The ECB's OMTs (Out-of-Mandate Transactions)

BY JÜRGEN STARK

The former European Central Bank official takes aim at a central bank mandate stretched to the extreme.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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The European Central Bank has assumed a decidedly proactive crisis management role and, in doing so, has stretched its mandate to the extreme. The International Monetary Fund, politicians, market players, and academics on both sides of the Atlantic have called for the ECB to take on an even more proactive crisis management role. They have pressed the ECB to correct its "genetic defect" and step into the breach as the lender of last resort to buy up the government bonds of struggling euro-area countries—if need be on an unlimited scale—with a view to driving down the yields on these states' government bonds, which are deemed to be too high.

This also apparently triggered a heated debate within the ECB Governing Council. The outcome was predictable. On September 6, 2012, the launch of a new program was announced: the Outright Monetary Transactions (OMTs). The interventions in the secondary market for Italian and Spanish government bonds are, however, subject to conditionality. First, these countries must implement reforms and the European Stability Mechanism must participate in these interventions. Second, the monetary transmission mechanism must be dysfunctional. The path which the ECB has taken will overstretch the institution, further erode its political independence, and prevent it from carrying out its core mandate of safeguarding price stability.

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The ECB Governing Council has "repeatedly crossed red lines since the sovereign debt crisis began escalating," charges Stark.

This could open the door to high inflation—not today, not tomorrow, but in the longer term.

The dispute within the ECB Governing Council is not a personal conflict between individual Council members. It is a clash over deeper and broader fundamental issues concerning the future orientation of monetary union and the role that the ECB should play in this. The dispute mirrors differing basic positions, experiences, and interests. Indeed, it seems as if the ECB is more and more taken hostage by the national interests of the periphery. The Governing Council would be better advised to read up on the historical and institutional role of monetary union and to adopt a resolute market-based approach to macroeconomic management, instead of indulging in short-sighted actionism and over-the-top pragmatism. The ECB has to be mindful of the limits of monetary policy, defend the ECB's core mandate, conform to statutory and legal regulations, and honor the vow made when the euro was launched to nurture a stability culture in Europe and not to embark on the road towards a liability and transfer union for which it has no legitimacy.

After blurring the boundary between monetary policy and fiscal policy, the ECB has put its independence on the line.

The ECB has repeatedly crossed red lines since the sovereign debt crisis began escalating. It started in spring 2010 with the purchase of government bonds of the crisis-stricken states on the secondary market and the dilution of collateral standards. While the ECB argued that it was taking these measures on monetary policy grounds, in actual fact it complemented governments' measures and was engaging in fiscal policy and the prohibited monetary financing of government budgets. Market players have noted that, in view of the conditions prevailing in the markets, the ECB interventions effectively mean subsidizing the government budgets of the countries concerned and hence add up to a financial transfer from the euro area's core to its periphery.

The ECB appeared to be conscious of the fact that the purchases of government securities by the Eurosystem were at least legally questionable. This was the background to the Governing Council's decision at the end of 2011 to discontinue the Securities Markets Programme but instead to provide banks with longer-term liquidity through two three-year refinancing operations. This was "closer to the ECB's mandate."

What has happened since the start of 2012 to cause the ECB Governing Council to decide to resume the purchase of government bonds? The answer is the plight of two major economies, namely Italy and Spain. The yields on these two countries' government bonds rose significantly on account of higher risks and growing uncertainty. Is this of relevance to monetary policy? Are such bond spreads a

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monetary phenomenon? Hardly. Is the monetary policy transmission mechanism impaired, and if so, to what extent? How to tackle the fragmentation of the euro area money markets? Is it an issue for the ECB to address regional problems in giving up the singleness of monetary policy or is it an issue for national governments? These are very complex questions on which the ECB's response was a hyperactive one, stretching its mandate further.

The higher risk spreads for Italy and Spain are easily explainable, even if the markets may well be overreacting at present. After the general elections in December 2011, Spain was in a state of political paralysis for more than half a year. Only belatedly were the problems in the domestic banking sector acknowledged. Their existence was long denied. And it was only after a long delay that a start was made on grappling with the regional governments' budgetary maneuverings. In Italy, a flood of words promising reforms was followed by a mere trickle of deeds. As always, the crux of the problem is implementation. A bigger factor pushing up the risk spreads on Italian bonds is political uncertainty. Will the reforms that have been initiated be continued, or will they be abruptly terminated after the coming parliamentary elections in 2013 before the necessary critical mass required to stabilize trust in the country has been regained?

The higher interest rates for Italy and Spain are not only explainable but also necessary. They are a reflection of home-grown problems, not an extraneous shock that should be dealt with by the central bank. That could only cure the symptoms. The necessary reforms at government level would be further postponed. For this reason, the ECB made its interventions subject to conditionality. However, if a central bank makes its operational actions dependent on the conduct of third parties, the name of the game is no longer monetary policy but rather—as in this case—fiscal policy or "monetary politics." With the OMTs, the ECB is aiming once again—and this time on a much vaster scale than hitherto—to lower individual member states' refinancing costs, which, if implemented, is an implicit financial transfer and also lessens the market pressure on the countries concerned to undertake necessary adjustments. The ECB has no mandate whatsoever to make such implicit financial transfers. The ECB has no right to protractedly interfere with market mechanisms, let alone to seek to assume the bond market's function. What is more, such a policy would make the ECB bend and bow to political leaders and make it extremely difficult to reverse its non-standard measures. In short, the OMTs can hardly be interpreted as being in line with the ECB's mandate. It seems more appropriate to call the OMTs "Out of the Mandate Transactions."

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The real question now is this: What are the likely potential negative consequences of the ECB's hyperactive and panic measures on the credibility of and confidence in the central bank and the single currency? Popular confidence in the central bank and the euro is dwindling. That ought to set the alarm bells ringing for any self-respecting central banker. The ECB must reassign absolute priority to its core mandate of safeguarding price stability. That is the key task that a central bank should and can carry out. Everything else lies in the political domain—the province of parliaments and governments. A central bank is treading on very dangerous ground indeed if it seeks to play the role of superman, speeding to the rescue in every calamity and contingency, accumulating more and more tasks and arrogating to itself more and more power in the process. This road will lead to a very different monetary order—one for which the ECB was not set up.

After blurring the boundary between monetary policy and fiscal policy, the ECB has put its independence on the line. The problems in the euro area are not monetary phenomena that can be combated using monetary policy instruments. In fact, it is more likely that the ECB, through its current actions, is storing up monetary problems for the future. No one would dispute the fact that a central bank has a duty to ensure that banks do not default owing to an insufficient supply of liquidity. Liquidity measures are thus perfectly justified—subject to the proviso that the provision of liquidity should always be a short-term affair, so as to avoid distorting effects on the money/interbank markets and to ensure that the central bank does not narrow its policy options through its own actions. The ECB must concentrate on doing what it can do best, and that is to carry out its core mandate. Any attempt to inflate its mandate diverts its attention and efforts away from its primary responsibility of safeguarding price stability. This is a central bank's *raison d'être,* the task for which it has a democratic remit and for which it is accountable to the public. Taking on extra jobs, such as playing an active role in maintaining financial stability or volunteering to become the single banking supervisor in the euro area, inevitably entangles the ECB in conflicts of interest. It is forced to choose between different political objectives, endangering its independence.

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Together with the European Stability Mechanism, the ECB's decisions concerning OMTs have been interpreted as a backstop to a further escalation of the crisis. This is based on the hope that the provision of unlimited liquidity by the ECB, the ECB's role as a lender of last resort for euro-area sovereigns, and the creation of a high firewall might manage to reassure the markets. But it is an illusion to believe that flooding the markets with cash—or printing money—and building a towering firewall can, by themselves, magic away the crisis. Disruptions in the real sector and solvency problems cannot be resolved in this way. The most they can do is to buy some time, but this begs the question of whether this extra time will be made use of and, if so, in what way. ◆