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Policy Responses of the ECB in Managing the Euro Crisis and Its Evolutionary Role

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Background

The global financial crisis and the subsequent economic recession called for unprecedented policy responses by monetary authorities worldwide. From the onset of the financial tensions in mid-2007, the European Central Bank (ECB) reacted swiftly to deteriorating economic and financial circumstances. In addition to reducing interest rates to record level, the Eurosystem implemented a number of non-conventional monetary policy measures during the period of acute financial market tensions, under the approach of '*enhanced credit support*'.

However, in face of the Euro crisis from 2010, the ECB was late in responding and not strong enough to calm down the turmoil in sovereign markets, earning criticism at least during the early stages of the crisis. Later on, the ECB increasingly intervened in the financial market in an unprecedented manner, starting from the purchase of sovereign bonds under its Securities Markets Program (SMP) and pouring more than EUR 1 trillion into the European banking sector. In addition, the ECB's Governing Council announced, in September 2012, a plan for the unlimited purchase of sovereign bonds – outright monetary transactions (OMT) – in the case of a sovereign crisis. These exceptional and bold measures have helped sustain financial intermediation in the euro area and have been instrumental in maintaining the availability of credit for households and companies.

Unusual circumstances require unusual measures. However, the crisis responses of the ECB were ones unexpected before the crisis occurred, given that its primary mandate is ensuring price stability in the euro area. In this context, we raise the following two questions. *1) Why did the ECB not take bold measures to tackle the crisis from the beginning?* The ECB's measures were not preemptive, but tended to be announced at the last minute. *2) Is the increasing use of non-conventional measures temporary in response to an unprecedented crisis or is this a sign of structural change in the ECB's role?* This study seeks to answer these two questions by reviewing academic papers and official documents published by European institutions, including the ECB, and interviews with experts on the European financial market and central banking.

Main Features of the ECB

The ECB has features in common with most central banks of advanced countries. With a mandate of maintaining price stability, it defines and implements the monetary policy of the European Monetary Union (EMU). But the ECB differs from other central banks in three aspects.

First, the ECB has a mandate only with respect to price stability and limits its activities almost exclusively to monetary policy. This is in contrast with the Federal Reserve Board (FED), the Bank of England and to a lesser extent, the Bank of Japan. For example, the FED has mandates of *'promoting effectively maximum employment, stable prices, and moderate long-term interest rates in conducting its monetary policy'*.[1] The Bank of England Act defines objectives of the Bank as, *'(a) to maintain price stability, and (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment'*.[2] These mandates are similar to that of the ECB, but they provide more policy scope in conducting monetary policy, such as quantitative easing (QE), which the FED heavily relied on right after the global financial crisis.

Second, the ECB has a very high level of institutional and political independence. In fact, the independence of central banks is a common feature in most developed countries. It is well known that political pressure tends to lead to inflationary pressure and a central bank lacking political independence is hardly able to obtain confidence in its monetary policy from financial markets. In this context, the ECB and national central banks (NCBs) have been given a high level of independence in institutional, functional and managerial terms. The Treaty on the Functioning of the European Union (TFEU), Article 108, states that the ECB and national NCBs should be free from political pressure. Any attempt to influence the ECB and NCBs are forbidden. Political independence is built into the structure of the ECB. ECB executive board members hold relatively long (8 years) and non-renewable terms, and the ECB financed out its budget without the approval of any European and national institutions.

Third, the ECB and NCBs of the Eurosystem are forbidden to give loans to any public authorities within the EU. Such *'non monetization'* is salient in the sense that central banks used to take on the role of banks for governments and a number of them purchase government-issued bonds or bills. From the beginning of the EMU, the EU Treaty made it

[1] Federal Reserve Act. Section 2a. Monetary Policy Objectives.

[2] Bank of England Act, Article 11.

clear that any type of loan or credit from the ECB and NCBs in favor of European and national institutions is prohibited. This is related to efforts to prevent inflationary pressure caused by monetary financing. For this reason, the ECB cannot purchase sovereign bonds of its member government from the primary market and cannot conduct QE in the manner of the FED.

Table 1. Overview of the ECB, FED and Bank of England

Mandate	ECB	FED	Bank of England
Mandate	Price stability	Price stability, growth, employment,	Monetary Stability, Financial Stability
Independence	Executive Board nominated by EU Finance Ministers and elected European Council	Board of Governors nominated by President, confirmed by Senate	Appointed by the Crown
	8 year term	14-year-term	5-year term
	No reappointment	No reappointment	One reappointment allowed
	No loans to governments	Acquiring and holding bonds allowed	Lending to government allowed
	Independent since its creation 1998		Independent since 1998

Source: Richter and Wahl (2011).

Development of the ECB

The ECB's features are very similar to those of the German Bundesbank. Given the role of the Deutsche Mark and Bundesbank in European monetary integration, it seems that the ECB would include features that are legacies of the Bundesbank. A number of papers argue that the memory of hyperinflation in the early 1920s in Germany shaped public preferences and create strong support for a monetary policy aimed to maintain price stability. Stable money was considered an indispensable prerequisite of a well-functioning market economy. In this context the Bundesbank was assured its independence from government authority from the very beginning of its foundation in 1957. Its main task was to protect national currency, both in exchange rate stability and internal price stability. This principle was respected regardless of changes of governments. The Deutsche Mark served as the anchor currency for the 'snake in the tunnel' and the European Monetary System (EMS) in the 1970s.

According to Hagen (1999) and Hetzel (2002), the launch of the EMS led the Bundesbank to set its monetary objective further toward price stability. The EMS and its basket currency ECU was a weighted average of national currencies and had the potential to repeat the experience of Bretton Woods, with the Bundesbank forced to create money and inflation by supporting a weak currency, for example the French Franc.

The Bundesbank was not in favor of introducing the Euro in the early 1990s. According to Mikhel (2012), Hetzel (2002) and Bundesbank (2008), the German central bank advocated several conditions for the Eurosystem, as follows.

① The primary objective of the ECB should be price stability.

② The ECB should be guaranteed its independence from any political pressure.

③ New monetary system headed by the ECB should include NCBs of EMU member countries.

④ A governing council and executive board should be set up in the ECB.

⑤ The ECB should be given all necessary instruments for conducting monetary policy.

⑥ The ECB should have its authority in exchange rate policy.

⑦ Monetary financing to governments through the ECB is forbidden.

These conditions suggested by the Bundesbank are fully reflected in the Eurosystem. Touffut (2008) argues that the EMU inherited the German monetary approach based on economic supply, giving up the steps of France to impose its expansionary Keynesian policy. However, Issing (2010) proposes that an optimal institutional arrangement for a central bank should include three principles; ① independence for the conduct of monetary policy, ② a clear mandate and ③ prohibition of monetary financing of public finances. According to his argument, the Bundesbank adhered to these principles very successfully, setting an example in Europe. Therefore, designing the ECB based on the German model is a natural convergence toward best practice.

The ECB and Euro crisis

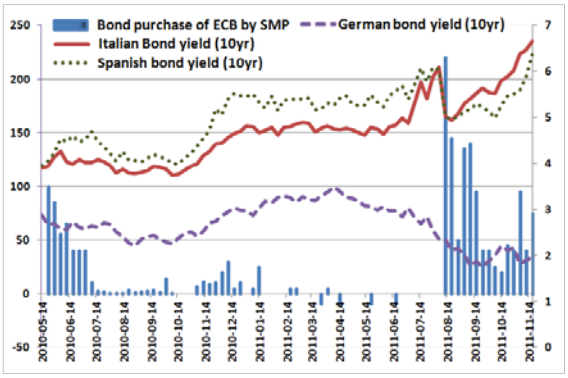
As the Euro crisis spread across the entire euro area starting from European peripheries, ECB responses became increasingly active. In order to keep financial markets stable, the ECB lowered key interest rates and took various non-conventional measures, equivalent to those taken during the global financial crisis. The ECB also introduced additional new measures.

Securities Market Program (SMP)

The ECB announced the launch of the Securities Markets Program in May 2010. Under the program, the ECB and NCBs (Eurosystem) purchased euro area public and private debt securities to ensure depth and liquidity in dysfunctional market segments and to restore the proper functioning of the monetary policy transmission mechanism. In line with the *'non-monetary financing principle'*, the Eurosystem's purchases of government bonds were strictly limited to bonds from secondary markets. The ECB emphasized that overall liquidity conditions would not be affected, because all purchases would be fully sterilized by conducting liquidity-absorbing operations. The ECB did not make public issuers (countries) of the sovereign bonds it purchased. However, it is obvious that most of the sovereign bonds were ones issued by countries under financial stress. The ECB further increased purchase volumes when Italian and Spanish sovereign bonds were under pressure during August-November 2011. Sovereign bonds held by the ECB through the SMP reached EUR 219.3 billion as of February 17th 2012 and consequently ECB's balance sheet expanded at a historically high level.

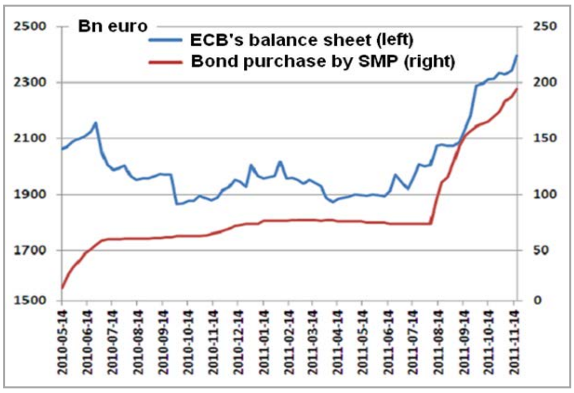
Figure 1. ECB's SMP

(million euros)



Source: Bloomberg.

Figure 2. ECB's balance sheet and SMP



Source: Bloomberg.

Figure 3. 10 year sovereign bond yield rate

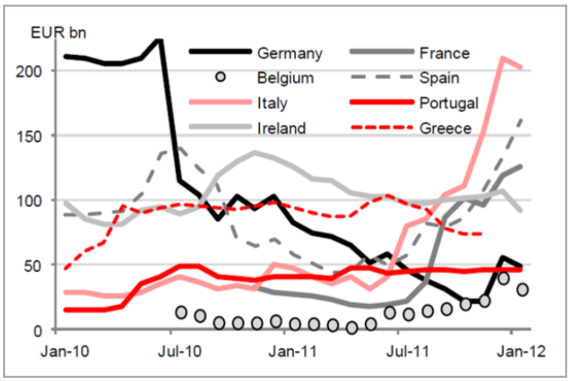
Source: Bloomberg.

Long Term Refinancing Operation (LTRO)

In the autumn of 2011, the euro area banking system came increasingly under strain due to adverse interaction between sovereigns and national banking systems. As depressed sovereign bond prices weakened bank balance sheets, markets questioned the viability of a number of banks across euro area countries, and the strained sovereigns were seen as increasingly unable to provide credible backstops. The spiral led to falling sovereign bond prices well beyond countries under strain, including France, Belgium, and Austria. Bank equity prices fell by up to 70 per cent during the year, bank credit default swap spreads exceeded the Lehman peak, and the interbank market became dysfunctional. Large parts of euro area bank funding dried up; the bank issuance of covered bonds was severely constrained, and uncovered issuance virtually closed. Banks lacked funding and their liquidity beyond the immediate horizon was also brought into question. The situation of banks across euro area countries became increasingly differentiated, with some banking systems facing acceleration in net payment outflows.

In this context, it was necessary to take measures in order to provide banks not only with short-term liquidity support but also with a sufficient perspective so that they would maintain credit lines in this very special environment. In December 2011, the ECB announced two LTROs with a maturity of 3 years each. Around €1 trillion was allotted in total for the two operations. In the second operation in February 2012 some 800 banks participated, including, for small amounts, 460 banks from Germany alone. This demonstrated that liquidity was reaching out to small and very small banks, including those whose primary business is to refinance small and medium-sized enterprises. Two LTROs suggest that the ECB tends to act as the *de facto* lend of last resort in a crisis, but in a different manner from the FED during the global financial crisis.

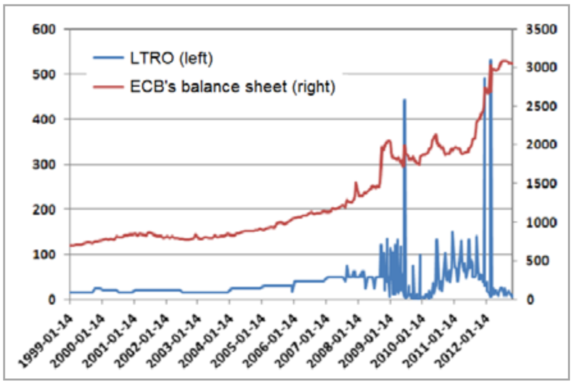
Figure 4. Total ECB funding by country



Source: http://www.zerohedge.com/news/ltro-2-101-top-down

Figure 5. LTRO and ECB's balance sheet

(1 billion euros)



Source: European Central Bank.

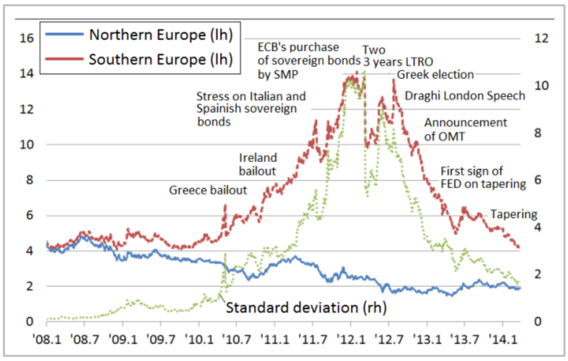
Outright Monetary Transaction (OMT)

Despite the LTROs, the euro area headed into a second economic recession and some countries faced political uncertainties in mid-2012. The Greek election in May and June evoked a severe *'Grexit'* and the Euro crisis was no longer regarded as a sovereign crisis, but as a crisis of a single currency system. Euro's status as a stable currency had been weakened. In this context, President Dragui declared that "*within ECB's mandate*, the *ECB is ready to do whatever it takes to preserve the euro*".[3]

The ECB's Governing Council decided, on 6 September 2012, on a scheme to intervene in secondary sovereign bond markets subject to strict and effective conditionality, the so-called OMT. The aim was to preserve the singleness of the ECB's monetary policy and to ensure the proper transmission of the monetary policy stance toward the real economy throughout the area. The OMT has not been activated so far. However, announcing the ECB's willingness to provide unlimited backup worked as a *'game changer'* and the sovereign market became stabilized.

Figure 6. Sovereign bond yield rate in the Euro crisis

(10 year bond yield rate %) (St. Dev.)



Note: Northern Europe includes Germany, France, Netherland, Austria, and Finland. Southern Europe is defined as Italy, Spain, Greece and Portugal

Source: Bloomberg.

Discussions on the Role of the ECB

The ECB's measures, the SMP and OMT in particular, caused disputes between different actors and principles. They were conceived and implemented amidst tension between member states, especially Germany and France, and between ECB's mandate (price stability) and financial stability (response to

3 Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London (26 July 2012)

the euro crisis). The belated response of the ECB to the crisis (compared to the FED) has been the subject of much debate and criticism. As mentioned previously, the ECB's 'wait and see' attitude during the early phase of the crisis was largely due to the limits of its mandate and its prohibition of monetary financing. Even though the ECB excluded all political pressure, the divergence between member states in crisis management seemed to work as a '*delay*' factor in the ECB's decision making.

However, as the crisis spread, economists from academic circles and financial markets increasingly called for the more active role of the ECB in tackling the crisis. De Grauwe (2011a) argues that Eurozone governments issue debt in a *de facto 'foreign'* currency – the Euro - that they cannot control. Thus governments cannot guarantee to the bondholders that they will always have the necessary liquidity to pay off the bond at maturity. According to his argument, it is crucial for a central bank to play the role of a lender of last resort in the government bond market. Otherwise, it will be difficult to regain confidence from the financial market. De Grauwe (2011b) goes further to say that the reluctance of the ECB to take up its responsibility as a lender of last resort is the single most important factor explaining why the forces of contagion in the Eurozone's sovereign bond markets have not been stopped. In the same vein, Wyplosz (2011) insists that the ECB should guarantee public debts. If the ECB guarantees rollover at face value of maturing sovereign debts, this would immediately stop the sovereign debt crisis. Gros and Mayer (2011) advance the same idea in a more specific context. The authors suggest that the European Financial Stability Facility (EFSF) be registered as a bank vis-à-vis the ECB. If it gets access to potentially unlimited ECB refinancing when necessary, the general breakdown of confidence could be stopped.

All these highlighted arguments may be summarized in the following question. *Is there a role for the ECB as a lender of last resort in the government bond market?* In fact, the ECB has assumed increasingly more responsibility in tackling the crisis. The SMP and OMT are *de facto* back-ups presented by the ECB for the fragile sovereign bond market. The question is whether the increasing use of non-conventional measures is temporary ones in response to an unprecedented crisis or if this is a sign of structural change in the ECB's role.

The ECB's Position

During the crisis, the ECB made it clear that its priority and mandate lie in maintaining price stability and emphasized that non-conventional measures were implemented to secure a '*transmission channel*' of monetary policy. Eventually its measures contributed to the mitigation of tensions in the sovereign market, but it repeatedly stressed that these measures were conducted as a part of its monetary policy. Besides, the ECB president underlined numerous times that the ECB excluded completely all political influence in its policy consideration.

Table 2. The ECB's main measures to the crisis and objectives

ECB's measures	Aim and justification
1st series of SMP (May 10, 2010)	- Address the malfunctioning of securities markets - Restore an appropriate monetary policy transmission mechanism - Specific operations will be conducted to re-absorb the liquidity injected through the SMP
2nd series of SMP (Augt-Oct. 2011)	- Restore a better transmission of ECB's monetary policy decisions - Ensure price stability in the euro area as a result

Two 3-year LTRO (Dec. 8, 2011)	- Announce the scale, duration and modalities of LTRO - ECB did not explain background of the LTRO nor justify this operation against the EU treaty or ECB statue.
OMT (Sep. 6, 2012)	- Safeguard an appropriate monetary policy transmission and the singleness of the monetary policy - A necessary condition for OMT is strict and effective conditionality attached to an appropriate EFSF/ESM program. - The liquidity created through OMT will be fully sterilized.

Source: ECB.

For its first purchase of sovereign bonds through the SMP, President Trichet insisted that the decision was made on the basis of three guiding principles - price stability, independence of the central bank and prohibition of monetary financing.[4] He emphasized that the ECB called upon governments to respect budgetary discipline and prevent bad fiscal behavior. In this sense, the SMP is part of the ECB's monetary policy in that its objective was to restore an appropriate monetary policy transmission mechanism. However, *sensu stricto*, the SMP leaves two questions regarding its compatibility to the ECB's mandate. First, the SMP was discussed in controversies. ECB chief economist Jürgen Stark opposed the SMP on the grounds that a massive purchase of sovereign debt, *albeit* from the secondary market, is not compatible with the EU Treaty. President Axel Weber of the Bundesbank was not in favor of the SMP, insisting that this measure would eventually hamper the political independence of the ECB. Both of them resigned from the ECB's Governing Council before the second series of SMP were rolled out for Italian and Spanish sovereign bonds. Second, most sovereign bonds purchased through the SMP were without doubt Greek sovereign bonds, while their share in the overall Euro area bond market is small. The question remains on how far Greek bonds would work as an intermediate of monetary policy.

Controversies on ECB's Measures

President Draghi has called the OMT program 'probably the most successful monetary-policy measure undertaken in recent time.'[5] However, the decision to enact the OMT operation was not supported unanimously, with President Wiedmann of the Bundesbank voting against it. According to *MarketWatch*, he viewed the OMT as 'too close' to central bank financing of government deficits with a *'printing press'*.[6] In addition to the controversy on monetary financing, German policy-makers argued that the ECB's bond-buying plan may erode the willingness of Eurozone member states to implement reforms. In fact, the OMT can only be activated under strict conditionality attached to an EFSF/ESM program and liquidity created through the OMT will be fully sterilized. This conditionality was planned to prevent moral hazard of debtor countries and inflationary pressure.

The OMT decision has been challenged in the German Federal Constitutional Court with a signature campaign by 37,000 German citizens. According to the argument, the OMT is unconstitutional; its operation goes beyond the mandate of the ECB and may impose a fiscal

4 Trichet 2010. The ECB's response to the recent tensions in financial markets. Speech by Jean-Claude Trichet, President of the ECB, at the 38th Economic Conference of the Oesterreichische Nationalbank, Vienna, 31 May 2010.

5 Financial Times, Draghi lauds 'most successful' ECB action. (June 6, 2013).

6 MarketWatch, Bundesbank confirms Weidmann opposed bond buys (Sept. 6, 2012).

burden on German citizens without the approval of German parliaments. In June 2013, the Court held a hearing to deliberate and President Weidmann, member of the ECB's Executive Board Jörg Asmussen and German Finance Minister Wolfgang Schäuble were called to be present. Before the hearing, the Bundesbank expressed its caution through a report warning that the ECB's purchase of such debt could "*compromise the independence of the central bank*" and be difficult to stop.[7]

The German Court requested a preliminary ruling to the European Court of Justice (ECJ) concerning the compatibility of the OMT decision with the EU Treaty. In its request for a preliminary ruling, the German Constitutional Court expressed doubts about the legality of the OMT under German and EU law. In January 2015, an Advocate General Opinion stated that the program is in principle compatible with the EU Treaty. Given that the opinions of the Advocate General are usually accepted in final rulings, it is likely that the OMT will be determined as legitimate. However, a number of experts on EU laws still regard the SMP and OMT as illegitimate under the current EU Treaty. The ECB's selective purchase of sovereign bonds, *albeit* from the secondary market, is *de facto* to provide a subsidy to issuer governments by reducing their fiscal burdens. In this sense, the separation between the fiscal and monetary policy areas becomes ambiguous.

According to our research through the review of documents and financial data, and interviews with experts, the ECB still only has the mandate of 'price stability', while its task is expanding to financial supervision under the banking union. All non-conventional measures were conceived and taken in view of ensuring the proper transmission of monetary policy, when some segments of the financial market were severely impaired. These measures were very effective in calming the tension in sovereign markets, but the ECB emphasized many times that the measures were '*parts of monetary policy'* and political consideration was completely excluded. However, the ECB's response to the crisis was late and weak at least for the first phase of the crisis and its full-scale measures were taken at the last minute. This is due to the specific features of the ECB. It seems that the ECB learned how to interpret its mandate in an *affirmative* way and invented *creative* methods to intervene in sovereign markets.

Future Changes in the ECB's Role

Regarding future changes in the ECB's role, it is necessary to note and consider three aspects. First, the Euro crisis provided occasion for reflecting upon the role of the central bank as a 'lender of last resort'. As the crisis deepened, the role of the ECB has been up for discussion. This means that all debates regarding its role during the crisis could become a starting point for its institutional change, *albeit* small. Second, the role of the ECB will be impacted significantly by the level of economic integration in the EU. Considering that the EU does not have any authority to impose taxes and conduct fiscal policy, it is hardly expected that the ECB will provide credit to any European institution and government. Third, the ECB now has supervisory authority over commercial banks in the Eurozone under the ongoing banking union. This means that the ECB has to pursue two objectives simultaneously; price stability and financial stability. While the ECB declared that the two objectives will be treated

[7] Reuters, Bundesbank takes aim at ECB bond-buying via German court. Reuters (Apr 26, 2013).

individually according to the 'principle of separation,' the political and economic dynamics that the ECB has to encounter will be more complicated than ever. KIEP

(*Original version of this paper is 100 pages and published in Korean*)

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