10 March 2013 - FINAL

Was the ECB crisis response appropriate?

Background Report for week 6, IGA663

Henrik Enderlein

Miguel Villalobos and Cecile Billaux

1. The ECB's role and scope of action in the context of the crisis

- The primary mandate of the ECB, as established in the Maastricht treaty, relates to monetary policy and consists of (1) ensuring price stability and (2) ensuring effective monetary policy transmission mechanisms to deliver on this pursuit of price stability. The independence of the ECB is instrumental in maintaining price stability. Both EU institutions and national governments are bound by the treaties to respect the ECB's independence. But what about ensuring financial stability? While it is primarily a responsibility of governments, the Treaty leaves room for interpretation on the role of ECB in "supporting general economic policies of the Community". In addition, there is nothing in the ECB's mandate related to handling crisis management as the focus was rather on crisis prevention. When the sovereign debt crisis emerged, it touched the fundamental limits of the ECB's mission and the ECB was not prepared to give answers on deeper issues about its mandate.

- The ECB's governance structure is also a key determinant to understand the room for maneuver of the ECB. We should keep in mind that it has 17 shareholders with an equal weighting in the decision-making process, although in practice certain Member States (in particular Germany) are more influent and may dictate the ECB's decisions and interpretation of the grey zones of its mandate.

- In light of this, the key question that we should consider could read as follows: what was the adequate role and level of action for the ECB in backstopping sovereign debt and avoid contagion? How to deal with reckless creditors? Is restructuration of their debts using the help of the private sector or other assistance mechanisms (with the IMF or the EU or both) an option?

- To assess this, what could the ECB do beyond its official strict mandate or pushing the grey zones of its mandate? Clearly, the ECB could not buy debt of Member States in primary markets (strictly forbidden by its mandate). However, the question of buying sovereign debt in secondary markets was left open. Under a very orthodox vision of the role of a central bank (following the model of the Bundesbank), this was not conceivable. However, if you take a more pragmatic approach of the ECB's mission, it may be an adequate response. The experience in the US and in Japan where the FED and the Japanese central bank are actually doing this justifies the fact that it was a well-founded option to consider.

- Overall, it is clear that the ECB had <u>limited room for action</u> in the crisis due to the fact that it was trapped between politicians, who are not providing clarity on the ECB's role, are sending mixed messages and are responding very slowly to the crisis and the markets, which felt anxiety when the ECB went over its strictly interpret role and are very reactive.

- The ECB also had limited information and knowledge of the situation when it acted – it is easy to say afterwards that the ECB should have acted differently but we should keep in mind the awkwardness and intensity of the situation as it occurred in 2009-2011. For example, Greece seemed to have just a liquidity problem. However, social and political problems were revealed when the administration demonstrated its inability to implement effective reforms.

2. What happened? The different steps of the ECB's intervention in the sovereign debt crisis

Origins of the sovereign debt crisis and limiting factors for ECB's intervention

The sovereign debt crisis in Greece that started in 2009 was at the origin of the ECB's later interventions. There are a number of important profound elements that need to be taken into account to understand ECB's reaction to the crisis:

- Fear of contagion of the sovereign debt issue to other countries in the euro-zone.

- Division amongst states regarding whether the role of the IMF in the problem of Greece (support from Germany but opposition from France).

- Risk of "transfer union" (East and West Germany, North and South Italy).

- The idea that debt restructuring is only for developing countries (based on the experiences of Mexico, Poland, Soviet Union and Argentina).

- The strong opposition of the Bundesbank to the principle that the ECB should buy debts. Inside the ECB, this also caused enormous tensions and the fact that, the President of ECB, Axel Weber decided to resign in May 2011 shows how divided the ECB was about the issue.

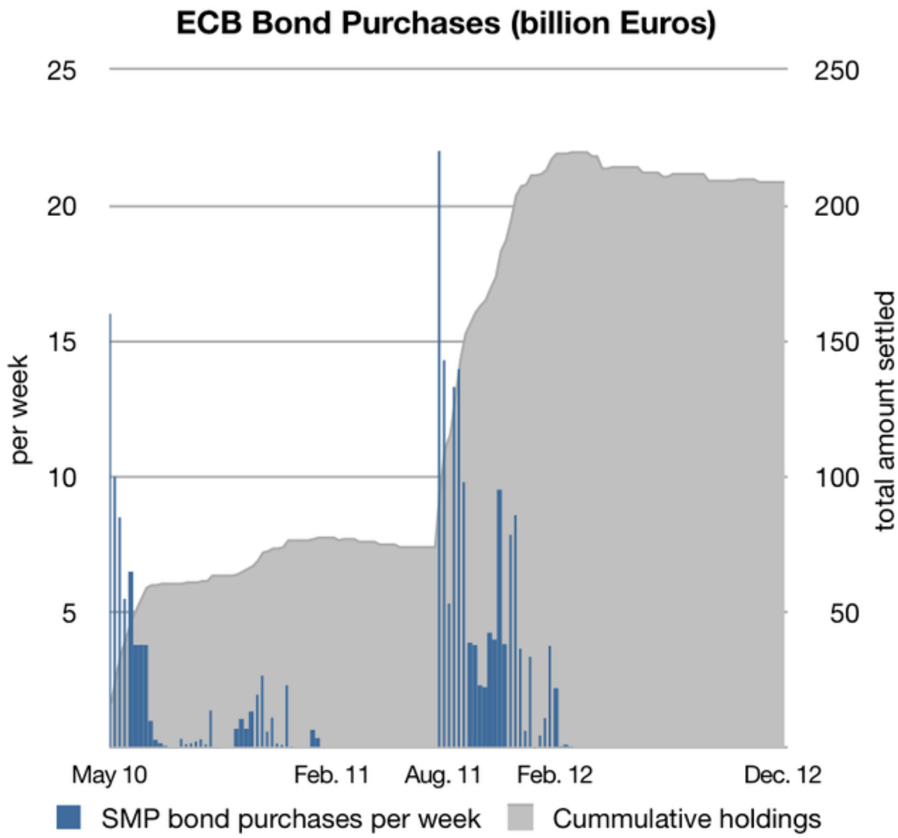
- The long-term credibility of the ECB, which is at stake and is linked to the tools that the ECB would decide to use and whether these are seen to send strong signals and be within the scope of its mandate or not.

Timeline of key ECB actions

Below is a summary of the major interventions the ECB took between 2010 and 2012 at the climax of the sovereign debt crisis. Generally, these interventions (mainly directed at buying bonds on the secondary markets) tend to be seen today as "half interventions", which did not generate enough trust from the markets and that took place in parallel to political decisions by the Council of ministers. These interventions led to the radical decision in September 2012 to establish a new plan to buy bonds with no time or size limit, called the Outright Monetary (OMT) program.

Euro-zone sovereign debt crisis – key ECB interventions

2009-2010	9 May 2010	11 May 2010	Summer 2011	December 2011	September 2012
Sovereign crisis emerges	Creation of the EFSF as a permanent financial assistance mechanism (leading to ESM) → ECB's role rejected and EFSF amounts not ambitious enough (Euro500b)	ECB buys secondary sovereign debts in Greece and Portugal (so-called Securities Market Programme – SMP) – in limited amounts - unsuccessful as market values of bonds continue to decrease –	ECB buys secondary market sovereign debts for Italy and Spain – reactivation of its securities market programme	ECB decision to inject massive amounts of liquidity into European banking system – LTRO (Long-Term Refining Operation) 3-year refinancing operation, lending banks a total of €489bn, followed by another €529bn in Feb 2012	ECB announces Outright Monetary Transactions (OMT) programme - a new plan for buying bonds from eurozone countries with no ex-ante time or size limit



The coordination between the ECB, the IMF and the EFSF/ESM

The actions of the EU Member States at political level seem to have taken place in parallel to ECB decisions. Coordination with the IMF was also not optimal. Was the ECB isolated in the crisis?

Both the European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM) were established in 2010 as temporary arrangements to tackle the urgent need to finance governments as a result of the sovereign debt crisis. The European Financial Stability Facility (EFSF) was given a limited amount

(500 B€) to carry out tasks that could have been handled by the ECB (i.e. precautionary interventions, secondary market debt purchases, and bank recapitalization). The ESM which will replace both the EFSF and the EFSM in 2013 will be able to intervene in the secondary government bond markets on the basis of an ECB analysis recognizing the existence of exceptional financial market circumstances and risks to financial stability. So coordination seem to be happening now but this was lacking initially at the core of the crisis in 2010-2011.

3. The theoretical debate: Debt restructuring vs. debt socialization vs. guaranteeing public debt as exit crisis response

In this paper we will ignore those exotic options that involve the fragmentation of Europe, such as over-indebted countries leaving the monetary union, or Northern and Southern States creating separate Unions. Before analyzing the actual ECB's response to the crisis and its appropriateness, we will clarify that the different high-level political choices to solve the euro crisis may be framed in two groups: early sovereign debt restructuring, and debt socialization. Each of the two options has its advocates and critics. In addition, both involve different benefits and risks. We will also shortly analyze a third possibility, which consists in guaranteeing public debt (and the link to the introduction of European bonds possibly).

Sovereign debt restructuring

Sovereign debt restructuring or "haircut" involves entering into negotiations with bondholders in order to agree on a delay or partial reduction of the state's debt payments (governments rarely default on the entire value of their debt). Some advocates of this approach believe that insolvency crises should be solved through an orderly restructuring of the state's debt, and that delays in launching this orderly default may have disastrous consequences. Others go a step further and argue that not forcing banks into recognizing their portfolio losses worsen the situation in Europe. The idea behind these two positions is that controlled default organized by regulators and supranational lenders helps to identify the measures required to ensure the repay of the remaining part of the sovereign debt.

Debt socialization

Debt socialization consists in transferring the debt to other people, States or institutions. In the case of the euro crisis, debt socialization would involve a burden to States with limited debt in order to pay for the debt of over-indebted countries.

The best argument in favor of debt socialization is the unaffordable cost of sovereign debt restructuring. It would involve risks in form of a disastrous spread of default. This is because the nature of creditors. For example, Greek banks, pension funds and insurance companies held a third of the Greek debt. Sovereign debt restructuring might provoke the default of these organizations and, hence, catastrophic consequences in European social and economic fabrics. A remarkable advocate of this approach was Jean-Claude Trichet, former President of the ECB, who opposed sovereign debt restructuring. Moreover, Lorenzo Bini Smaghi, who was Member of the Executive Board of the ECB, stated that sovereign debt restructuring would be a “political suicide” and “would have disastrous effects on social cohesion and the maintenance of democracy”.

An alternative to restore confidence: guaranteeing public debt

In 2011, Lucas Papademos, who was Prime Minister of Greece, proposed deploying “a comprehensive and convincing policy package that could help restore market and public confidence”. Despite the nature of such a package, this suggests that the key for the recovery is restoring confidence. Indeed, Charles Wyplosz, who is Professor of International Economics and Director of the International Centre for Money and Banking Studies at the Graduate Institute in Geneva, stated that “all the ECB has to do is to guarantee public debts”. According to Wyplosz, it would immediately stop the sovereign debt crisis, and would restore market and public confidence. In addition, the measure would not be expensive since confidence would contribute to reduce the risk of default. Building on that, some proposed a collective European bond issue (Eurobonds) that would allow the ECB to purchase a European version of U.S. Treasury Bills. To make European sovereign debt assets more similar to a U.S. Treasury, a collective guarantee of the Member States' solvency would be necessary. Both the ECB and the German government resisted this proposal. “Eurobonds can only follow further European political integration” as European Central Bank Executive Board member Benoit Coeure said

4. Evaluation of the ECB's crisis response

The ECB could choose between two extreme options. The first one was sticking strictly to its mandate and its traditional policy toolbox (ensuing price stability only, with no additional intervention). The second option was taking the so-called "all in" approach. This is based on intervening at various levels, and is what the ECB chose to do after 2 years of crisis. The 26 July 2012, Mario Draghi pronounced the London speech. It summarizes the approach taken by the ECB: "*Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough*".[1]

In addition to these two extreme options, there is a middle ground option, involving interventions at different moments and with different intensity to "muddle through" the crisis. This is what the ECB has been doing until the Autumn 2012. Overall, it seems that the ECB has taken a pragmatic approach. The ECB changed its message when it was clear that the situation was out of control in political terms, and that contagion was unavoidable.

We will assess the ECB reaction by distinguishing whether it acted within its mandate or beyond its mandate and the tools it had at its disposal.

[1] The speech is available at:
http://www.ecb.int/press/key/date/2012/html/sp120726.en.html

Assessment of the ECB's actions within its mandate (strict interpretation)

Despite its limited scope of action due to its mandate, there are positive elements in the ECB's management of the crisis:

- The ECB managed to restore confidence on the "irreversibility of the Eurozone", something which was primordial and could have been dramatic if overall the Eurozone would have fell apart in the early days of the crisis.

- Overall, the outcome of the sovereign debt crisis is rather positive – the bailout of some countries has been avoided, and instruments have been found to avoid major breakouts.

However, there have been two major critics on the ECB's interventions in this context:

- The Communication of the ECB on the SMP was not optimal. The main message from Trichet was that the intervention is "temporary and limited", which did not reassure the markets. Later Draghi slightly changed the language and said that it was "not eternal, not unlimited". This failure in restoring markets confidence contrasts with the success on restoring the trust in the unity of the Eurozone.

- Overall, it was felt that the ECB intervention took too long, was too little and too inconsistent, and included too risk averse strategy and actions. This harmed the long-term credibility of the intervention. First, lack of agreement among European countries caused a delay in the ECB intervention. Dominique Strauss-Kahn, former Managing Director of the International Monetary Fund (IMF), and Barack Obama, President of the US, stressed the need to adopt an emergency response that never happened (at least with the urgency required by an emergency). During the first stages of the crisis, European leaders were hesitant to rescue Greece. However, they finally agreed not only to support Greece, but also Ireland, Portugal, Cyprus and Spain. This process delayed the response to the crisis and generated additional issues. Furthermore, measures were not consistent enough. Budgets were far below what was needed in order to solve the crisis. Charles Wyplosz suggested that Eurozone leaders "have not yet realized the magnitude of the problem" because "they are talking of billions when they need to be talking of trillions". This mistake, along with the first one, is what Wyplosz regards as the motto of Eurozone leaders: ***"too little, too late".***

Assessment of the ECB's actions beyond its mandate

It is clear that the ECB took actions that went beyond the traditional interpretation of its mandate. In this context, it is important to recall that there was no precedent for the ECB for crisis management and prompt reaction. Overall, we can assess more negative elements than positive ones:

- The ECB was not able to prevent the fragmentation of private credit markets inside the Eurozone

- Coordination between the ECB and policymakers was difficult, and put the core principle of the ECB's independence at risk. The ECB was trapped between the politics and the markets.

- ECB intervention suffered from their democratic deficit and it felt like impositions on politics and EU citizens – clearly going beyond its role and mandate in this respect.

- Moral hazard of debt socialization, encouragement of free riding and contagion. On the one hand, debt socialization was against the spirit of the Treaty. On the other hand, banks were reluctant to implement debt restructuring. Northern states did not want to pay for Southern over-indebted countries, whereas creditors did not want to recognize their losses. The outcome of this situation was an ambiguous strategy that neither convinced sovereign debt restructuring advocates, nor debt socialization supporters.

5. Conclusion

The mandate of the ECB is very specific: ensuring euro area-wide price stability. Although nothing prevents the ECB from going beyond its mandate, this involved political tensions with ECB's 17 stakeholders. The ECB's risk aversion to prevent conflicts with Member States may have been one of the causes of ECB's lack of commitment to a more full-fledged policy.

Resistance to debt restructuring from governments and banks impeded the sovereign debt restructuring approach to be taken. Since the ECB is not allowed to print money or to purchase sovereign debt securities in the primary market, the institution started purchasing sovereign debt securities on the secondary markets. This was a step toward the debt socialization approach. However, the limited scope of the measures and the need for recurrent interventions did not restore enough confidence. According to Ulrich Hege and Harald Hau, the ECB "redistributes default risk from a country to the whole zone, but does nothing to restore a country to solvency".

Summarizing, the ECB intervention was within the limits of its mandate and its current knowledge of the situation at that point in time. The ECB took some non-conventional measures to ensure effective transmission of monetary policy, preventing a credit crunch. Overall, these actions contributed to gradually restore the confidence, and did not lead to the falling down of the Euro. However, ECB's interventions were criticized for starting too late, for lacking the intensity that could help restore market and public confidence, and for not being articulated within the framework of a coherent and coordinated strategy. It is clear that recovering from the crisis will take time. Europe is facing a decade of adjustments.