should have endeavoured to reassure the markets by jumping "ahead of the curve" and providing long-term answers.

Instead, as previously noted, the ECB acted late and always sought to portray its actions as strictly limited in time and space. This is somewhat surprising since a central bank's main strength in crisis time is that it can pre-empt markets with unlimited resources. It is likely that two main reasons explain the ECB's timid reactions.

First, disagreements were visibly deep.[1] Given the exceptional and unforeseen nature of the crisis, it is absolutely normal that different members of the Executive Board and Governing Council hold different views (raising once again questions about the size of the Governing Council). In other central banks, disagreements are dealt with through voting and a strong leadership is required to chart a consistent strategy. The Euro Area, however, is not a "country" and national differences, sometimes voiced by political leaders and relayed within the Eurosystem, have had a deleterious effect. The Eurosystem was intended to be fiercely independent from national politics; it obviously failed.

Second, when a central bank acts as lender of last resort it inevitably assumes some fiscal responsibility. The ECB has repeatedly voiced concern that it did not want to endorse such a responsibility. The reason is clear: taxpayers are national. This is a structural weakness of the European monetary union. The result, emphasized by de Grauwe (2011), is that for member countries the euro is effectively a foreign currency and it has long been known that borrowing in a foreign currency is a vulnerability that can lead to self-fulfilling crises.

These are deep structural deficiencies of the Euro Area, which call for a serious debate on possible solutions.

Inconsistent strategy

These deficiencies may also explain – not justify – the inconsistent strategy followed by the ECB. As is well known, initially the ECB rejected a bailout AND recourse to the IMF. It also rejected debt writedowns and it stated unequivocally its opposition to change its collateral requirement:
"We will not change our collateral framework for the sake of any particular country. Our collateral framework applies to all countries concerned." Press conference, 14.1.2010
Whether it was denial of the gravity of the situation or a misunderstanding of its likely evolution, the ECB did not project itself into the future.

In addition, the ECB backed the view expressed by policymakers that Greece was a "special and unique" case. As we have seen, and will continue to see, everything that has been done in the Greek case had to be done for other countries. This too was foreseeable (and foreseen by many observers).

[1] The résignation of Executive Board Member Juergen Stark has revealed the depth of these disagreements.

A leadership issue?

While the structural deficiencies of the Euro Area may explain these grave shortcomings, things have changed in late 2011 following the replacement of half of the Executive Board members. In two instances, the "new ECB" has taken the lead over both policymakers and the markets.

In early December, the new President let it be known that the ECB could intervene more forcefully if governments adopted a new "fiscal compact":
"We might be asked whether a new fiscal compact would be enough to stabilise markets and how a credible longer-term vision can be helpful in the short term. Our answer is that it is definitely the most important element to start restoring credibility. Other elements might follow, but the sequencing matters."
Hearing before the Plenary of the European Parliament on the occasion of the adoption of the Resolution on the ECB's 2010 Annual Report
Within three weeks, a new treaty was adopted, pushing the Euro Area toward decentralizing fiscal discipline, a little understood but crucial paradigm shift. In return, the ECB undertook its three-year LTRO programme.

Several aspects of this event are remarkable. The ECB offered member governments a bold *quid pro quo*. The ECB understood that markets can only be stabilized with "a credible longer-term vision", i.e. by jumping "ahead of the curve". The LTRO marked a new determination to use the central bank's unlimited resources. Finally, governments did respond. Even so, the LTRO is a roundabout way of backstopping public debts. Operating through the banking system, the LTRO depends on the (limited) willingness of banks to acquire public bonds that, one day, may turn out to be toxic.

The second important move is under way. The ECB President again indicated that the Bank could act on the banking crisis provided governments were ready to move toward a banking union. The ECB is encouraging governments to finally establish a single European bank supervisor, which would allow the Bank to act as lender of last resort. The Commission has seized on the occasion to advance procedures for bank resolution. This would represent another paradigm shift and deal with one side of the vicious circle that links bonds owned by banks and governments' own indebtedness.

5. Conclusion

The ECB is operating in a difficult institutional environment, which has contributed to the crisis and which makes it difficult to solve the crisis. One view of the ECB is that its lack of strategy and its numerous reversals is the best that can be done in this environment. Another view is that the "old ECB" lacked a vision of what is needed to solve the crisis while, in the same environment, the "new ECB" has already been able to induce governments to move in directions that were inconceivable beforehand.

Reference

de Grauwe, Paul (2011), "The European Central Bank as a lender of last resort", VoxEU.org, 18 August.