Some Remarks on the Eurosystem's Outright Monetary Transactions

Josef Christl, 25. September 2012

1. The rationale for the Outright Monetary Transactions (OMT)

Mario Draghi stated in his Introductionary Statement of the Governing Council Press Conference of September 6, 2012:

> "As we said a month ago, we need to be in the position to safeguard the monetary policy transmission mechanism in all countries of the euro area. We aim to preserve the singleness of our monetary policy and to ensure the proper transmission of our policy stance to the real economy throughout the area. OMTs will enable us to address severe distortions in government bond markets which originate from, in particular, unfounded fears on the part of investors of the reversibility of the euro. Hence, under appropriate conditions, we will have a fully effective backstop to avoid destructive scenarios with potentially severe challenges for price stability in the euro area. Let me repeat what I said last month: we act strictly within our mandate to maintain price stability over the medium term; we act independently in determining monetary policy; and the euro is irreversible."

2. Technical features of the Eurosystem's Outright Monetary Transactions (OMT)

The Eurosystem's OMT (exectuted in secondary sovereign bond markets) will be conducted within the following framework:

- **Conditionality:** A precondition for OMT is a "strict and effective" conditionality attached to an appropriate EFSF/ESM program. Programs can take the form of a full EFSF/ESM macroeconomic adjustment program or a precautionary program (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases. The involvement of the IMF **shall** also be sought for the design of the country-specific conditionality and the monitoring of such a program. Governing Council will consider OMT to the extent that they are warranted from a monetary policy perspective as long as program conditionality is fully respected, and terminate them once their objectives are achieved or when there is non-compliance with the macroeconomic adjustment or precautionary program. Following a thorough assessment, the Governing Council will decide on the start, continuation and suspension of OMT in full discretion and acting in accordance with its monetary policy mandate.

- **Coverage:** OMTs are considered for future cases of EFSF/ESM macroeconomic adjustment programs or precautionary programs. They may also be considered for member states under a macroeconomic adjustment program when they regain bond market access. Transactions focused on the shorter part of the yield curve, and in particular on sovereign bonds with a maturity of between 1 and 3 years. No ex ante quantitative limits are set on the size of OMT.

- **Creditor treatment:** The Eurosystem accepts the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area countries. Pari passu means "on equal footing" so effectively the central bank will be giving up its seniority to convince bond holders that if they invest in highly indebted nations, in the event of a default or debt restructuring the ECB will not stand in front of them in line to be repaid.

- **Sterilisation:** The liquidity created through OMT should be fully sterilized.

- **Transparency:** The aggregate OMT holdings and their market values will be published on a weekly basis on the ECB home page. The publication of the average duration of OMT holdings and breakdown by country will proceed on a monthly basis.

- **Securities Markets Programme (SMP):** The SMP will be terminated. The **l**iquidity injected through SMP will continue to be absorbed, existing securities in the SMP portfolio will be held to maturity.

3. Positive features of the OMT

- The program managed to calm financial markets (at least in the short-run).

- It is much better designed than the SMP.

- It buys time for the necessary structural adaptions in the peripherial Euroarea countries.

4. Problems of the OMT:

- Opposition of the Bundesbank because of inflation fears in the medium-term: Jens Weidmann voted against the OMT in the Governing Council decision on September 6. For him the OMT as the SMP is very close to government financing by the central bank (which is prohibited by the EU-treaty). If a central bank tries to solve political problems, the central bank risks to lose more and more control over the primary target of price stability. But price stability is a public good which a central bank has to defend.

- The ECB becomes more and more involved in political (ESM/EFSF) decisions: Consequently the independence of the central bank is reduced! What happens, for example, when a ESM program country does not comply with conditionality and the ECB is running an OMT?

- No democratic legitimation of redistribution of risks: Buying bonds by the Euroara central banks means that tax-payers of Euroarea countries finally have to bear the credit risk. In democracies such kind of communitisation of risks should be decided by the relevant parliaments and not by the ECB.

- Will sterilisation of OMT work? The Eurosystem will absorb back the money created, which means it will fully offset the purchases by selling other securities such as treasury bills or by issuing 7-day fixed-term deposits every week, as was done for the sterilization for the SMP.

By doing this, the ECB avoids going down the path of quantitative easing of the Fed which involves creating new money. Bidding in the tenders for these 7-day fixed-term deposits is not compulsory, therefore the amount of bids may vary. In fact, several “failed” sterilizations happened in the past. Even if the ECB is not able to sterilize the full amount of its purchases on a certain week, this would not be problematic per se. The ECB has already lost the control of the amount of liquidity in the system to the banks with full allotment in its regular repo operations. Hence, the whole idea of sterilization to ensure a “neutral” effect on total money supply in the economy is merely to help calm fears (and avoid critics) that ECB bond purchases could be inflationary, even though it has no real impact in the short-run in practice.

- Legal interpretation of the Treaty**:** The Eurosystem seems to be sure that it is acting within its mandate, not violating Article 123 of the EU-treaty. Outright purchases of bonds are also identified, in Article 18 of the Statute of the ECB. However, some doubts remain.

5. Two scenarios for the near future

Two scenarios could develop over months to come:

- A positive scenario: financial markets continue to react positive to ECB’s announcement, achieving a permanently lower level of interest rates throughout the maturity curve. Under these conditions countries might not even need to apply to a program and the ECB’s threat for action would not have to be implemented.

- A negative scenario: the ECB’s announcement have short lived effects as financial markets are not be convinced that countries can manage on their own. Rates would soon start rising again, amid renewed financial turbulence, forcing countries to apply to an IMF/EU program. The political costs of such a move could then be even higher, as countries would be perceived as being forced into a program, rather than autonomously choosing to request one. The ECB would have to intervene, as indicated, starting however from a much higher level of interest rates and thus with much larger amounts.

The likelihood of the two scenarios depends on 2 critical factors.

- The first is the reaction of governments and parliaments to the improved market conditions that have resulted from the ECB’s announcement. If national authorities take the opportunity of the renewed calm in financial markets for strengthening their reform programs aimed at increasing growth prospects, and adopt further measures, in particular privatisation, to accelerate the reduction of the debt, the likelihood of a positive scenario might increase .If instead the euphoria that follwed the ECB’s announcement leads to a relaxation of the reform effort, or even to question some of the measures, the negative scenario would become more likely.

- The second factor is the prospects for economic recovery in the various countries. Any unexpected cyclical improvement, which would contribute to ease the adjustment of the budget deficits and debts, could consolidate market confidence and make the virtuous scenario more likely. If, on the contrary, the general deterioration of economic conditions continues, with further downward revisions of growth prospects and upward revision of unemployment prospects, the risks of a negative outcome increase.