Conference on The ECB and its OMT Programme

A financial market and financial stability perspective on the OMT

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The main purpose of this conference is to assess the economic arguments underlying the ECB’s decision, one year ago, to resort to Outright Monetary Transactions. This is not an easy task. The reason is that economists analyze problems on the basis of models, which very often make simplifying assumptions that may occasionally make them unfit to assess the complexity of the economic situation, especially at times of crises. In fact, the euro crisis has shown how difficult it is to analyze the euro area with standard monetary theory. The reason is that the euro area is a unique construction which does not necessarily fit simple analytical models. When some of the assumptions made in the models are removed to try to fit the reality, the analysis becomes much more complicated. This applies also to economic policy – more specifically monetary policy.

Let me just mention a couple of complex aspects of the euro area which are not always reflected in standard economic models.

The first is the irrevocable nature of the euro. In theory the adoption of the euro on 1 January 1999 was irrevocable. However, the possibility of a country exiting the euro area or of a disintegration of the monetary union was raised several times during the crisis, not only by academics and market participants but also by some policy makers, both in creditor and debtor countries. Just to quote a couple of examples, in October 2011 George Papandreou proposed to have a euro referendum in Greece, questioning the irrevocable nature of the Union; in the Summer of 2012 Jean Claude Juncker, President of the Eurogroup, stated that “the exit of Greece could not be excluded”.

From the Summer of 2011, after the first Greek debt restructuring, markets attributed a non-zero probability to such an event. This meant that the euro was not considered as a fully-fledged monetary union but a probabilistic combination of a monetary union and a fixed but adjustable exchange rate.
Monetary policy acts under very different conditions in a fixed but adjustable exchange rate system compared to a fully-fledged irreversible monetary union.

If for some reason market participants expect that a country might devalue, interest rates paid on the assets of that country have to rise to cover for the exchange rate risk, which may make domestic economic conditions unsustainable (either in terms of public debt or of economic growth) and ultimately increase the likelihood of a devaluation. This can give rise to multiple equilibria, with self-fulfilling expectations. There is a large literature on multiple equilibria in this type of exchange rate system.¹

Under these circumstances there is very little that monetary policy can do to stop self-fulfilling crises. If interest rates are raised to counter capital outflows generated by the expectation of a devaluation, the negative repercussions on domestic economic conditions may actually increase the probability of the devaluation.

The only way in which monetary policy can be effective under these circumstances is to stand ready to conduct unlimited foreign exchange interventions. This implies buying assets of the country which suffers from capital outflows and selling assets of the country whose currency is under upward pressure.

In a fixed but adjustable exchange rate system the central banks of the participating countries do not have the possibility to intervene for unlimited amounts. In the EMS, for instance, exchange rate interventions conducted when the bilateral rates reached the respective margins where in theory unlimited, but in practice where limited by two main constraints:

- First, the debtor country’s interventions were financed with a 3-month loan, whose extension had to be negotiated, and
- Second, the Eminger’s letter to the German Government at the start of the EMS relieved the Bundesbank from such an obligation if the intervention put in jeopardy the achievement of price stability in Germany.²

The euro was created precisely to overcome the limitations of the EMS, which did not allow central banks to intervene for unlimited amounts. However, monetary union is credible only if the central bank has all the instruments to eliminate unwarranted risks of falling back into an exchange rate system. This requires the ability of the central bank to intervene for unlimited amounts, which means being ready to buy assets of countries experiencing severe capital outflows and selling assets of countries experiencing inflows which are motivated by the expectation of an implosion of the monetary union.

This type of risk does not exist in any other country or monetary area, and is thus not considered in economic models. No other central bank in the world has to face such a problem. However, the ECB has to be adequately equipped to tackle this problem, because this problem exists in the euro area.

It is of course not the task of the ECB to decide which countries are in or out of the euro area. This is a political decision. It cannot be excluded that some countries may actually exit. However, as long as the political authorities have not changed the composition of the euro area, it is the statutory task of the ECB to implement the single monetary policy for that whole area. “Money is a veil, but when the veil flutters the economy sputters”.

The key question is what instruments are needed for the euro area to be a fully credible monetary union. The answer, based on the experience of the euro crisis,

² H. James, “Making the European Monetary Union”, Harvard University Press, 2012
is that any limitation on the ECB’s possibility to intervene to counter convertibility risk puts into question the credibility of the euro. This is not surprising. No other central bank in advanced economies would put any ex ante limit to its balance sheet, or parts of its balance sheet. This would immediately fuel a run on the banks, to obtain central bank money. It is the central bank’s implicit commitment to convert central outside money into inside money, to accommodate portfolio substitution, which prevents bank runs and ensure that monetary policy achieves price stability. William Poole has explained this issue quite well over 50 years ago.

To sum up this first argument, the OMT is a necessary condition for the ECB to be credible in implementing the single monetary policy and ensuring that the euro area is a fully fledged monetary union and not a fixed but adjustable exchange rate system. In fact, any central bank around the world has an instrument similar to the OMT at its disposal, i.e. the possibility to intervene for unlimited amounts in any segment of the market, in order to implement monetary policy and ensure the convertibility of its currency.

The natural objection to this argument is that central banks generally do not intervene in specific assets, like local bonds or shares, but rather in the market for a broadly representative assets like the public debt. This brings me to the second peculiarity of the euro area, which makes it difficult to use standard models.

The second peculiarity of the euro area is the full separation between the fiscal and monetary powers. This means de facto that member governments issue debt in foreign currency. In theory such a separation is ideal and desirable. This assumes however that markets are always efficient and capable of ensuring full substitutability between assets, especially those that are in large supply in the economy and play a key role for investors, like government bonds.
Public debt instruments play a very important role in the functioning of financial markets, for a series of reasons on which I will not elaborate. Regulation is an important (sometimes distortionary) factor, so as market practices (rating agencies). Furthermore, market integration in the Euro area has not proceeded rapidly enough, so that public debt continues to be held largely by residents, in particular domestic banks. The crisis has made this peculiarity more evident. This implies that any problem in the pricing of a member country’s public debt has deep rooted consequences on the country’s financial system and on the underlying economic conditions. Given the integration of the euro area financial system, the problems in one country can spread rapidly throughout the whole union.

Where there is full correspondence between the monetary and fiscal dimension, which is the case of most countries except for the euro area, any instability in the domestic financial market, including in the segment of the public debt, the central bank can intervene to restore stable conditions, in order to achieve price stability. This has happened many times in the past, including in Germany. In the US, UK, Japan, the central bank has recently intervened heavily in the government bond market, in particular through QE, in order to achieve its specific objective of price stability. A collapse of the government bond market in these countries would produce such dire consequences that the central bank would intervene, in some form or another, to restore stable financial conditions, which are necessary in order to achieve its objective. Market participants in most countries thus know that it is very unlikely that important parts of the financial markets – such as the public debt market - will be subject to liquidity problems. This reinforces the efficiency of such a market, even in the absence of central bank intervention. It also reduces the possibility of multiple equilibria and self-fulfilling expectations in the pricing of such assets.
The euro area is different as the ECB does not face a single euro public debt market, but 17 different ones. If the ECB wanted to conduct standard open markets operations it would have to create a basket of national debt instruments, which would be quite complicated. This is why the ECB tends to operate through repo operations with the banking system, which is the main channel of transmission of monetary policy. Economic models tend to ignore such a peculiarity.

What is the implications of a system in which the central bank cannot intervene in the government bond market? We have the experience of the sovereign debt crises in Emerging markets. In normal times, the full separation between the monetary and fiscal dimension may create the right incentive for markets to search for the good price, and differentiate between various credit risks. In times of crises however, the fear that there may be severe tensions in some markets and that the central bank will not intervene, can amplify liquidity crises and transform them into solvency crises. Sudden stops in the financing of the debt may occur. This generates multiple equilibria in the pricing of assets, which is typical in markets without a lender of last resort. There is an ample literature on this issue.\(^3\)

This is actually one of the main reasons why central banks have been created, i.e. to reduce the risk that liquidity crises develop into solvency crises. It is also the reason for the creation of international financial institutions like the IMF. The OMT should thus be considered as a way to avoid bad equilibria from materializing, leading to financial instability and thus preventing the central bank from achieving its primary objective.

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The availability of the OMT does not mean that the central bank will use it to interfere continuously with the markets. It rather means that the central bank has at its disposal an instrument which can avoid catastrophic risk. Like for the nuclear weapon, the expectation that it can be used may be sufficient to avoid having to use it. Any self-limitations, in that respect, is counter-productive and leads to a Pareto inferior solution.

Let me address briefly some problems with the use of the OMT.

It is well known that the problem with lenders of last resort is moral hazard. This problem has been tackled, however, by attaching conditionality to any intervention. The IMF lends only to solvent countries, solvency being assessed on the basis of debt sustainability. Central banks are supposed to lend only to solvent banks, against collateral.

The OMT is in line with this tradition. The ECB has stated that it stands ready to intervene in the markets, but only with instruments and institutions of countries which have submitted themselves to an adjustment program.

We can certainly discuss whether the conditionality is sufficiently strong to avoid moral hazard. This is an old discussion. In my view, the problem might in fact be the opposite, i.e. an excessive stigma for applying to ECB support. This is leading banks to reimburse the LTROs in advance, instead of lending to the real economy. It is also discouraging countries from applying to the ESM, as this would supposedly undermine (what is left of) their sovereignty.

The problem with the current system is rather that countries apply too late for adjustment programs, when the markets have already become unstable. This is the worse of times for the central bank to intervene, going against the wind and having to stand ready to purchase enormous amounts of assets in order to achieve the objective.
A different system could have considered an automatic trigger, based for instance on the level of the spread consistent with the convergence criteria (200 basis points), above which a country would be forced to enter a program, and thus benefit from the OMT umbrella. Such tighter conditionality and automaticity would limit the risks for the central bank. There would be much less political discussion among euro area governments and within countries about whether to enter programs but rather on the contents of the program, with a view to reduce the risks for the area as a whole.4

Such a mechanism could be accompanied by a reform of the regulatory framework aimed at reducing the distortions in favor of public debt instruments, for instance with respect to banks’ risk weighting system.

Another criticism of the OMT, which has been made in particular by the Bundesbank, is the lack of democratic legitimacy. By intervening in the government bond market of specific countries the OMT may imply that the central bank assumes country-specific risk which, if they materialize, will be borne by the taxpayers of other countries. This would imply a redistribution of wealth that would not be legitimated.

This view ignores that whenever the central bank intervenes in the market, by exchanging inside money with outside money, it always takes risks. Because inside money is the only safe asset in a fiat money system. When the central bank injects long term financing at a fixed rate it takes the interest risk, but this risk may be necessary to reduce a greater risk, which is that markets misprice assets because they give excessive weight to a tail risk which is unjustified.

To be sure, the central bank must manage risks, for instance by applying haircuts or providing liquidity against adequate collateral. But it has to assess

also the risks of not acting, i.e. limiting the amount of risks that it is willing to take. Not acting could in fact increase even more the risks in the economy, and ultimately in the central bank, and imply even greater distributional consequences. If the central bank is primarily concerned about its own balance sheet, it may ultimately fuel concerns about excessive risk in the markets and create major liquidity problems which add to financial instability.

It is an illusion to think that monetary policy does not have distributional consequences. It always has, ex-post, for instance when interest rates change unexpectedly; or when the central bank decides to provide liquidity with one type of tender rather than another one. The important aspect is that monetary policy is not motivated ex-ante by distributional reasons but by its primary objective, which is price stability. For instance, while an interest rate rise may damage holders of long term fixed rate assets, it should not be postponed if it is necessary to achieve price stability. OMT may increase the risks for the ECB shareholders but should not be precluded if it is necessary in order to maintain the integrity of the monetary system and achieve price stability in the euro area.

Finally, it may be right to worry about all possible risks entailed in monetary policy operations. However, we should not forget that since the ECB started its unconventional monetary policy, from the exceptional 90 bn euro intra-day operation of 9 August 2007, all the fears of the doomsayers – especially in Germany – that this would produce inflation proved wrong. Price stability has been maintained in the euro area. This should suggest that the doomsayers made a wrong analysis of the crisis and of the role of monetary policy during the crisis.

To conclude, the OMT is a natural complement to the monetary policy toolkit in a less than perfect monetary union like the euro area is. Its use may create risks and raise moral hazard issues. These are problems that monetary authorities
know and are used to deal with and to manage. It would be an even bigger risk not to have such an instrument or to prevent the central bank from using it. In fact, it would mean undermining the ability of the ECB to achieve its objective, and thus its independence. It would mean that the euro area is not really a fully-fledged monetary union. This would be the start of its disintegration.