Institute for Monetary and Financial Stability

CENTER FOR FINANCIAL STUDIES

IMFS

IMFS Interdisciplinary Studies in Monetary and Financial Stability

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The ECB and Its Watchers

2012

About the IMFS

The *Institute for Monetary and Financial Stability* (IMFS) is an academic center of *Goethe University Frankfurt*, Germany. The Institute's main objective is to raise public awareness of the importance of monetary and financial stability – a project funded by the Foundation *Stiftung Geld und Währung*.

The IMFS conducts interdisciplinary research on all questions relating to monetary and financial stability. Apart from its focus on excellent research, the Institute's scholars are committed to knowledge exchange between the academic world and decision makers in politics, administration, financial industry and central banks.

The IMFS is composed of six chairs of which three are funded by the Stiftung Geld und Währung. The research areas of these three chairs – Monetary Economics, Financial Economics, and Money, Currency, and Central Bank Law – are closely linked and designed to stimulate interdisciplinary research and policy work.

About the IMFS Interdisciplinary Studies in Monetary and Financial Stability

With this series launched in 2012 the IMFS aims to present interdisciplinary work crossing the boundaries between monetary economics, financial economics and central bank and financial law. It serves as a first outlet for joint work by IMFS faculty and researchers. The series is open to contributions to basic research as well as writings providing new policy advice. Importantly, it also provides a vehicle for disseminating the results of IMFS research and policy conferences that are joint initiatives of IMFS faculty. Copy rights remain with the authors. The series is edited by the IMFS professors, Helmut Siekmann and Volker Wieland.

Recent Issues

1/2013, The ECB and its Watchers 2012, eds. Helmut Siekmann and Volker Wieland, August 2013. This study contains articles based on speeches and presentations at the 14th CFS-IMFS Conference „The ECB and its Watchers" on June 15, 2012 by Mario Draghi, John Vickers, Peter Praet, Lucrezia Reichlin, Vitor Gaspar, Lucio Pench and Stefan Gerlach and a post-conference outlook by Helmut Siekmann and Volker Wieland.

1/2012, The ESRB at 1, eds. Stefan Gerlach, Ernest Gnan and Jens Ulbrich, December 2012. This study contains articles based on speeches and presentations at the fifth IMFS Conference on Monetary and Finanicial Stability organized jointly with SUERF and Deutsche Bundesbank. It includes contributions by Hermann Remsperger, Stephen Cecchetti, Stephan Ingves, Alberto Giovannini, Jens Weidmann, Alexandros Vardoulakis, Stefano Neri, Jürgen Stark, Elöd Takáts and Christian Upper, Claudia M. Buch, Sandra Eickmeier and Esteban Prieto, Abdul Abiad, Giovanni Dell'Ariccia and Grace Bin Li and Francesco Mazzaferro.

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THE ECB AND ITS WATCHERS

About the ECB and Its Watchers Conference

In 1999, the European Central Bank (ECB) and the Center for Financial Studies, represented by Otmar Issing (ECB) and Axel A. Weber (CFS) respectively, initiated the conference series "The ECB and Its Watchers" as a platform for discussing the challenges lying ahead. Since 2004, it has been organized by Volker Wieland (CFS and Goethe University Frankfurt). The 2012 conference was the first one to be jointly sponsored by the Center for Financial Studies and the Institute for Monetary and Financial Stability, both of which are based in Frankfurt at Goethe University's House of Finance.

Every year, this conference brings together central bankers with academics, media representatives and professionals from the financial community for a debate on monetary policy. The outside experts have criticized ECB decisions and strategies, reviewed new research findings and provided recommendations for improving practical policy making in the euro area. The ECB has welcomed this exchange and stood ready to answer to, clarify, adopt or reject initiatives raised by conference participants. ECB watchers have frequently commented on the usefulness of this platform for a two-way dialogue with policy makers. Perhaps, the greatest compliment has been the start of similar fora in the United States and the United Kingdom in 2007 and 2008, respectively.

Over the years, the ECB watchers have addressed many important policy questions and monitored the ECB's performance and economic developments in the euro area. These topics included, among others, ECB transparency and communication, the divergence of national inflation rates and growing economic imbalances in the euro area, inflation scares and deflation fears, the two-pillar strategy of the ECB, financial bubbles and instabilities, the international role of the euro as well as the interaction of monetary and fiscal policy, fiscal sustainability and the future of the Stability and Growth Pact.

In the past five years, the focus of the conference was on the financial crisis. When ECB officials and watchers met in 2007, President Jean-Claude Trichet (ECB) reported that liquidity-starved banks had been rushing into the "ECB's emergency room" to receive immediate aid. One year later, the ECB emerged as one of the most effective central banks in treating its liquidity-starved patients, though its success may have been as much due to the luck of inheritance of a broader set of instruments for liquidity-provision as to the competence of the "ECB physicians".

At the ten-year anniversary in 2008, ECB watchers discussed, among other questions, whether the euro area possessed an appropriate framework for dealing with the threat of an immediate failure of a large, European, cross-border bank. A number of commentators were highly skeptical. Shortly thereafter, the ECB proved very adept in helping governments coordinate such bank rescues. In 2009, ECB watchers reviewed the ECB's policy response to the great recession and the threat of deflation. While some critics would have preferred earlier interest rate cuts and more quantitative easing, the overall judgment remained fairly positive. ECB officials even praised their two-pillar strategy as ideally-suited for maintaining financial stability in the future.

The question of fiscal sustainability has been discussed almost every year at the ECB watchers conference. In 2005, 2006 and 2007, the reform of the Stability Pact was subjected to particular scrutiny. Speakers included ECB Board members, EU and IMF officials and EU parliamentarians. Typically, they tended to give cautiously optimistic assessments of the workings of the Stability Pact accompanied by regular admonitions that proper implementation was essential, that the European statistical system ought to be improved and that careful monitoring of national governments was needed.

By 2009, much more pressing warnings were voiced in view of the run-up in government debt due to recession, bank rescues and fiscal stimulus. José Manuel González-Páramo (ECB), for example, declared "if confidence in future stability is to be ensured, now is the time to set out an effective fiscal exit strategy". Unfortunately, this warning came too late. By the date of the 2010 conference, some of the worst fears of fiscal stability pessimists had been realized. Within a short period of time, euro area policy makers decided that the "no bailout" regime would have to be replaced with mutual guarantees. The IMF was called in for support, and the ECB surprised many of its watchers by starting direct purchases of euro area government bonds.

Contrary to earlier policy responses to the financial crisis, these measures proved to be highly controversial. Some supporters judged them indispensable for the continued survival of the euro zone as a monetary union, while opponents considered the policies themselves to sow the seeds of continued euro area crises. In his 2010 address to the ECB watchers, President Jean-Claude Trichet emphasized that governments must send a clear message to markets. Just like consumers and countries, governments cannot live beyond their means forever. He called for national fiscal reforms, stronger institutions, more stringent implementation of euro area fiscal rules with greater automaticity and strict conditionality in crisis management.

Subsequently, Ireland and Portugal turned to the EU and IMF for fiscal support, while doubts regarding the ability of the Greek government to achieve its program targets reached ever greater heights. Concurrently, government officials sent conflicting messages regarding the desirability or dangers of sovereign debt restructuring, dragging out its eventual application in Greece till 2012.

At the 2011 conference, President Trichet rejected the seemingly common belief that the euro area as a whole is significantly more heterogeneous economically than the United States of America. He acknowledged, however, that governing such diverse economies with a single currency is more of a challenge in a union of sovereign states than in a political federation. For this reason, he advocated strongly reinforcing euro area economic governance and aligning the economic policy of each member with EMU requirements. He closed quoting Alexander Hamilton, "we should ourselves learn to think (more) continentally".

EU leaders have been working on the creation of new institutions of fiscal governance and financial surveillance. A historic regime change is in the making but uncertainties regarding the future of euro area governance, the outcome of political negotiations and, importantly, electoral support continues to abound. Surely, the analysis, criticism and advice of ECB watchers is needed more than ever before by policy makers, financial market participants and the citizens of the member countries of the euro area.

The debates and speeches at the 2012 conference focused on urgent questions in the current policy debate. Three areas received much attention: banking regulation, monetary policy, and economic adjustment in the euro area. On banking, it was discussed what regulatory structure would be appropriate for managing systemic risk in the sector and whether a form of banking union was needed. Regarding monetary policy, speakers debated whether ECB liquidity provision was insufficient, appropriate or excessive, and whether the ECB had dealt effectively with the challenges arising from the heterogeneous economic situation in the euro area. This was followed by in-depth reviews of divergences and needs for economic adjustment in the euro area. Progress on the adjustment path was evaluated and diverse visions of the future of euro area governance and the make-up of the monetary union were presented.

Program ECB and Its Watchers Conference, June 15, 2012

08:15-08:45 Registration and Coffee

08:45-08:50 *Welcome*
Volker Wieland (IMFS & CFS)

08:50-09:30 *President's Address*
Mario Draghi (President, European Central Bank)

Lead Questions:
Michael Wickens (University of York)
Thomas Mayer (Deutsche Bank)

09:30-10:30 Debate:
What is the appropriate regulatory structure for managing systemic risk in the banking sector? What are the most important challenges for the EU in this regard?

Chair: Jan Krahnen (CFS)

Speakers:
John Vickers (Oxford University)
José Campa[1] (IESE, University of Navarra)

Lead Questions:
Beatrice Weder di Mauro (University of Mainz)

10:30-11:00 Coffee Break

11:00-12:30 Debate:
ECB liquidity provision in stressful times: Has it been insufficient, appropriate or excessive? Has the ECB dealt effectively with the challenges it faces in a heterogeneous monetary union?

Chair: Michael Binder (CFS)

Speakers:
Peter Praet (Member of the Board, European Central Bank)
Lucrezia Reichlin (London Business School)
Willem Buiter[1] (Chief Economist, Citi Investment Research & Analysis)

Lead Questions:
Manfred Neumann (University of Bonn)
Luigi Buttiglione (Brevan Howard Asset Management)

12:30-14:00 Lunch

14:00 - 14:40 Speech

Divergences and adjustment in the euro area

Vítor Gaspar (State Minister of Finance, Portugal)

Chair: Volker Wieland (IMFS & CFS)

Lead Questions:

Gertrude Tumpel-Gugerell (formerly Member of the Board, ECB)
Ulrich Kater (DekaBank)

14:40 - 16:10 Debate:

Euro area governance: Are the reform of the fiscal framework and national consolidation efforts effective in containing the sovereign debt crisis? Is the burden-sharing between monetary and fiscal authorities appropriate, or has the ECB ventured too far into the fiscal domain? Does the euro zone suffer from a balance-of-payments crisis?

Chair: Michael Binder (CFS)

Speakers:
Lucio Pench (Director Fiscal Affairs, European Commission)
Hans-Werner Sinn[1] (President CESifo, University of Munich)
Stefan Gerlach (Deputy Governor, Central Bank of Ireland)

Lead Questions:

Julian Callow (Barclays Capital)
David Marsh (OMFIF)
Michael Melvin (Blackrock)
Helmut Siekmann (IMFS)

16:10 Closing Remarks

since 1999

THE ECB
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WATCHERS

[1]The contributions of these participants were not available for inclusion in this issue.

Volker Wieland
Introduction

President Draghi, State Minister of Finance Gaspar, Ladies and Gentlemen,

I am very pleased to welcome you to this conference, which brings together "The ECB and its Watchers" since 1999. This year, the Center for Financial Studies is joined by the Institute of Monetary and Financial Stability as co-sponsor of the event. Both institutes are located in the House of Finance of Goethe University Frankfurt.

Today, we meet at a dramatic confluence of events concerning European Monetary Union. Several EMU members' commitment to the type of policies that are required to maintain stability in a monetary union continues to be challenged by financial market participants. In some cases, electoral support for such policies is highly questionable.

At the same time, European Union leaders are considering to augment the monetary union with a banking union, a debtor's union and a fiscal union. Such changes would bring us much closer to a political union. They would involve a substantial shift of power from the national to the supranational level. The hope is that supra-national institutions would perform better than national governments in terms of committing to and implementing the type of policies that are required to maintain stability in a monetary union.

Surely, the analysis, criticism and advice of ECB watchers is needed more than ever by policy makers, financial market participants and euro area citizens. So, let me emphasize how much we appreciate that ECB President Mario Draghi has agreed to continue the tradition of the President's Address at the ECB and Its Watchers Conference which was established by his predecessor, Jean-Claude Trichet.

President Draghi is well known to everybody in this room. You're familiar with his earlier responsibilities as Governor of the Bank of Italy, Chairman of the Financial Stability Board, Vice-Chairman and Managing Director at Goldman Sachs International, Director General of the Italian Treasury and Executive Director at the World Bank. You might even know that he studied in Rome, obtained a Ph.D. in Economics from the Massachusetts Institute of Technology, and was a professor at the universities of Trento, Padua, Venice and Florence.

I was wondering what I could tell about President Draghi that has not yet been publicized many times. So, I looked into his writings, in fact, into one of his earliest writings, his 1977 Ph.D. dissertation supervised by Franco Modigliani.

And I found something interesting to tell you. In the third chapter, entitled "Short-run stabilization policy and long-run economic plans", Ph.D. student Mario Draghi referred to a "trade-off between short-run stabilization policies and long-run plans". He discovered that "if policies suggested by short-run optimization are implemented, the long run (optimal full employment) path will never be reached". By contrast, "if policies that are optimal from a long-run point of view are actually enforced on the short-run economy, it will remain stable and the optimal growth path will be achieved".

I believe that EU leaders, especially those keen on economic growth, would be well advised to base their decision making on such thinking.

Without further ado, I am very pleased to invite President Draghi up to the podium to speak to us.

Mario Draghi
President's Address

Ladies and Gentlemen,

It is a great pleasure to take part in this fourteenth edition of the ECB watchers conference – and the first I am attending as President of the European Central Bank.

As you are all aware, the ECB has the crucial role of providing liquidity to sound bank counterparties in return for adequate collateral. This is what we have done throughout the crisis, faithful to our mandate of maintaining price stability over the medium term – and this is what we will continue to do. The Eurosystem will continue to supply liquidity to solvent banks where needed.

In normal times, "adequate liquidity" may be defined as a volume of refinancing in line with the need for banks to meet the obligatory reserve requirements and the financing of other autonomous factors. In times of increased financial instability, "adequate liquidity" indicates a volume of central bank money that also counteracts a temporary inability of banks to refinance in the market, which could lead to systemic consequences for the banking sector as a whole.

In my introductory remarks this morning, I will talk in a little more detail about the ECB's monetary policy. I will also discuss Europe's agenda for growth and issues relating to a longer-term vision of our economic and monetary union.

1. Considerations on monetary policy
Let me start with monetary policy. There are two features I would like to highlight. The first relates to the effectiveness of the three-year long-term refinancing operations (LTROs) that we launched a few months ago.

As you will recall, these operations were introduced in an environment where money market spreads had surged, liquidity had dried up and banks' access to market-based funding had eroded rapidly. The uncertainty about market-based funding for banks – especially medium-term funding – was perhaps the most critical issue in that environment. It truly threatened to undermine bank lending and created pressures for a broad-based deleveraging. A resulting credit crunch would have severely aggravated the slowdown in economic activity, hurt employment and given rise to acute downside risks to price stability. We must always remember that over two thirds of external financing of firms comes from banks. This ratio is even higher for small and medium-sized enterprises, which account for about three quarters of corporate employment in the euro area.

It is against this background that we decided to launch the three-year LTROs. Their objectives have been broadly met.
The April bank lending survey points to a marked decline in the net tightening of credit standards and a general improvement in banks' funding conditions. This evidence is supported by a range of market and other indicators. Overall, it confirms that supply side constraints on bank credit have been removed. This has been a very important result.

The full supportive impact of the three-year LTROs needs time to unfold, so it is too early to draw firm conclusions about the behavior of a single variable – namely, bank credit to the private economy – that is influenced by a multitude of factors. In the current environment of very weak credit demand and heightened risk aversion, a rebound in the volume of credit will be particularly slow.

Yet granular balance sheet data indicate that in February and March, banks domiciled in stressed constituencies could interrupt and partly reverse the sustained decline in loans over the previous months. Indeed, smaller banks in some of those countries could increase their supply of loans.

Inflation expectations remain well anchored and there is no inflation risk in any euro area country. Financial market-based inflation expectations over a ten-year horizon are consistent with our definition of medium-term price stability. And should risks to price stability emerge, the Eurosystem has sufficient tools at its disposal to absorb excess liquidity. The second point I would like to highlight as a way of understanding the ECB's current conduct of monetary policy is heterogeneity. The situation regarding economic growth is quite different across the euro area.

This is not the first time; we had clearly diverging cycles ten years ago. At that time, growth in Germany was very low and growth in other countries was buoyant. This is part of a normal degree of cyclical heterogeneity that we observe in very large continental economies. It is very similar to what we observe in terms of cyclical heterogeneity within the United States.

What is new in the current episode is the parallel fragmentation of financial markets. This first concerns the interbank market, which works almost exclusively on a national, collateralized and very short-term basis. It is also true for broader capital markets and private capital flows, where home bias is rising.

The prime reason for the current home bias is general risk aversion. In addition, we are very attentive in monitoring whether regulatory initiatives – including anticipation of future liquidity ratios – or initiatives from national supervisors are affecting this market, especially across borders.

We have partly responded to the fact of increased heterogeneity by allowing some national central banks to enlarge the collateral pool. This was essential to ensure sufficient outreach to the real economy in their constituencies in a context of significant heterogeneity. They could accept more direct credit claims, particularly to support credit to the small and medium- sized enterprises that are so important for investment and employment.

This collateral enlargement was crucial for addressing a situation of liquidity abundance in some countries and liquidity scarcity in others. The enlargement has taken place with prudence and its risk management framework is overseen by the Governing Council.

While the process will take time, the restoration of adequate credit flows and the renewed functioning of the interbank market remain our firm objectives.

2. Europe's growth agenda

Let me now turn to the European growth agenda. Strengthening the growth potential of our economies is crucial.
We have a whole range of pending reforms at the national level: the liberalization of product markets; the removal of bureaucratic impediments to entrepreneurial activity; greater labor market flexibility, which facilitates the re-entry of the unemployed into the job market; and a growth-friendly composition of fiscal adjustment. Let me elaborate a little.

Product market regulations can be streamlined so as to foster competition, particularly in sheltered professions and the services sector. Extensive administrative reforms should facilitate the start-up of new firms. Moreover, judicial systems can be adjusted so as to resolve and avoid court backlogs, which hamper the conduct of business activities. Once a critical mass for such reforms is achieved, they will considerably strengthen economic dynamism, innovation and employment.

These efforts should be complemented by active labor market policies, targeted at the low- skilled, the elderly and young unemployed people. This would facilitate re-entry into productive activities for those who typically face the most difficult starting position. It would also foster social cohesion despite the burden of economic adjustment facing our economies.

Second, important reforms are pending at the EU level, with the implementation of the Services Directive being a very important initiative to facilitate cross-border trade in services. By reducing the market power of producers, these reforms will put downward pressure on prices and upward pressure on productivity.

Third, I believe that we should oversee national reforms to promote growth in a way that is a parallel to the way in which we oversee fiscal policies. Here we might draw inspiration from the fiscal compact and the idea of avoiding unsustainable policies in the first place and providing incentives for positive reform. In a single currency area, national reforms that affect growth potential and competitiveness are just as important as fiscal policies because they are equally essential for economic sustainability.

Fourth, many items that are considered at the national level could be considered at the EU level. For example, measures to foster labor mobility could be implemented, inter alia by facilitating the cross-border portability of pension rights. European funds could be reallocated to areas most conducive to long-term growth and durable employment opportunities. And the capacity of the European Investment Bank to finance infrastructure projects could be strengthened.

As you can see, there is a long-standing agenda on growth. It is time to implement it with determination and confidence about its longer-term benefits. Collectively, we can compete more effectively in the global economy. Collectively, we can better support growth and job creation. And collectively, we can preserve our common European values of fairness, social cohesion and social progress.

3. Considerations regarding the longer-term vision for economic and monetary union

Let me turn to the broader question about the evolution of the euro area towards a genuine economic union – one that is commensurate with our monetary union.

As you know, I am in close contact with Presidents Herman Van Rompuy, José-Manuel Barroso and Jean-Claude Juncker to reflect on elements of a longer-term vision for our economic and monetary union. Ultimately, such a vision can be the basis for a process where objectives, progress, conditions and deadlines are specified; and where credibility is substantiated by action in the short run that is in line with long-term objectives.

Since this is a joint effort and our work is still in progress, I cannot provide specifics about this matter as yet. But I can tell you that my reflections are founded on the central aim of securing stability and sustained prosperity for the euro area. Price stability will remain a cornerstone of economic and monetary union, as it has been since the beginning. But in order to preserve broader economic stability, we need strengthened foundations in the fields of financial, fiscal and structural policy-making.

The strengthened foundations should secure the past achievements of integration. They should improve the management of the euro area economy. And they should bring economic and monetary union closer to the hearts and minds of Europe's citizens, whose ownership of our collective project of integration has been shaken by the crisis.

A key issue in this context is sovereignty. In processes of economic integration, we often speak about giving up sovereignty. Yet integration is far from being equivalent to giving up sovereignty. There are many cases in which integration implies a "sharing" or "pooling" of sovereignty. And there are some cases where integration actually leads to more sovereignty and at a higher level. For example, some smaller euro area countries actually regained sovereignty with the euro by regaining influence over monetary policy at a higher level.

Something similar may hold for countries joining the EU, when they can participate in the shaping of the single market rules rather than having to adjust to them. In a globalised economy, the dwindling of individual influence may actually be reversed through integration.

Of course, this is only true if countries and their citizens are involved in joint decision-making. The degree of participation is therefore much more important than the level of policy assignment to determine whether sovereignty is lost, shared or actually gained.

In the case of Europe, more and more decisions have been elevated to a supranational level because they could only be taken efficiently and effectively by accounting for interlinkages and spillovers. But at some point, when supranational institutions and processes continually gain influence, the need for greater political legitimacy becomes more and more pressing.

In some cases therefore, the first issue to consider with any possible further transfer of competencies would be the transfer of legitimacy through political accountability. If legitimacy is fully ensured at all levels, the policy assignment question can be answered on grounds of policy optimality.

4. Conclusion

Let me conclude. As half a decade of crisis has forcefully demonstrated, macroeconomic and financial imbalances entail considerable challenges for the smooth functioning of our economic and monetary union.

Despite these challenges, our monetary policy framework, which is firmly anchored in central bank independence and a clear focus on price stability, has provided a robust basis for the ECB to deliver on its mandate. By preserving an unambiguous commitment to price stability, the ECB has made its best contribution to mitigating the fallout from the crisis. This commitment will continue to guide our policy in the time to come.

Thank you for your attention.

Sir John Vickers[1]

Structural Reform in Banking

I want to talk about three things. First, I'll sketch the context for the work of the UK's Independent Commission on Banking (ICB). It began exactly two years ago, in June 2010, and it concluded nine months ago, on September 12th, 2011. It's very timely to be talking about this work today because yesterday the UK government announced its implementation proposals, as some of you may have read, for example, in the Financial Times. Second, I'll spend most of my time trying to explain the rationale for the recommendations we made on financial stability. Partly they are structural and partly they are about loss absorbency. I will end with some comments on the debate on structural reform in Europe with which, of course, my fellow panellists, Jan Pieter Krahnen and José Manuel Campa, are intimately involved as members of the Liikanen Group.

On the context for our work, you can see at a glance a chart **(Figure 1)** that encapsulates absolutely the point that ECB President Mario Draghi was making today about heterogeneity, in this case, of banking systems across Europe and beyond. The UK has a very big banking sector in relation to GDP, about five times GDP including some individual banks that are themselves individually very, very large in relation to year's output. The US, nearly at the other end, is very different. There, the ratio is about one. The economy is of a different size, and the relationship between bank finance and non-bank finance is very different, exactly as President Draghi was saying. Among European countries you see a mixed pattern. This is only one dimension. The nature of the banking systems across Europe is also very heterogeneous and I think that makes the task of the Liikanen Group particularly difficult.

Through the decades until the late nineties, for the UK banks leverage **(Figure 2)** – that's in unweighted assets – was in the region of twenty. In the run-up to the crisis it became forty and in some cases even fifty. It was not just that there was a thin layer of equity; it also turned out in the UK, as in many other places, that debt-holders, when the crunch came, in many cases took very little pain or no

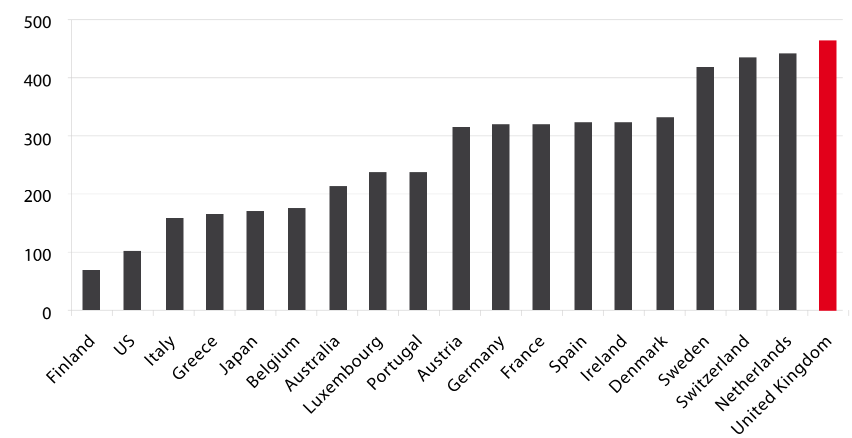


Figure 1: Domestic banking assets as a percentage of GDP consolidated by nationality of headquarters

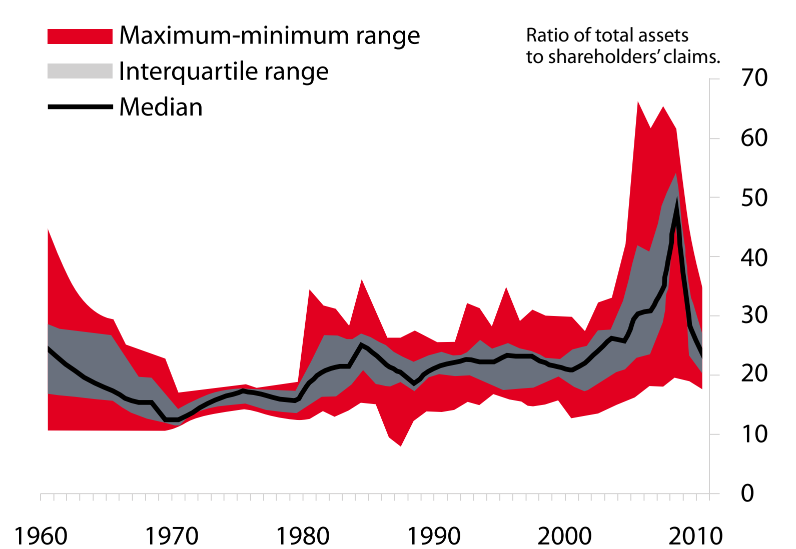


Figure 2: Increase in UK bank leverage in the past fifty years

[1] *This text is an edited transcription of the speech by Sir John Vickers at the ECB and its Watchers Conference XIV on June 15th, 2012.*

pain at all. So, thin equity layer and brittle debt structure.

How did leverage grow so much? This chart **(Figure 3)** goes back just 25 years – again it's focussing on the UK. The lower red and black slabs are, if you like, bank lending to the real economy. The pink part is bank lending to elsewhere in the financial system of the banks, of the financial institutions, and while in relation to GDP all of these things grew, the lending to other financial institutions grew most spectacularly. In a way, that heightened the crisis and the propagation of shocks. On the other hand, I think it shows that there is scope for a degree of leverage reduction, which need not hit the real economy.

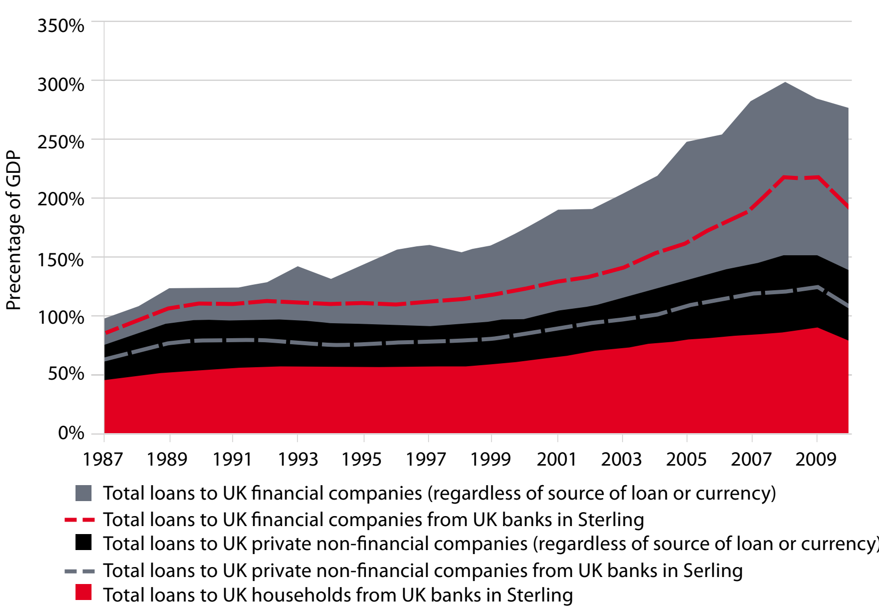


Figure 3: Total loans to different economic sectors as a proportion of GDP

When the shocks came they were partly domestic – through the property market, in particular commercial property – and affected some banks badly. But the proximate cause of all this was, of course, the US sub-prime shock. The UK has banks that are very international in scope, so things on the other side of the Atlantic, or other side of the world, can come back and jeopardize, literally high street banking in the UK. So, in the UK you had this thin equity layer, brittle debt structure, great international exposure, a lot of wholesale and investment banking, interconnectedness not only between banks but also within banks, in that you had in the same legal entity UK high street banking – current accounts, for example, to individuals and small businesses, payment system things – and some geographically remote and, in terms of services, very different kinds of activity (derivatives, proprietary positions, etc). So, when the shocks hit and got amplified through the financial system, the UK, being so exposed, had a bad crisis, but the government of the day faced up to the problems pretty swiftly. There were huge capital injections and many other means of support, which stabilized it. Then the new government embarked on a fiscal consolidation programme. Even with all that support to the banks and massive injections of UK taxpayer funds, there was, of course, huge disruption of economic activity and output is now on a path way below its previous trajectory, even if you soften the previous trajectory, taking the view that some of it may have been somewhat bubble related.

Against that background, the ICB were set up exactly two years ago. There is an annual event in the City called the Mansion House Speech, which also happened last night in London. Among the announcements in the 2010 speech was the creation of our group. Some of you will know my fellow commissioners very well, including Martin Wolf, who in the Financial Times today talks about yesterday's white paper. Our task was not only focussed on financial stability but also on competition issues.

We were given fifteen months and our final report was, as I said, issued in September 2011. Since then the government did its initial consultation. In December it accepted the recommendations in principle. Yesterday the implementation phase started, and the government is implementing our recommendations in very large part. There are also some variations. Some of those are completely sensible. In fifteen months you can only get so far, and in a further nine months the government has refined the proposals. We, the ex-commissioners – former members of a commission that no longer exists – are very pleased that the bulk has been implemented. There are some points where we disagree, for example on leverage ratios, which we could discuss if people wanted. We ourselves recommended going further than the government proposals yesterday, but the main point is that the bulk is going to be implemented.

How did we think about these questions and issues? It's always hazardous to boil something down to a two-by-two slide, but this is a way of explaining how we approached things **(Figure 4)**. The financial stability aim has two sets of instruments that we looked at, as well as the surrounding regulatory reform on liquidity, market infrastructure, supervision etc. and remuneration. The first dimension is the structural question, which we were explicitly asked to look at, of whether there should be some form of separation between retail banking, somehow defined, and wholesale investment banking, somehow defined.

The other dimension was loss absorbing capacity, not just equity capital but also trying to make the prospect of debt, especially senior unsecured term debt, more likely to absorb losses in a future crisis. Those were the two dimensions.

In some sense we favoured being in the middle, in the crosshairs of that diagram. Trying to do it only by structural means, even if you go very radical, would still leave the taxpayer on the hook for retail banking. We didn't think that would be an adequate solution. Trying to do it all, however, by high capital with no structural measures, would leave in the same entity geographically remote activities, derivatives, proprietary positions, market making, etc., on the same book as domestic high street banking. That would not be an adequate remedy either.

We favoured a package consisting of the two – both elements – in moderate but firm combination. We think the package is radical. It's probably fair to say it's more far-reaching than any other major jurisdiction has so far adopted, but we were not super-radical on either dimension. So it's a combination of the structural measures, which I'll focus on today, but in our minds the loss absorbency is at least as important, and indeed the two have to be seen together. Our structural recommendation goes under the heading of ring-fencing. I'll explain what that is shortly, and why we adopted it.

		Structural reform	
		Mild	**Radical**
Loss-absorbing capacity	**Mild**	**Fails to solve stability problem**	**Taxpayer still on the hook for UK retail banking**
	Radical	**Fails to shield retail banking from risks elsewhere**	**Goes further than needed, real risk of geographical arbitage**

Figure 4: Reform options for financial stability

I want to stress the point that we see what we're doing very much as interlocking in philosophy, and objective, and principle, and in terms of practical implementation, with the developing international agenda through the G20 process, Basel, as well as the CRD IV from Brussels. We had last week the RRD proposals, the draft Recovery and Resolution Directive, and we see a close dovetailing between these things, though, in some respects, the UK is certainly going beyond internationally agreed baselines.

Mandated	Permitted	Prohibited
• Deposits and overdrafts to individuals and SMEs	• Deposits and payments for any EEA customer	• Any non EEA-services
	• Non-financial lending, trade and project finance and advice to EEA customers	• Most trading and underwriting of derivatives and debt, asset-backed or equity securities
		• Lending to financial companies

Figure 5: Ring-fence design

This is all part of trying to get the taxpayer off the hook, or at least very remote from the hook, in future crises. The implicit subsidy is very likely still to be large and this is part of the solution. Ring-fencing allows you to do that in a way that is consistent with global competitiveness because you can have higher capital requirements within the fence than outside, so we do not see it as unduly detrimental to the global competitive position of the UK banks, and we also think that in the longer term it gives a good long-run framework for lending to the real economy.

We could spend a lot of time on the ring-fence design. In short, our proposals were to have a strong fence – it's got to be a strong fence, otherwise there's no point in having it. But its location within parameters could be flexible. Certain things would have to happen within the ring-fenced entity. Certain things could not happen within the ring-fenced entity but they could happen in the wider group. Those are Volcker-prohibited things plus a whole lot more as you can see from the table **(Figure 5)**. But then, in between, on either side of the balance sheet, there is a margin of flexibility where it would be up to the banks and their customers whether to undertake those activities within the ring-fenced subsidiary or in the rest of the group.

Why ring-fencing? That question has two parts. One is: why should we do anything structural? The other is: why not be more radical? I will address both. Ring-fencing is based on the recognition that the continuous provision of domestic retail banking (and that's defined in EU, in the EEA terms) is not just economically vital but also socially vital, and therefore that no government with a capacity to rescue that in a crisis would fail to do so. Ring-fencing means that you would have a separate legal entity, very likely to be within a wider banking group, which would have its own capital support and its own liquidity ratio. There could be movements of capital around the group subject to those requirements, but it would give you a degree of insulation. Nothing is perfect, but we think an important degree of insulation of those vital retail banking services from global shocks is provided by ring-fencing. We also believe it would hugely ease resolution. When the UK government and others had to step in, in the autumn of 2008, their support had to be very wide and very deep. The options did not exist for more targeted interventions, in part because the legal powers were not there (the regulatory tools), in part because you had co-mingled, in the same banking entities with no internal structural breaks at all, widely diverse activities. Just as resolution would be helped by such measures, so would be supervision.

If you applied that, taking a snapshot of the UK bank balance sheet as it was a year or two ago – the position now is slightly changed but is not altogether different – you would have between a sixth and a fifth belonging to those mandated activities. A similar amount would be in the middle range but almost two thirds would be outside the fence. This pie chart **(Figure 6)** would look very different in other EU member states. This reflects just how globally active UK headquartered banks are. In some places you'd have a similar picture but in others it would be very different indeed: you'd have much more either required to be or permitted to be within the fence.

You need independent governance of the ring-fenced entity, which needs to have its own liquidity and capital standards. There would be limits, essentially on a third party basis, about dealings between the ring-fenced entity and the rest of the banks and there would be reporting and disclosure requirements. We recommended this as an independently listed company. From yesterday's measures, the government thinks there are better ways of doing it and I think they are probably right on that point. But the principle is common.

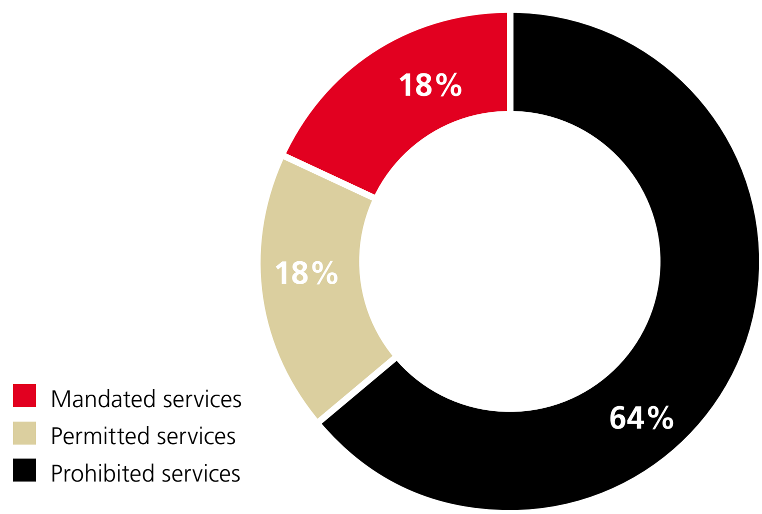


Figure 6: Ring-fence asset split

Why not a full breakup? We got criticism from both sides of the debate. Some quite powerful voices have been arguing for a total split. However, the costs of that would be considerably higher. And it's not obvious that it would give you more financial stability. For some kinds of shock, a full breakup would be a better way of defending domestic retail. However, you would do better, you would be more stable with universal banking, in the case of other kinds of shocks (domestic, property market shocks, for example). So, we remained with universal banking. Our proposals are not anti-universal banking. We're rather favouring universal banking with structures within banks rather than these completely unstructured, comingled activities.

Why not Volcker? Our philosophy is very similar to Volcker and very similar to a lot of the measures that the US instituted in the 1930s. Government-backed deposits should not be funding certain kinds of activities. In some ways, we think Volcker does not go far enough. Our prohibited activities, i.e. prohibited from the ring-fenced entity but allowed in the rest of the group, give a much wider range, geographically and in terms of products and services, than Volcker. In another way we are less radical than Volcker in our recommendations because we're not saying that those activities should be banned from the banking group. We're rather saying certain activities can't happen inside the fence, but they can happen elsewhere in the banking group. Some of the wrangling in the US about the design of the Volcker rule results from the fact that the line has been drawn in quite a difficult place (through market-making, for example) and it's an all or nothing thing. To say to a bank "you cannot do those activities" is very different from saying "you can't do that in the deposit taking part of your bank, but it's fine if you want to do it elsewhere, that's entirely a matter for you".

And that leads on to a further point that the US context is very different from that in Europe and in the UK, not only with respect to the banking systems but also with respect to the regulatory situation. They have Section 23a of the Federal Reserve Act, which was perhaps rather a sleeping part of the legislation during the era of Glass-Steagall, but which still provides for a kind of separation within banking groups. What we're proposing is not quite the same, but everyone, when they think of Volcker, should look at it in that context, of that existing legislation, which Dodd-Frank has taken further.

Finally, a few closing remarks on the situation in Europe. Do the current stresses and strains weaken the case for bank reform for the medium and long term? In our view, this is absolutely not the case. They underline the need for such reform.

We got quite a bit of criticism in the UK for the long timeline we were recommending, which is essentially the same end date as Basel, the start of 2019. We think that timeline gives appropriate time for adjustment and I would echo what President Draghi said about having credible paths. That would be a path where something is feasible and achievable and everyone, including the market, expects the adjustment is going to happen in a much more comfortable way than otherwise. So we would really stress the importance of the "too-big-to-fail-problem" not getting translated or twisted into a "too-delicate-to-reform" problem.

Furthermore, we think that banking stability in the EU member states is a public good for Europe. This point has been made in relation to UK financial stability by the IMF. Christine Lagarde in London a couple of weeks ago, was saying that UK's financial stability is a global public good given the nature of London as a financial market. I think that is absolutely right. So our reform package is pro-European. All the externalities, I believe, are positive. Also, for single market reasons, it is desirable to iron out and remove the implicit subsidies, which I believe are still there. There seems to be much more risk of national watering down, including in the Basel process, than of beefing up. You need a very strong baseline.

I doubt that, given the heterogeneity, a "one size fits all" prescription is going to be right. I'm certainly not here to say that everyone should adopt precisely the ICB package. I think there's a shared set of principles here and objectives, and the diagnosis for the UK banks has a lot in common with a diagnosis for banks elsewhere in Europe. I do believe that the optimal policy mix is not only about capital, liquidity, loss-absorbing debt etc., and I didn't mention other aspects of our proposals on that like deposit preference and all the rest. Structural elements are also part of the optimal package. The problem is under-capitalized and unstructured universal banking. The problem is not universal banking by itself, and our package, which the UK government yesterday very largely endorsed, addresses this Europe-wide problem for the UK. In my view, it is extraordinarily important that policy-makers now address these issues in Europe, all the more so with the debate turning to banking union.

My final remark is about banking union. The arguments for it have been articulated by many people and it seems to me that in the context of euro zone banking union, they are very cogent. But it depends on how it's done. A banking union in which you continue to have under-capitalized and unstructured banks could in a way be exacerbating the problems of implicit guarantee because not only would, as it were, my bank have my national taxpayer as a backstop, it would have taxpayers across the euro zone as a backstop. It seems to me that an essential ingredient of a sound and stable banking union is precisely reform aimed at these objectives, to have properly capitalized and properly structured banks for the medium and longer term. Thank you.

Peter Praet, Executive Board Member, European Central Bank[1]

Heterogeneity in a monetary union

When the euro was introduced, many critics claimed that economic and monetary union (EMU) would not work because euro area countries' business cycles and economic structures were not sufficiently similar. But does economic integration really need to imply economic uniformity? I do not think so. This can clearly be seen in the US.

Regional economies are hit by different economic shocks and perform differently owing to their differing economic structures, even over extended periods. At the same time, institutional safeguards are required to ensure that heterogeneous developments do not become self-reinforcing and pose a threat to overall macroeconomic stability. In the euro area, we have to acknowledge that economic conditions have become increasingly heterogeneous. But this does not imply that a common currency cannot succeed in the euro area. We need to address the institutional shortcomings and weaknesses of EMU to allow the euro area to cope with heterogeneous economic developments and large asymmetric shocks, as is the case in the US. There, too, economic and monetary union did not occur overnight; it was a long process.

Since the introduction of the euro, many of us have been aware of institutional deficiencies, both in terms of the prevention of imbalances and as regards the management of such imbalances in the event of a crisis. The crisis is now forcing us to address these issues.

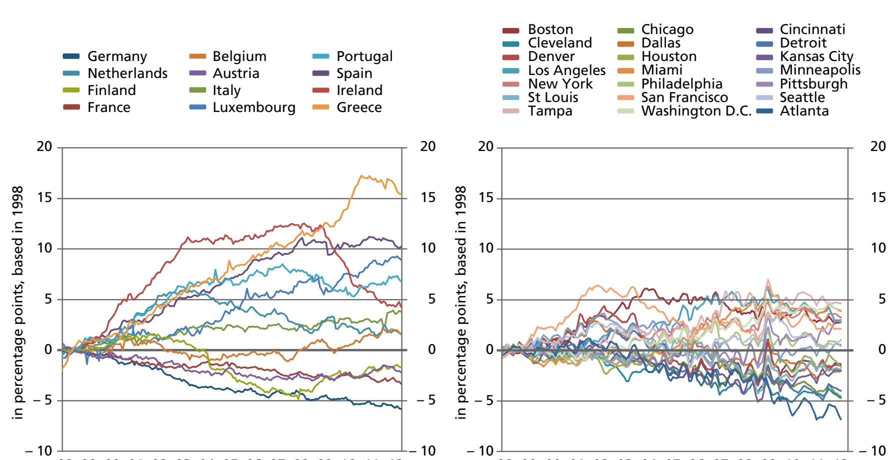
In doing so, we need to look at how and why imbalances arose in the euro area and how the ECB's monetary policy responded to them.

Before the financial crisis, euro area countries achieved a very high degree of convergence in financial conditions. At the same time, large macroeconomic and financial imbalances were gradually accumulating.

With the advent of the euro, euro area banks were able to trade with one another in a unified money market. Consequently, there was significant convergence in the interest rates that banks charged households and firms. Indeed, these are necessary conditions for a single monetary policy that affects all economic agents in the same way.

However, the sovereign bonds of the various euro area countries were also priced at rates that were very similar. These rates bore little relation to countries' fiscal and macroeconomic fundamentals. With the benefit of hindsight, this is a puzzling outcome. Clearly, a single monetary policy should imply a single money market interest rate, as well as a single long-term risk-free interest rate. And with inflation expectations converging across the euro area, sovereign bond yields could be expected to become less dispersed. However, despite the single monetary policy, differences in the credit risk of individual countries, consumers and firms remained. But financial markets were less wary of such risks, thereby establishing improper incentives for public and private sector borrowers.

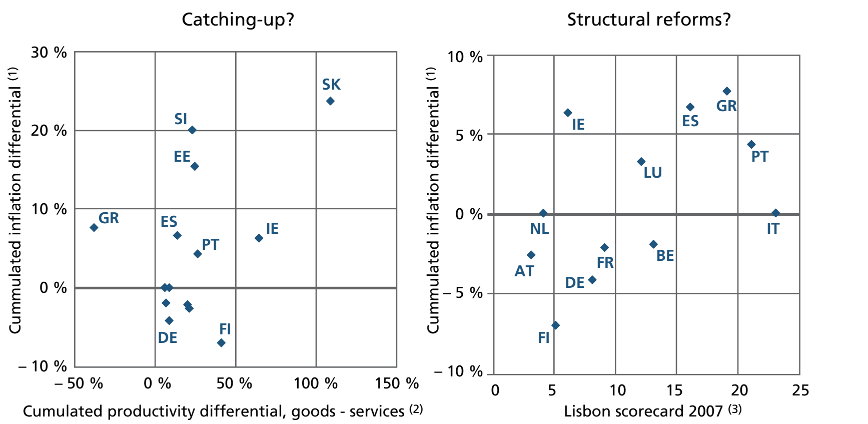
One simple summary indicator of the degree of economic heterogeneity is cross country inflation differentials. These



Note: Regional inflation differentials with respect to the aggregate of the euro area or the US are cumulated starting in 1998.
Sources: Eurostat, Bureau of Labor Statistics and ECB calculations.

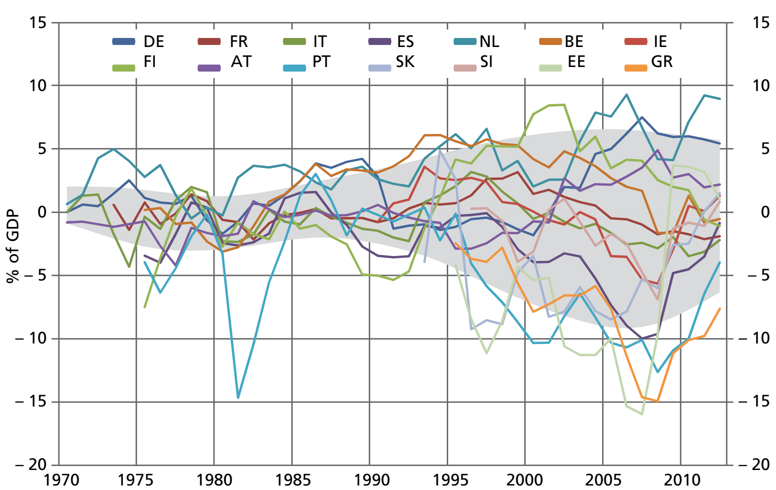
Figure 1: Persistent inflation differentials in the euro area

[1] *This text is an edited transcription of the speech by Peter Praet at the ECB and its Watchers Conference XIV on June 15th, 2012.*



(1) HICP, 2000 to 2007.
(2) Productivity based on total employment, 2000 to 2007, total industry (excl. construction) vsa selection of services.
(3) This measures the implementation of the Lisbon strategy. The higher the score, the less the strategy has been implemented.
Sources: Eurostat, Centre for European Reform

Figure 2: Sources of inflation differentials



Note: The grey area represents the difference between the HP filtered trend of the 90th and 10th percentile of the current account balances across countries.
Sources: OECD and ECB calculations.

Figure 3: Current account divergences in EMU

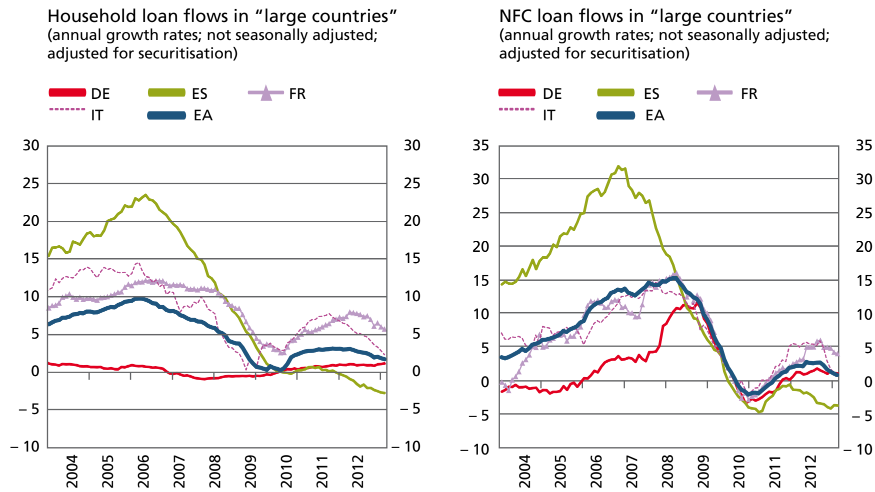
reflect differences between countries in the business cycle, productivity growth and the functioning of labour and product markets. They also affect countries' real interest rates, as well as the international price competitiveness of their goods and services. Monetary union resulted in inflation differentials in the euro area falling to a level comparable to the US. However, although the two areas had similar inflation differentials, they were more persistent in the euro area. As a result, euro area inflation differentials led to a divergence of relative prices that was twice as large as in the US. **(Figure 1)**

The main reason behind these persistent inflation differentials reflected differences in implementation of structural reforms especially in product and labour markets. Consequently, wage growth exceeded productivity growth and prices rose faster than in other countries. **(Figure 2)** These inflation differentials led to divergent developments in international competitiveness and contributed to unprecedented current account imbalances in the euro area. **(Figure 3)**

In a number of countries, this led to economic activity gradually shifting away from export-oriented manufacturing industry towards domestically-oriented construction sector. Because sectoral reallocation is typically slow, adjusting these countries' economies is very challenging. In addition, in most countries there is a high degree of downward wage rigidity, which is a further impediment to rapid adjustment.

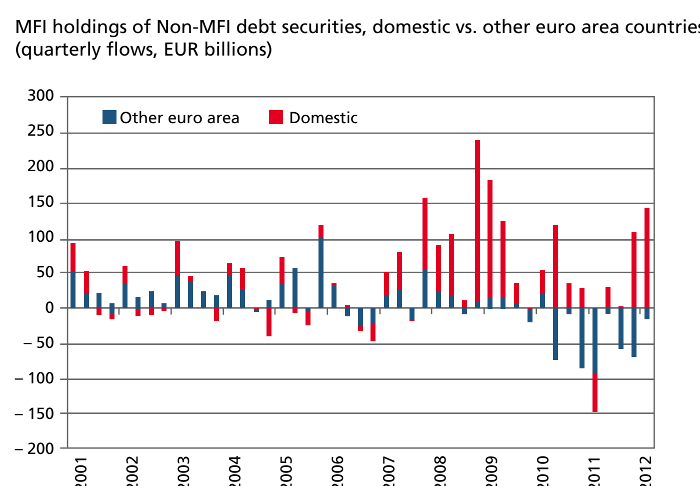
Moreover, persistently higher inflation rates in some countries implied persistently lower real interest rates, particularly in light of the high degree of convergence in terms of nominal lending rates. Countries with lower real interest rates experienced stronger credit growth and housing booms, which placed further pressure on wages and prices. **(Figure 4)**. Lower real interest rates allowed governments to borrow on easier terms, slowing fiscal consolidation.

Governments did not adopt sufficiently counter-cyclical policies to limit their own accumulation of debt or to counteract the accumulation of debt in the private sector. In fact, because those economic booms were based on stronger domestic consumption and rising property prices, they led to improvements in cyclical fiscal balances as long as the boom went on, so that governments had few incentives to tighten fiscal policy before the bust set in.



Source: ECB and ECB calculations.

Figure 4: Lending to the non-financial private sector in the largest euro area countries



Notes: "Domestic" shows purchases by MFIs in a euro area country of government and (non-bank) private sector debt issued by that country. "Other euro area" shows purchases of such debt by MFIs in other euro area countries.

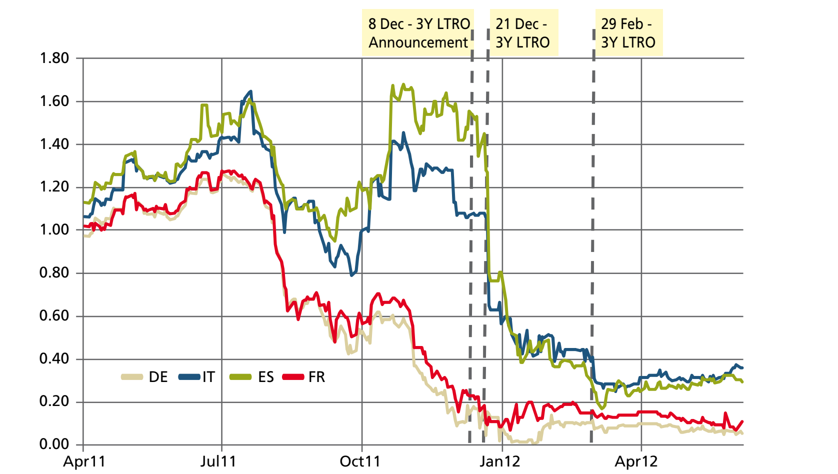
Source: ECB and ECB calculations.

Figure 5: Heterogeneity during the crisis: financial flows

The institutional design of the euro area has clearly given rise to moral hazard and lacked the capacity to engage credibly in measures to prevent rising imbalances. Although there was an unseen accumulation of debt in some euro area countries, financial markets set financial conditions in such a way that private and public sector borrowers in those countries could continue to borrow at the same interest rates as borrowers in countries with much sounder fiscal and macroeconomic fundamentals. As a result, financial flows ran from countries with strong productivity growth to countries with weak productivity growth, fuelling a persistent economic boom based on the accumulation of debt. To be efficient, financial flows should instead have run towards countries with higher levels of productivity growth.

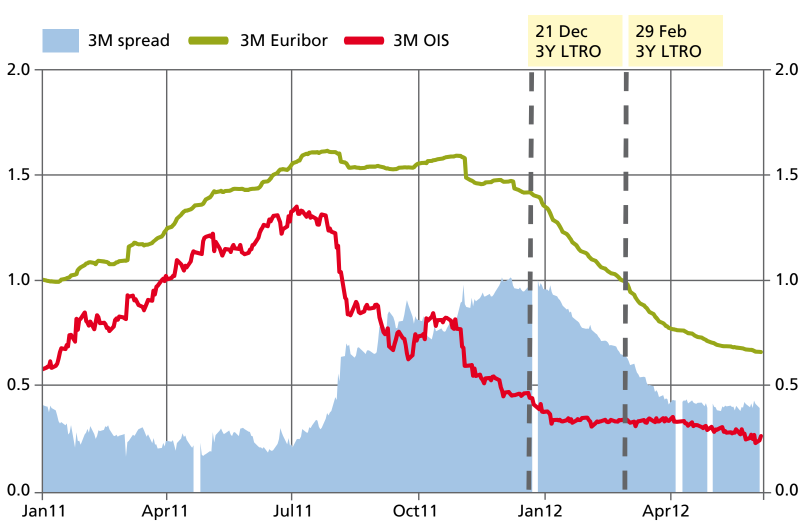
The financial crisis has led to a strong increase in heterogeneity within the euro area. The re-emergence of cross-country differentials in financial conditions has prompted further divergence in macroeconomic and financial fundamentals. Conversely, these heterogeneous financial conditions mainly reflect persistent fiscal, macroeconomic and financial imbalances, as well as persistent structural problems in several countries.

The first dimension of heterogeneity concerns real economic developments. Some countries have recovered well while others continue to be affected by persistent structural problems. Some macroeconomic imbalances have begun to adjust. Competitiveness has improved in countries where labour costs persistently exceeded the euro area average. The second – and most evident – dimension of heterogeneity applies to the sharp divergence observed in financial conditions



Source: Commerzbank

Figure 6: Repo (secure) market interest rate for banks in the largest euro area countries



Source: Thomson Reuters.

Figure 7: Money market spread compressed following three-year LTRO

in euro area countries. During the crisis, secured and unsecured money markets have become increasingly impaired, especially across national borders. Countries' sovereign bond yields have diverged significantly. Corporate bond markets have experienced tensions. Overall, there is ample evidence that country-specific factors have become more important in driving yields.

Fragmented euro area financial markets emerged in the aftermath of Lehman Brothers' default and intensified following the onset of the sovereign debt crisis in May 2010. Financial integration came to a halt and was partly reversed. Non-bank debt securities were increasingly purchased domestically, with non-domestic euro area holders selling these bonds **(Figure 5)**. Euro area countries' financial sectors retreated within national borders.

As a result of those fragmented financial conditions, the transmission of the ECB's monetary policy stance was increasingly impaired. Banks in countries with strained government finances faced restricted access to the money market and other sources of financing, given the interconnectedness between banks and sovereigns. Had this been allowed to continue, these funding restrictions would have hampered growth in credit to households and non financial corporations, resulting in a credit crunch in several parts of the euro area, with negative consequences for the economy and price stability.

In reacting to this, the ECB's monetary policy remained guided by the objective of ensuring price stability for the euro area as a whole. Key ECB interest rates have been reduced significantly. Non-standard measures were adopted to support the functioning of the monetary transmission mechanism by bringing back liquidity to dysfunctional markets. **(Figure 6 and 7)**

Overall, banks' recourse to refinancing operations has been particularly strong in countries most affected by the crisis. While open to all, the ECB's non-standard measures have been used most intensively in countries facing financial stress. Cross-country differences in non-standard measures have largely reflected heterogeneity in financial conditions across the euro area.

The extent of the heterogeneity in banks' financing needs can be inferred from national central bank's balances in Target 2 **(Figure 8)**. These balances reflect the national central banks' net claims or liabilities resulting from commercial banks' cross-border payments. The increasing net liabilities of some national central banks mainly reflect funding stress in individual banking systems, with financial outflows compensated for by increased recourse to Eurosystem refinancing operations.

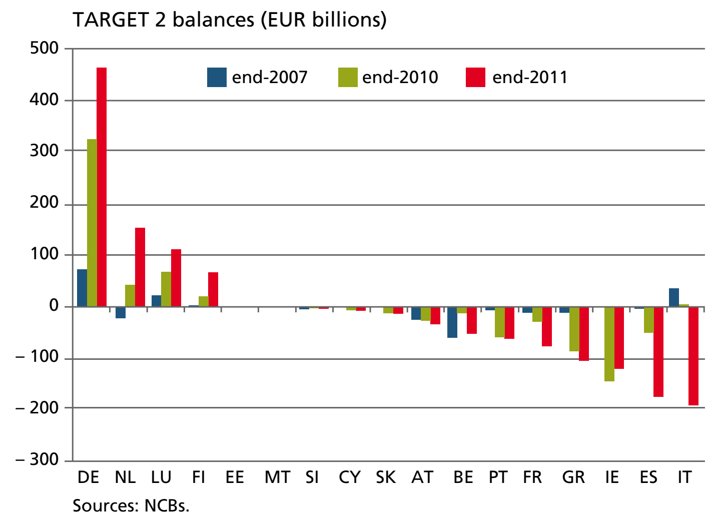


Figure 8: Heterogeneity during the crisis: TARGET

Our policy measures have increased the ECB's intermediation between banks. Looking at the interbank market, reduced willingness to lend, especially across borders, has hampered the distribution of liquidity to those banks that most need it. Increases in deposits held with the Eurosystem in financially strong countries reflect money market disintermediation. **(Figure 9)** Banks in such countries tend to be recipients of cross-border payment flows and therefore need less central bank liquidity than banks in countries facing financial stress.

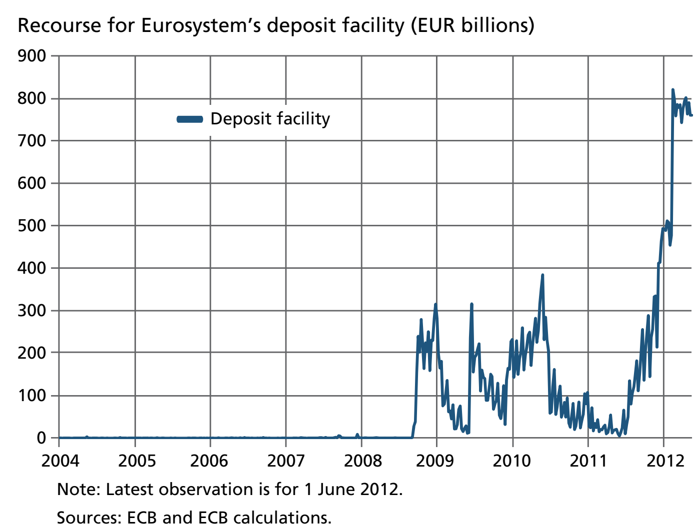


Figure 9: Heterogeneity during the crisis: excess reserves

The surplus of central bank liquidity in banks in financially stronger countries has raised concerns that such liquidity could fuel asset price bubbles in parts of the euro area, potentially posing a threat to price stability. These concerns are currently not justified. Thus far, only a moderate recovery has been seen in asset prices. As regards housing markets, developments in money and credit – traditionally good leading indicators of booms in house prices – have remained subdued. However, we will continue to pay close attention to such developments.

Looking ahead, further steps will be needed to supplement the single monetary policy with a more integrated framework for bank supervision, resolution and deposit insurance, as well as far more extensive coordination of government policies affecting competitiveness. If we are to achieve this, euro area countries will inevitably need to surrender more national sovereignty and increase policy coordination. The global economy is becoming increasingly integrated and the importance of national sovereignty has been waning. In an integrated world, countries cannot decouple themselves from developments elsewhere.

Lucrezia Reichlin[1]

"ECB liquidity provision in stressful times: Has it been insufficient, appropriate or excessive?"

Thank you very much and thank you for inviting me here. It is quite nice to come to Frankfurt and see this atmosphere of calm while in London we have such a sense of agitation. I guess these are two different approaches for dealing with difficult times.

The organizer asked us to answer two questions. The first is "ECB liquidity provision in stressful times: has it been insufficient, appropriate or excessive?" and the second question is "Has the ECB dealt effectively with the challenges it faces in a heterogeneous monetary union?"

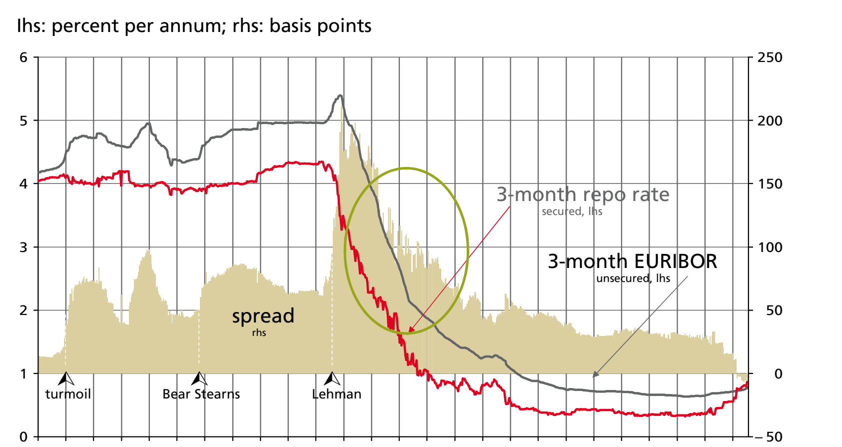
So let me start with the liquidity question. Has it been insufficient? No, by definition. The ECB is providing liquidity at satiation. Since the beginning of the fixed rate full allotment liquidity operations in early 2009, banks' liquidity has been determined by demand: banks obtain the liquidity they want at a fixed rate against collateral. The ECB followed the Bagehot rule which says that a central bank, when faced by a liquidity crisis, should supply liquidity at a penalty rate in exchange for good collateral.

Has it been excessive? This is a more difficult question. There are different criteria to establish whether this has been the case. But if the criterion is price stability, then there is no evidence of inflation expectations rising yet. Moreover, if we look at the monetary aggregates – I say this for the benefit of the German audience – we do not see M3 growth rising and signalling inflationary pressure in the long run. However, I will argue, liquidity provision has carried some risks.

Before discussing the risk, let us evaluate the effects of these policies on financial stress and on the macroeconomy. Quantifying these effects is a difficult exercise and there has been very little empirical work on the matter. However, there is evidence of the effectiveness of liquidity policies, especially in the first phase of liquidity policy. This is true about the times that preceded the sovereign crisis while it is less clear since 2011.

An informal indicator is the compression of the spreads in the money market which we saw shortly after the spike at the time of the Lehman collapse, corresponding to the introduction of non-standard liquidity policies by the ECB. It is difficult to establish a precise line of causality because other policy measures were implemented at the same time, but it is reasonable to conjecture that ECB liquidity provision avoided a meltdown of the financial system in that period.

Figure 1 shows the three-month secured repo rate against the unsecured 3-month Euribor. The spread between the secured rate and the unsecured rate is an indication of the counterparty risk in the inter-bank market. Clearly, the liquidity measures introduced just after the Lehman collapse at the beginning of 2009 (LTRO), are associated with a compression of these spreads. The ECB, through the LTRO, substituted inter-bank activity and acted as an "intermediary of last resort", as it has been called, I think, by Willem Buiter.



Source: Bloomberg

Figure 1: Post-Lehman: success in compressing spreads between secured and unsecured interest rates

[1] *This text is an edited transcription of the speech by Lucrezia Reichlin at the ECB and its Watchers Conference XIV on June 15th, 2012.*

As an additional indication of the effectiveness of liquidity policies we can look at the answers collected from the banking surveys. They indicate that most banks do not refer to liquidity positions as one of the main factors contributing to tightening credit standards. (See the answer to the question "what are the factors contributing to tightening credit standards?" in **Figure 2**). Rather, they mostly refer to the business cycle.

In more formal research with Giannone, Lenza and Pill (2012a) we have quantified the impact of liquidity policies on lending, output and unemployment and found significant effects.

Figures 3, 4 and **5** illustrate some of our results by showing our measure of the size and the effectiveness of the euro-system of central banks' intervention.

In **Figure 3**, the solid line represents the level volume of lending from the euro-system of central banks to the banking sector, while the dashed line is what we calculate that volume would have been if the euro-system had behaved as in previous recessions. The difference between the actual and the counterfactual path is a measure of the size of central banks' interventions via the LTRO. Interestingly, contrary to past behaviour, lending to banks by the central banks has been anti-cyclical rather than pro-cyclical.

Figure 4 plots our estimate of the effect of the euro-system intervention on various categories of loans. It shows that, although the effect was quite muted on long-term loans, it was sizeable on short-term loans.

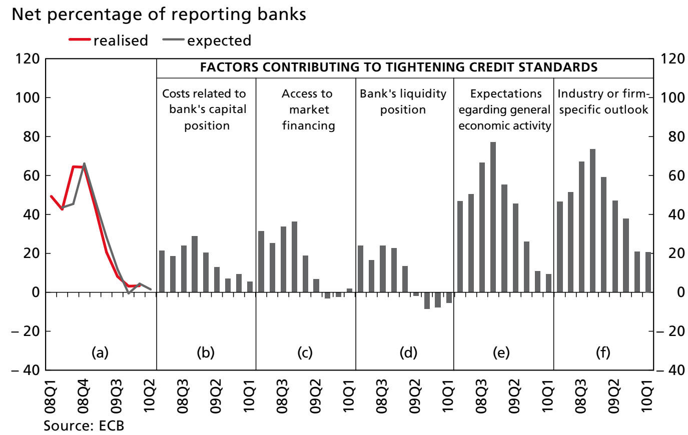


Figure 2: Post-Lehman: success in guaranteeing banks access to market financing

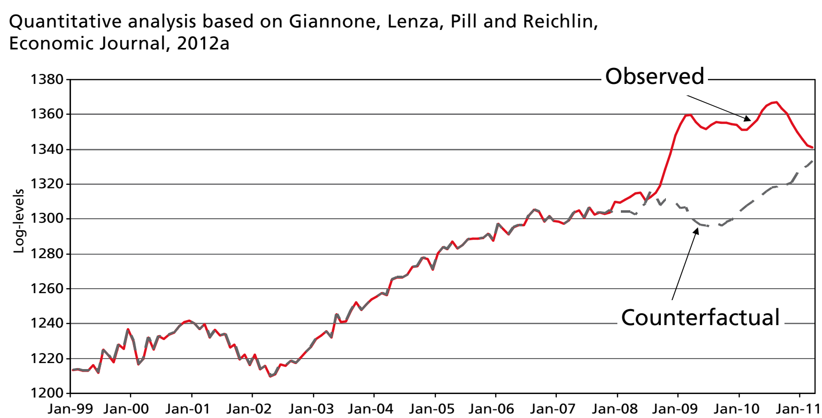


Figure 3: Lending from Eurosystem: observed and counterfactual

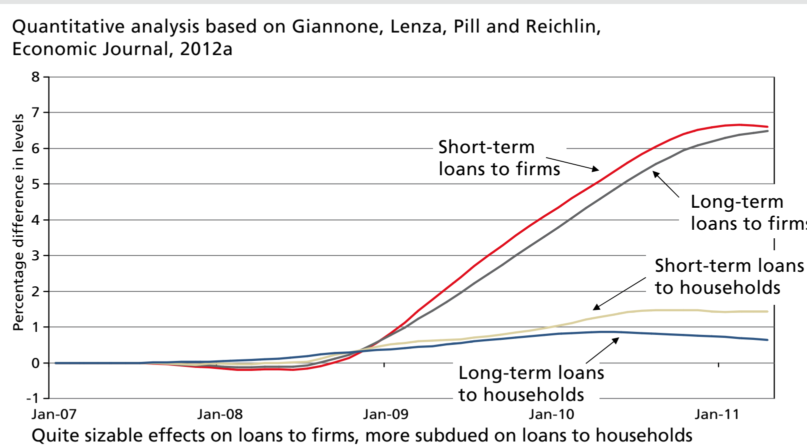


Figure 4: Macro effects: loans to households and firms

Finally, **Figure 5** shows that the main effect of the LTRO has been through the wholesale funding of the banking sector. By repairing the liquidity position of the euro area banking system, the ECB has been able to sustain short term loans and, as our paper shows, to stabilize economic activity to a certain extent.

To summarize, I think there is quite a lot of evidence, quantitative and also heuristic, that the ECB liquidity intervention between 2009 and mid 2011 had a large effect on sustaining banks funding and thereby avoiding a collapse of the banking sector as well as evidence that this had positive effects on the real economy. In that sense it was effective.

However, these policies carried risks. These risks were already clear in 2009-2010 but they became obvious when the debt crisis exploded in 2011.

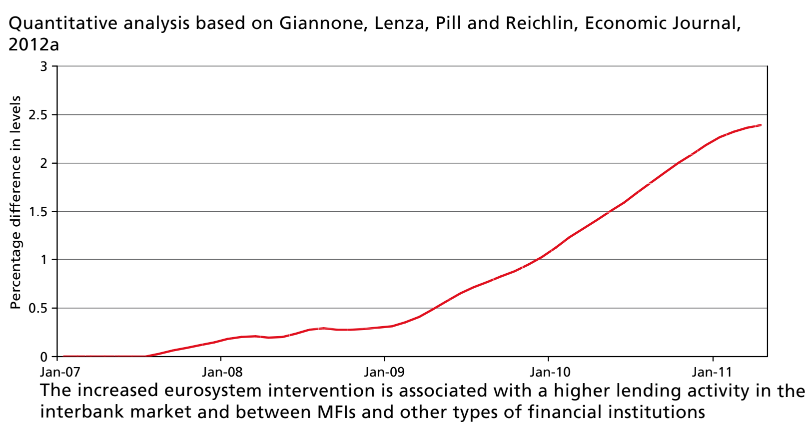


Figure 5: Balance sheet effects: wholesale funding

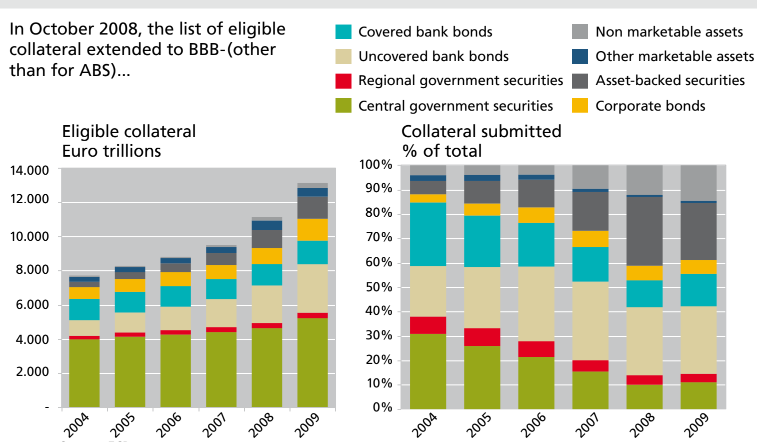


Figure 6: Expansion of eligible collateral

The basic problem is that liquidity injection was, in some cases, temporarily relieving institutions which in fact were facing solvency problems. It is very hard to draw a line between liquidity and solvency problems in practice. But when a central bank becomes involved in dealing with solvency problems, the line between monetary and fiscal policy becomes blurred.

In the euro area, it became increasingly evident that the market was segmented, that some banks were not solvent and were being artificially kept alive. Clearly, when the collateral is not adequate, these policies can create a situation of structural dependence and distortion of incentives.

Figure 6 shows some data on the expansion of eligible collateral since 2008 (Figure 6). These charts have been around; you will find them in the web. They show that, as the crisis unfolded, changes were made to the eligibility criteria for the collateral to be used against the ECB loans.

Figure 7 shows how securitization actually peaked in the fourth quarter of 2008, which suggests that banks were trying to generate eligible collateral to post in order to obtain ECB funding, a mechanism known as 'retained securitization'.

To understand this point it is also useful to look at evidence of market segmentation. One way to detect this is to compare the volume of liquidity allotted to banks by the ECB and their recourse to deposit facilities. **Figure 8** does this for the period 2007-2010. The extent of recourse to the ECB deposit facility points to stress in the financial markets and suggests, indirectly, a segmentation between banks that borrow to redeposit and those that borrow because they need the liquidity.

With the sovereign crisis things became worse. Here, we truly entered a new phase. Mario Draghi arrived in November 2011 and introduced a new round of LTRO, this time allowing loans with up to a three year term (LTRO2). In a way, this was more of the same: a bit bolder than the first wave of LTRO since the horizon of the loans was extended, but actually more of the same.

To have a sense of the size of LTRO2 it is useful to compare the balance sheet size of the three major central banks: the Eurosystem, the Bank of England and the Federal Reserve. **Figure 9** shows total assets as a percent of GDP.

You can see that all of the three central banks increased the size of their balance sheets post-Lehman but the big jump for the Eurosystem was with LTRO2 after the sovereign crisis. Measuring it this way, the Eurosystem has expanded its balance sheet more than the Bank of England and the Federal Reserve even if it was not engaged in traditional quantitative easing.

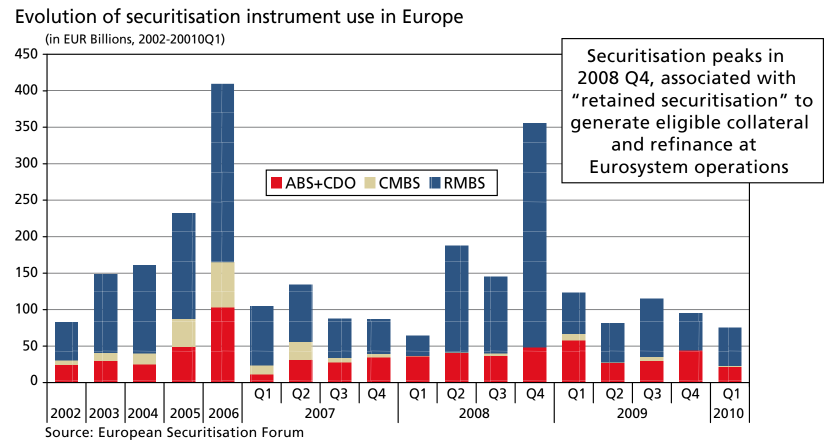


Figure 7: Securitisation

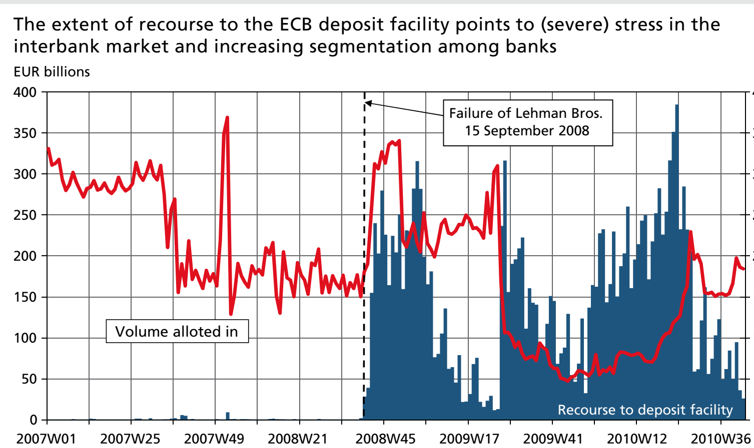


Figure 8: Market segmentation

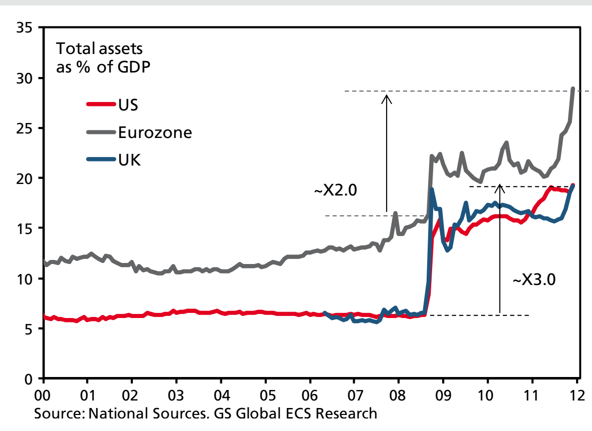


Figure 9: More balance sheet measures

In **Figure 10**, you have the long term refinancing operation as compared with the main refinancing operation. You can see the two peaks, in correspondence of LTRO1 and LTRO2, in the long term refinancing operations and their relative size with respect to the main refinancing operations.
In the meantime, the context changed.

According to calculations by Now-Casting Economics, a service which produces timely estimates of the current state of the economy by updating the latter continuously as new data are released throughout the quarter, the euro area started a sharp slowdown in May 2011, leading to a second recession.

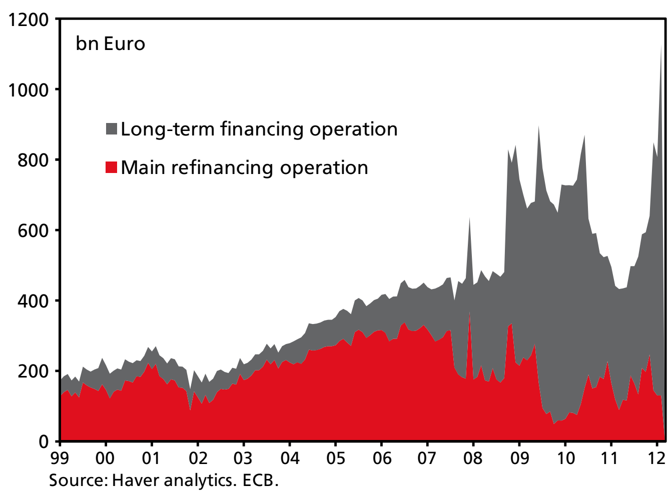


Figure 10: LTRO1 and LTRO2

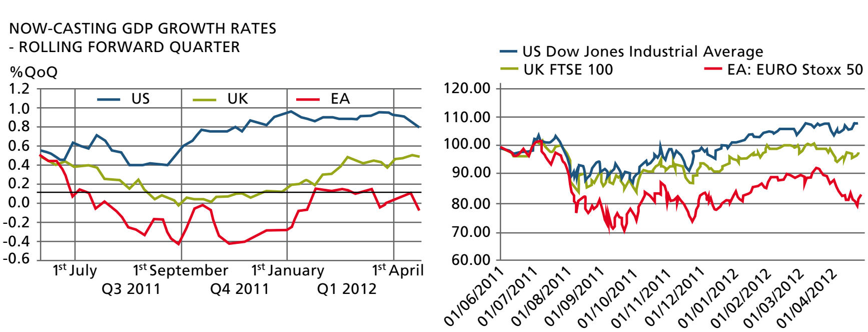


Figure 11: Now-casting economics: signs of a new slowdown from spring 2011 decoupling with respect to the US

The left panel of **Figure 11** shows a rolling forward quarter of the GDP growth rate for the euro area, the US and the UK. Clearly, the euro area started decoupling from the US in spring 2011 while the US actually stabilized and recovered. The right panel shows that this data-driven view of the real economy was reflected in stock market prices, which behaved similarly to our rolling GDP forward quarter estimates. In a way, I think that the ECB was to some extent in denial about this, only later coming to understand what was going on.

To understand the problem the ECB has been facing since Lehman and its evolution, one has to appreciate the sizeable role that wholesale funding has for European banks and the importance of banks in the European financial markets (see Giannone, Lenza, Pill and Reichlin, 2012a). With the wholesale market drying up, the entire financial system was at risk and the ECB had no choice but to intervene and actually replace private interbank market transactions.

The drying up of extra euro area funding explains a lot of the euro area banks funding stress post Lehman, both in the north and in the south (Giannone, Lenza, Pill and Reichlin, 2012b). However, since 2011, in countries of the periphery all non-domestic transactions stopped, including those from other euro area countries.

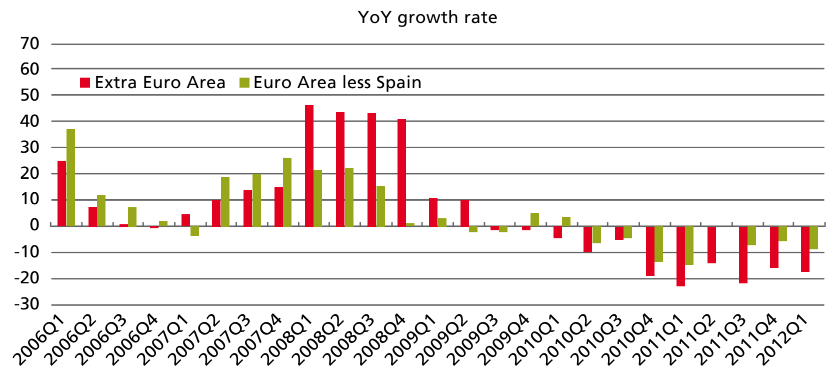
I think this is the most significant aspect of the second phase of the crisis: a reversal of financial integration.

You can see this phenomenon for Spain in **Figure 12**, but a similar picture can be produced for other peripheral countries of the euro area.

In this context, LTRO2 has been extremely important for providing funding for Spanish banks and banks in other countries of the periphery. In **Figure 13**, I show deposits in the Spanish main financial institutions (MFI) from other MFIs, including the euro-system, and from non MFI. The picture speaks for itself.

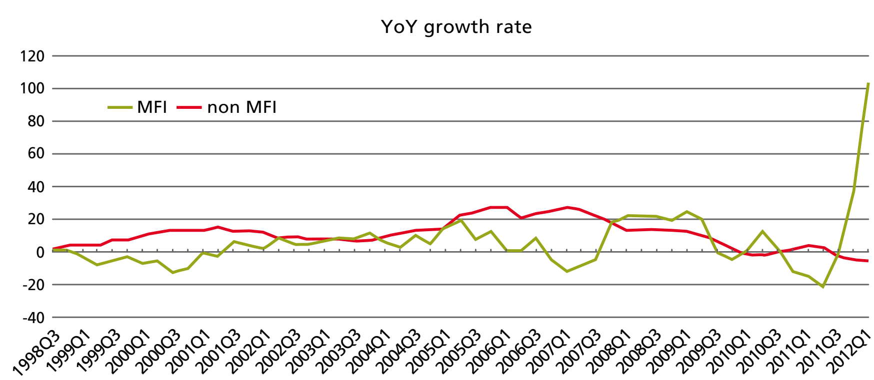
The consequence of the sudden freezing up of the nondomestic wholesale funding market led to a dramatic reversal of financial integration and to an increase in the correlation between sovereign and banking system risk.

In this situation, the danger of the ECB's liquidity operations was that they might constitute indirect support to sovereigns.



Definition: Outstanding amounts at the end of the period (stocks), MFIs excluding ESCB reporting sector - deposit liabilities, Total maturity, all currencies combined. Counterpart: MFIs for Euro Area, "non-resident banks" for Extra Euro Area.

Figure 12: Spain MFIs - interbank foreign deposits



BS references sector breakdown: MFIs excluding ESCB. Balance sheet item: Deposit liabilities. Original maturity: Total.
Data type: Outstanding amounts at the end of the period (stocks). Currency of transaction: All currencies combined. Adjustment indicator: Neither seasonally nor working day adjusted.

Figure 13: Spain-domestic deposits

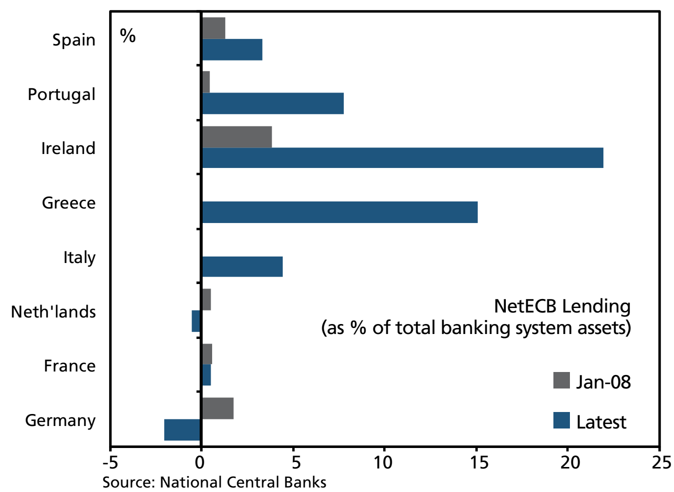


Figure 14: Banks are increasingly dependent on the ECB

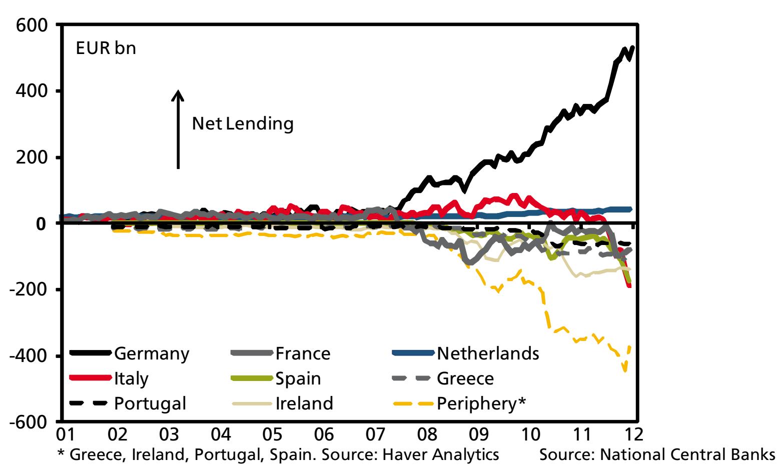


Figure 15: Intra-Eurosystem cross-country (IM)Balances

Figure 14 shows that, increasingly, the banks benefiting from ECB loans were those from countries on the periphery: Portugal, Ireland and Greece, but, increasingly, also Italy.

This resulted in growing intra-Eurosystem cross-country imbalances, as illustrated in **Figure 15**. This is also a chart which has been all over the web, all over the newspapers and all over the classrooms. Financial integration disappeared in the inter-bank market but reappeared in the Eurosystem balance sheet! Germany became a net creditor and the periphery countries net debtors.

With bank and sovereign debt accumulating and the balkanisation of the financial system, the line between solvency and liquidity policy has become even more blurred than in phase 1 and so has the separation between monetary and fiscal policy.

Liquidity policy has in a sense been effective but, given the persistence of solvency issues, it is ultimately limited in what it can achieve. This is the main point I want to make. In general, even a policy of liquidity provision to the point of satiation is limited by the availability of collateral. Of course, collateral can be re-priced and the eligibility criteria can be changed, but then the central bank is faced with a trade-off: by getting tougher on the eligibility criteria or on the haircut it applies to the bonds, it can reduce risk imbalances but, by doing that, it increases the credit risk in its balance sheet. Moreover, its policies, by keeping insolvent banks alive, might remove the incentives for banks and governments to deal with solvency issues.

The implication for the original question that I was asked to analyse is that, although liquidity policies were necessary to prevent a collapse of the financial system, they needed to be complemented by other policies and other tools associated with these other policies. The project of the European banking union is, in my view, a key piece in that direction. But that goes beyond my task today.

I now come to question two. I have a few minutes, I believe, to talk about the macroeconomic aspects of liquidity policy, that is, of whether the ECB dealt effectively with the challenges it faces in a heterogeneous monetary union.

The problem I see here is that monetary policy alone cannot affect interest rates which are driven by risk premia.

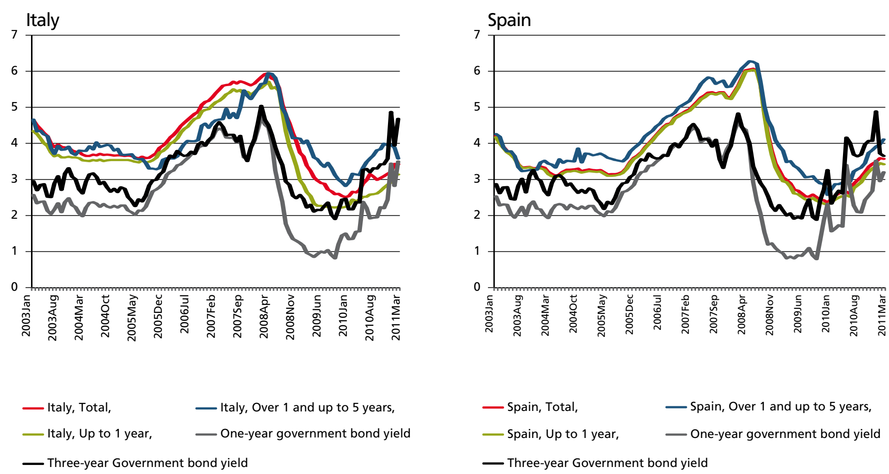


Figure 16: Yields on government and new housing debt

Sovereign and private sector interest rates are correlated. **Figure 16** provides some examples illustrating the dynamics of housing interest rates and government bonds in Italy and Spain. The correlation is very tight. This implies that the transmission mechanism of monetary policy has become heterogeneous across countries given different perceptions of sovereign risk and related differences in the cost of banks' funding. This heterogeneity does not date from the post-Lehman crisis but from the sovereign crisis. We have seen it since 2010.

Since then we have seen a break in the transmission mechanism of monetary policy whose solution is essentially fiscal because it involves solvency measures, bank recapitalization, liquidity measures, deposit guarantees, and eventually Eurobonds.

We cannot judge the monetary policy of the ECB without understanding the connection with the fiscal problem and the nature of the interaction between the monetary and fiscal authorities in the monetary union. And these steps involve governments. So the ECB can only be effective in its necessary role as liquidity provider if others – governments – play their parts, too. Without this, it is difficult for the ECB to act more decisively in the sovereign bonds market to mitigate self-fulfilling liquidity crises, a role that should be within its mandate. This implies that market rates may become unrealistically high even in countries which are illiquid but solvent. In turn, this difficulty may transform liquidity problems into solvency ones.

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2. *Banks balance sheets in the financial crisis (with D. Giannone, M. Lenza and H.Pill), mimeo 2012b.*

Vítor Gaspar[1]

Divergence and Adjustment in the Euro Area

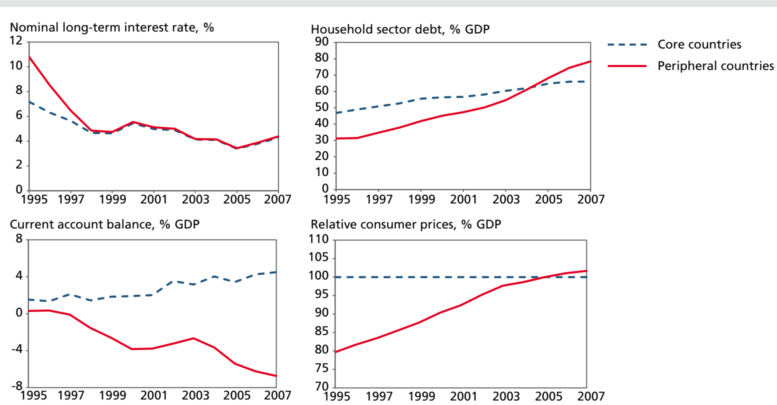
It is a tremendous pleasure for me to be once more at the ECB Watchers Conference. I was going through my notes and realized that I was actually on the program of the very first ECB Watchers Conference in the first session immediately after the welcoming introduction by Axel Weber. At that point in time, the topic was the ECB's monetary policy strategy. Given my current job, that is obviously completely out of bounds now.

What I am going to talk to you about today is something that I explored over the years, mostly with an ECB colleague, Gabriel Fagan, but we have been out of touch in the last two years, so, obviously, the mistakes that have meanwhile piled up are fully my responsibility. I want to tell you a very stylized story about adjustment in the euro area in order to give you a picture of what is going on in an incredibly simple conceptual framework that, hopefully, we will find useful in our debate on how adjustment is taking place and what we need to go forward.

So, the outline of my presentation today is this: I will start with the boom phase; I will then go on to the current stage, which is dominated by eliminating excessive debt; and I will conclude by looking at the challenges ahead. Naturally, one can think about the viewpoint of, say, peripheral countries or core countries. In my presentation I will take the viewpoint of peripheral countries. The situation of core countries can also be discussed within this framework, but it is not possible to do it within fifteen minutes. In any case, if you want to discuss that, I'm happy to oblige in the questions and answers.

So, let us start with the credit boom, the up side. Now, in the very stylized story, the process of adjusting to the euro for peripheral countries is dominated by more favourable financing conditions that we can simply model as lower interest rates. In a standard inter-temporal model, lower financing costs or interest rates lead to a household expenditure boom and an increase in investment. If you have a model with tradables and non-tradables, you will see an increase in the relative price of non-tradables. So, you have a real appreciation of exchange rates, a deterioration of current account and a gradual accumulation of a negative net foreign asset position. This is what you get from both the theoretical application and the empirical evidence.

Now, these are slides from my work with Gabriel Fagan **(Figure1)**. You have the declining nominal long-term interest rates and you have the various adjustments taking place in household sector debt, in the current account balance, and in relative consumer prices. You are seeing a data sample from 1995 to 2007. The core countries are composed of Belgium, Germany, France, Austria and the Netherlands, and the peripheral countries of Ireland, Italy, Portugal and Spain.



Source: AMECO, OECD and ECB
The variables for core countries were calculated as the arithmetic means of respective variables for Belgium, Germany, France, Austria and the Netherlands. Peripheral country variables were similarly calculated using data for Ireland, Italy, Portugal and Spain.

Figure 1: The process of adjusting to the euro: facts

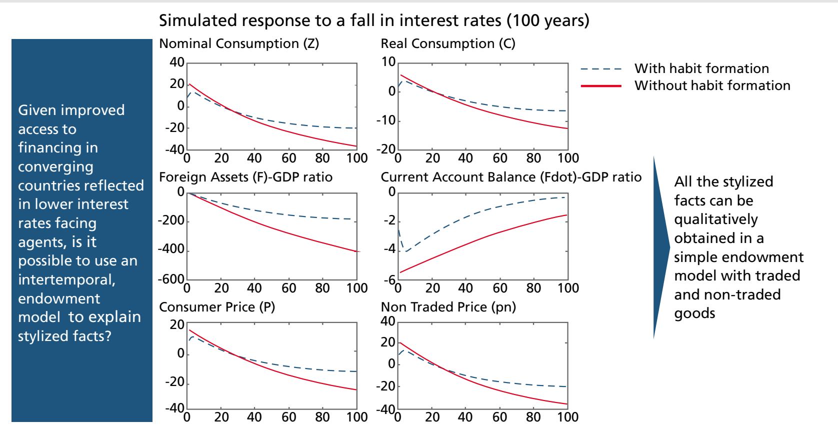
If you look at what you get from a standard inter-temporal model, you see that those stylized facts can be easily replicated **(Figure 2)**. If you want to have the quantitative magnitudes right, you have to introduce habit formation which I have done in an old paper with Gabriel Fagan[2]. I thought that I should quote this version at the ECB and Its Watchers Conference, although it has been published in the meanwhile.

[1] This text is an edited transcription of the speech by Vítor Gaspar at the ECB and its Watchers Conference XIV on June 15th, 2012.
[2] Fagan and Gaspar (2007)

Now, if you do not think about the model results as such, but about the real world, which is of crucial importance, you see that there are two competing stories. On the one hand, one can look at the type of adjustment that I described as an equilibrium adjustment phenomenon and think that in a world of integrated financial markets a current account that reflects the financial balance of the private sector is no reason for control. Credit risk monitoring is sufficient to deal with risk, and, from that viewpoint, the macro-economic imbalances that are normally spelled out, like the current account imbalance, are not really a problem because they take care of themselves. That is a doctrine which is associated with a British policy-maker so it is often called the Lawson Doctrine. In the context of the debate about monetary union, the Lawson Doctrine was associated with Blanchard and Giavazzi who put that view forward in a paper that they contributed to the Brookings Institute papers .

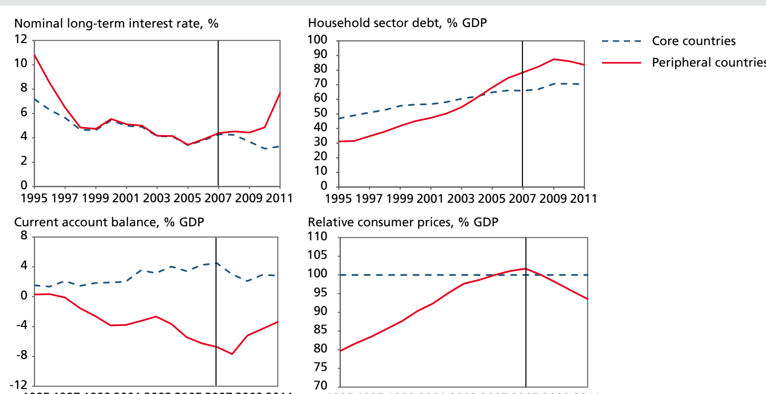
On the other hand, you can have a prudent view and say that the current account reflects private savings and investment gaps, and this in turn reflects distortions or frictions. Under these circumstances, deficits may be too large and, in that view, they reflect imbalances and cause fragility, in extreme cases associated with a sudden stop in private financing. Interestingly, that view is the one defended by most international organizations: the IMF, the European Commission, the European Central Bank. It is also associated with Olivier Blanchard and Milesi-Ferretti. This really shows how difficult it is to have an accurate policy call on such a difficult issue. I will postpone my own view for a while.

Now, let us go to the current situation. The crisis has shifted the process into reverse. Financing conditions have become much tighter and credit constraints have kicked in. So, from this type of story, you would expect households to reduce expenditure, investment to decline, a decrease in the relative price of non-tradable goods, a real depreciation of exchange rates, improvement in the current account and a reduction in the negative net foreign asset positions. This is exactly the same process in reverse gear. Indeed, if you complete the slides and add the numbers after 2007, you do see the process operating in reverse gear in the data **(Figure 3)** and you have the same in the model.



Source: Fagan, G. and Gaspar, V. (2007): "Adjusting to the Euro", ECB Working Paper nº 716 - www.ecb.int/pub/pdf/scpwps/ecbwp716.pdf

Figure 2: The process of adjusting to the euro: model simulated results



Source: AMECO, OECD and ECB
The variables for core countries were calculated as the arithmetic means of respective variables for Belgium, Germany, France, Austria and the Netherlands. Peripheral country variables were similarly calculated using data for Ireland, Italy, Portugal and Spain.

Figure 3: The reverse process has already started

[3] *Blanchard and Giavazzi (2002)*
[4] *Blanchard and Milesi-Ferreti (2011)*

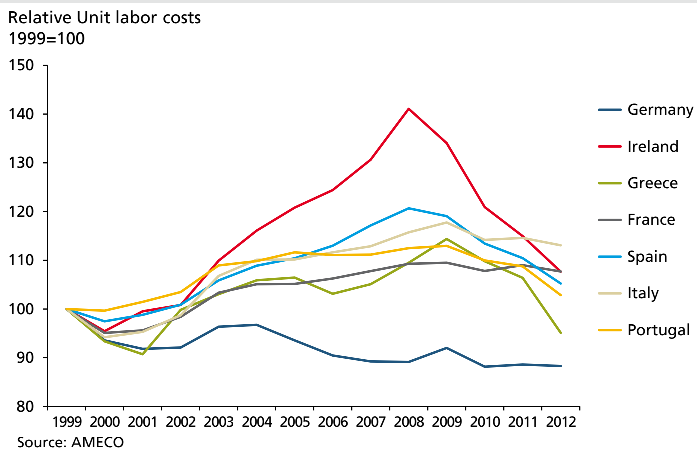


Figure 4: Competitiveness has already started to rebalance

What I want you to take away from this story is that there is the possibility of a main driver. What we have been witnessing in the euro area is a financial driver. The current account imbalances and the uncompetitiveness are symptoms. They are endogenous responses, not causes. When the adjustment process starts, the decline in excess demand leads to real depreciation, and competitiveness improves. For small countries, the ability to adjust is particularly strong because an adjustment of a small country like, say, Portugal is something that can take place without the rest of the world noticing. But as a matter of fact, one has a wonderful example with the experience of Latvia that was able to successfully adjust without external devaluation, contrary to many views according to which such a process was simply impossible to manage. When you look at competitiveness indicators, you see that, indeed, the adjustment is definitely taking place and seems to be progressing at a reasonable pace across all relevant countries **(Figure 4)**.

Now, let us come to the concluding section of my presentation: the challenges ahead and the policy diagnosis. As many of you know, I cannot make a presentation without quoting some old book. In this particular case, I thought that The Wealth of Nations would be appropriate. In The Wealth of Nations, Adam Smith formulated a theory of credit cycles with a boom period he called over-trading and a moment of switch that he called revulsion – the word actually exists in Adam Smith's book – and that finally leads to discredit. This cycle has an ancient ring to it, but I believe it captures the type of initial boom stage and the process in reverse.

Now, if you consider how one can look at substantial deviations from the Lawson Doctrine, you can, firstly, think of a key issue: weakness in prudential supervision and regulation and therefore the underestimation of systemic risk. Secondly, one can think of ineffective procedures to avoid excessive government deficits – you heard Mario Draghi emphasizing this point very much this morning. Thirdly, you have a period where, because of arguments that are reminiscent of the Lawson Doctrine, insufficient attention was paid to macroeconomic imbalances as well as to credit booms. Fourthly, in some cases the adjustment process that I have just outlined made structural competitiveness problems worse and countries accumulated nominal and real rigidity during the period. Moreover, when the process goes into reverse gear, labour and product market rigidities constrain the ability of the economies to adjust. And finally, if you have an economy where investment in non-tradables, the service sector and, say, real estate has been very profitable for a very long time, you may move into the direction of a rent-seeking economy where a lot of waste is going on. So, all these factors exacerbate the type of problems that we face in this context.

Now, being an old man I cannot help the temptation, but I apologize for that, of quoting myself. I was invited by the European Central Bank to look at these types of problems back in 2005[5]. I prepared my contribution jointly with Gabriel Fagan and what we said about the adjustment to the euro area was something like: "Such a process could, as a result of inaccurate expectations, real and financial frictions and weak institutions, develop beyond what is justified by fundamentals, leading to unsustainable developments

[5] *Fagan and Gaspar (2005)*

which, if not counteracted, would ultimately result in a severe crisis or in prolonged underperformance. Facing uncertainties of this magnitude, it is essential to pursue the prudent course. In particular, we would stress the importance of realistic assessment of future prospects (in the context of longer-term economic planning), extra attention to micro and macro financial stability, the importance of labour and product market flexibility and, last but not least, prudent public finance management with a strong emphasis on posterity." So, basically, what I thought about this back in 2005 is what I think about this now.

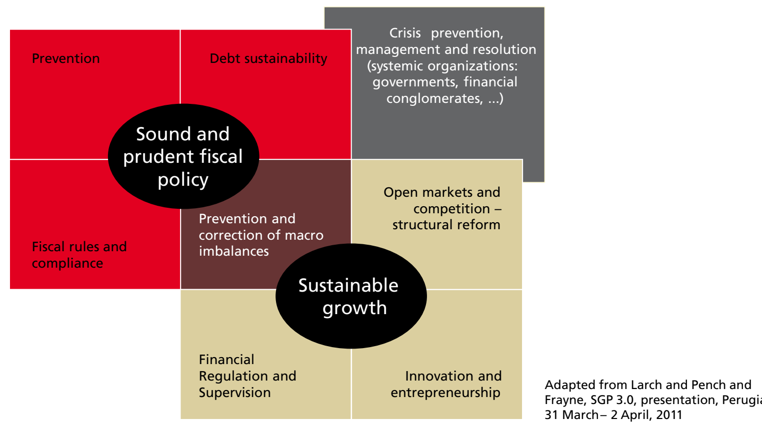


Figure 5: The reform of the EU Economic Governance

In normal circumstances, I would now spend a few minutes explaining to you this wonderful slide, which I stole from Lucio Pench and Martin Larch **(Figure 5)**. It shows an outline of the various relevant challenges to economic governance in the euro zone as well as the areas where much progress has been made in the last couple of years.

Although, as you heard from Mario Draghi this morning, a lot remains to be done. But since Lucio is here and will be speaking immediately afterwards, I think that he can present his own slide better than I possibly could.

To conclude, I believe that, at this point in time, we need decisive action at national and European level. For peripheral countries, countries under strong adjustment requirements, the three pillars of adjustment are well known: fiscal consolidation, financial stability and structural transformation. At European level, we need to revamp economic and financial governance of the euro area. We need to give strong priority to the preservation and deepening of the single financial market. And we need to cut off the link between sovereign risk and bank risk which will allow us to minimize systemic risk at this point in time. Obviously, the two levels reinforce each other, countries can only successfully adjust if they benefit from an environment of stability at the euro area as a whole; and stabilization and stability can only be achieved on a sustainable basis at euro area level if each country delivers on its part of the deal. So, dear friends, it is as simple as that. Thank you very much.

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Lucio Pench [1]

Euro Area Fiscal Governance: Shortcoming, State of Play, Future

Let me outline my presentation today. I will briefly deal with the origins of the crisis and give an indication of the size of the ensuing fiscal challenge. As the title of my presentation suggests and my job title would confirm, I will be looking at the crisis mainly from a fiscal angle. This, of course, does not necessarily mean that this is just a fiscal crisis. I will then describe and characterize the fiscal strategy now underway in the European Union (EU), dealing briefly with the so-called "austerity versus growth" debate. I will also characterize the fiscal and external adjustment that is being pursued in line with this strategy. I will conclude with some words on the reform of fiscal governance and, more generally, the way ahead in terms of the reform of euro area governance, because I think that there is a general consensus that one needs to act simultaneously on different fronts.

When speaking of the origins of the crisis, the term "feedback loop" recurs very frequently. **Figure 1** is a graphical representation of these feedback loops. It is adapted from a publication by Goldman Sachs; an institution that should know one or two things about it. When you have something circular like this, you can start and end at any particular point. I am not going into the different elements, which are more or less all familiar to you.

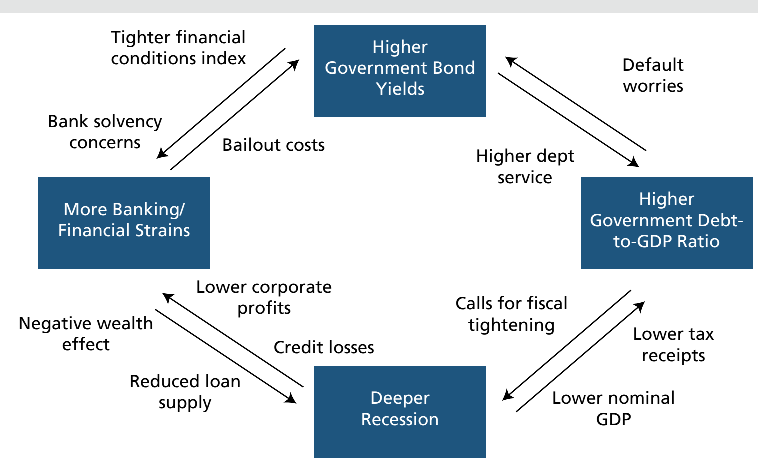


Figure 1: Banking crisis triggered dangerous feedback loops

The crisis emanates from the financial sector and results in a recession that puts government finances under strain, with the two together producing higher yields on government bonds which reflect increased risk premia; these, in turn, make the situation of all the elements worse. Perhaps it would be more interesting at this stage to say where one should intervene to stem and roll back the crisis: an answer that naturally suggests itself is that one should act simultaneously on several fronts. If I were to indicate a priority, my answer would be that probably, as it has already been said, the most pressing element for breaking this vicious feedback loop is the link between financial institutions and the sovereign.

Why did we have these crises? Again, I think, I can be rather brief here, because many of the things I could say have already been said. When you speak in the afternoon, you have the benefit – if it is a benefit – of repeating things that to some extent have already been said by people with more authority than you. There was an element of imprudent fiscal policy in the Member States. It has to be admitted, however, that this lack of prudence in part only became evident with the advantage of hindsight. For example, we heard earlier today about the difficulty of measuring structural balances. It also has to be admitted that the rules as they then were, though insufficient, were not enforced as they should have been. Arguably more important is the fact that the entire area of macroeconomic and macro-financial imbalances was left a little outside the scope of EU surveillance. This probably reflected a flaw – a missing element – in the original construction of the Economic and Monetary Union (EMU), which in turn echoes to some extent the "Lawson Doctrine" that has just been quoted. The focus was very much on the public sector, as this was where the problem was expected to come from. Hence, rules on the level of government debt and deficits were considered necessary, whilst everything else was left a little outside of the picture. Then, when the crisis in the

[1] *This text is an edited transcription of the speech by Lucio Pench at the ECB and its Watchers Conference XIV on June 15th, 2012.*

euro area came, we realized that we did not have a crisis resolution mechanism: one simply had to improvise.

The lack of a European supervisory regulatory architecture for financial institutions also became apparent: as we have already heard today, the problem of fragmented financial markets has become acute, making radical solutions in respect of supervision and resolution authority very necessary. The response has been to strengthen EU governance on various fronts and also for individual Member States to initiate specific policy responses.

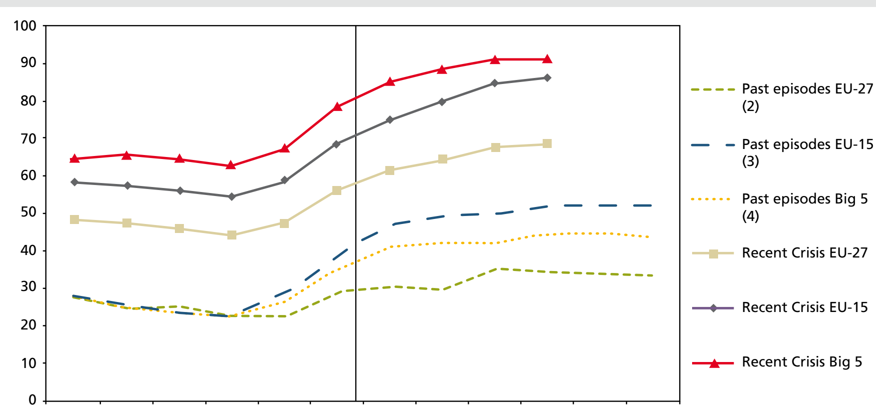
In the remainder of my presentation, I will mainly adopt a fiscal perspective. Although I do not "buy" the fiscal description – the "fiscal story" – of the crisis, I think that this is an element to be considered. However, as recalled earlier, a number of countries with solid fiscal positions nevertheless found themselves in a very difficult situation.

One point that I think is important when looking at the fiscal dimension of the crisis is illustrated in **Figure 2.** This merely describes the evolution of public debt in a number of financial crises, so the year "t" is when the crisis begins. The three upper lines refer to the recent crisis, with the first two of these representing the five biggest industrial countries and the initial 15 EU Member States, respectively. Past crisis episodes are depicted at the bottom, again in terms of the five major industrial countries and various configurations of EU Member States. And the point that I am trying to drive home with this graph is that – and there is a kind of regularity to this – when there is a financial crisis, one can expect some serious repercussions for public debt. In this respect, the current crisis is not much worse than others. In fact, there are repercussions for the public debt of countries creditworthy enough to borrow more, i.e. industrial countries, because during a financial crisis, the governments of the other countries more often than not simply go bust: "Only the rich can borrow", as the head of research of a rating agency once said to me.

What differs is the starting level of public debt in this crisis, which is significantly higher than that for previous crises. So, even if you do not fully believe the evidence regarding the threshold effects of debt on risk premia and growth, I think one can agree that, in retrospect, we entered this phase with a level of public debt that was too high and that this has to be factored into any solution that is applied to the current crisis.

Another difference which makes the current situation worse than in past crisis episodes stems from the fact that we are dealing with societies that are aging, so there are some long-term liabilities related to this; liabilities that come on top of the adjustment that is necessary just to stabilize debt at the current level or to bring it down to a more prudent one.

A stylized representation of the problem is presented in **Figure 3.** I am fully aware of the myriad of assumptions that go into the calculation of sustainability indicators such as those presented here, but these remain a powerful tool to encapsulate the issue of fiscal sustainability in a single number, namely the primary balance gap. The first one, the so-



Extract from: Marco Buti, Lucio R Pench, Fiscal austerity and policy credibility, 20 April 2012, www.voxeu.org

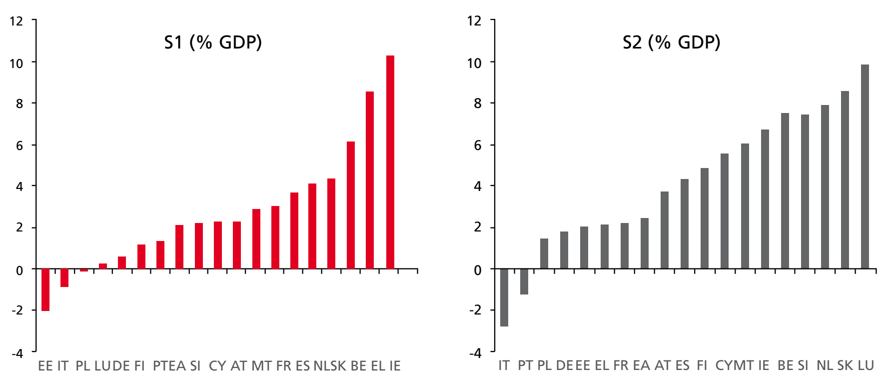
Figure 2: Gross public debt crises episodes (% of GDP)

called "S1", is calculated using the 2012 debt level as the starting point in our last forecast – with the objective of bringing it to 60% of GDP by 2030 – and factors in the foreseen increase in age-related expenditure. "S2" reflects the same concept over an infinite horizon, so there is clearly no final level of debt. These are obviously very large gaps. In part, they existed before the crisis and have been reduced and are still being reduced further through policy actions, in particular pension reforms, which, it must be said, have been quite significant. But, of course, they have partly been aggravated by the fact that the initial level of debt was higher because of the crisis and is increasing further, as a number of countries are still running structural primary deficits. Hence, this crisis clearly features a large fiscal component and, in the words of my friend Charles Wyplosz, I think that there is "no alternative" to some form of austerity.

What about the exit strategies that have been set out by EU countries in the fiscal domain? I think that European countries have identified a plan and I will try to demonstrate that, by and large, they have been sticking to it. While there may be differences of opinion as to whether this is good or bad, I think the point has to be made that a fiscal strategy exists and that it is being adhered to. It can be characterized as involving an adjustment which is, in most countries, not really a "cold shower" but generally spread out over a number of years. Clearly, the intensity of such adjustment has to be differentiated because of what is now customary to call "fiscal space" – basically, the ability to access the financial markets still differs across countries.

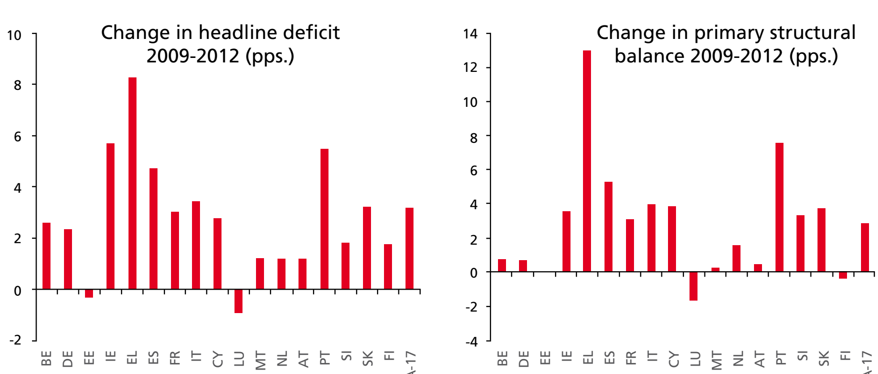
We are clearly living in relatively gloomy times, so the belief can take hold that not enough or too little has been done in terms of fiscal adjustment. **Figure 4** shows how deficits have changed across the EU (actually, we should not speak of "deficits" but "balances", as reductions in deficits are represented as increases in balances). As one can see, quite substantial improvements took place from 2009, the highest level, to 2012.

The improvement in the primary structural balance (the variable that governments can act upon) over the same period represents a very impressive effort by any standard (note that a



Source: European Commission.
S1: Adjustment of structural primary balance by 2020 to revert to 60%GDP debt by 2030.
S2: Adjustment of structural primary balance to fulfill the intermporal budget constraint.
S1 and S2 based on Commission Spring forecasts and cost of ageing of May 2012 Ageing Report.

Figure 3: Large fiscal gaps to ensure medium to long-run sustainability



Source: Commission 2012 Spring Forecast.

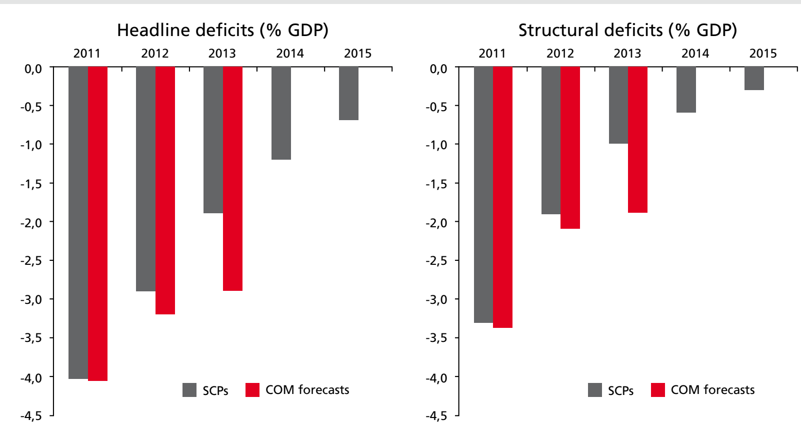
Figure 4: Differentiated fiscal adjustment

different scale is used, so this may not be very easy to gauge visually). More scientifically put, we have estimated a fiscal reaction function that describes the behavior of the primary balance in reaction to an increasing level of debt and adjusts for a number of control variables. What we find is that the reaction in this crisis is higher than – sometimes significantly higher than – what the fiscal reaction function would predict. So, in a way, countries in Europe are at least taking the fiscal challenge very seriously.

This characterization applies not only to what has happened so far, but also to the plans that are in place, as illustrated by **Figure 5,** which presents an aggregation of the targets in the stability and convergence programs (SCPs) submitted by Member States this year. The further deficit reductions planned are quite substantial. Clearly, there is still something of an "implementation gap", as evidenced by the comparison with the European Commission forecasts issued at about the same time. However, compared to previous occasions – note that a comparison is being made between the Commission's "unchanged policy" forecasts (which include only adopted or announced, detailed measures) and what governments actually put in their programs – we see somewhat less of a difference, which is a further reason to believe that consolidation will continue to persist.

Of course, showing that a fiscal strategy is by and large set and being implemented is not the same thing as answering the question: "Is this fiscal strategy the right thing to do?" And, of course, we know that there is a lively debate on this issue. My view would be that, clearly, one can always argue that waiting for growth, waiting for better conditions, notably financial conditions, would be better, and would reduce the cost of consolidation in terms of output. However, given the size of the consolidation that has to be undertaken sooner or later, the indicators previously shown suggest that with the gap that remains and the uncertainty about growth, a strategy of just waiting would simply not be credible. It is easy for a model to postulate that an adjustment is permanent and to show that, if this is gradual, output costs are lower, at least in the presence of nominal rigidities. However, it is quite another thing to have the real world, the financial markets, and to believe that the adjustment is permanent but will take place sometime in the future, while at the present time very little, if not nothing, is being done.

We also know all the usual objections about fine tuning and the ability to time the cycle and the fiscal effort. I must say that there is a debate (which is also evident in the different positions sometimes taken by European institutions) as to whether one should be targeting nominal or structural objectives. I think that there are both pros and cons. A nominal approach has the benefit, essentially, of clarity. Secondly, markets do not finance structural deficits. They look at the deficits as they are. So this may be a reason to aim for nominal targets. At the same time, there are also strong reasons for favoring a structural deficit approach, as this would be more consistent with a steady discretionary stance and the idea of minimizing the costs of adjustment, including the avoidance of some low-quality emergency package. The President of the European Central Bank, Mario Draghi, touched on this issue earlier today, when he referred to the fact



Source: Stability programs, Commission 2012 Spring forecasts. Data shown is euro area aggregate.

Figure 5: Fiscal plans

that some packages were much too biased towards "quick fixes" in respect of revenue measures. Thus, my conclusion is that the European strategy, when it comes to nominal versus structural objectives, should also be differentiated in terms of fiscal space. Clearly, a country that can afford it should implement a more structural approach. Meanwhile, those countries that face difficulties in accessing financial markets should be careful about fully accommodating the cyclical element, for example, vis-à-vis the deterioration of the deficit.

Having said this, I should stress – because this is a point that is often misunderstood – that the rules, as they are stipulated in the Stability and Growth Pact, are not as "stupid" as a famous misunderstood quote from a former Commission President would imply. In fact, the Pact is very much in line with the idea of focusing on the structural effort and also contains a number of "escape clauses", so to speak, that are there to help avoid extreme cases of consolidation. Thus, I think that it is the perception of what the financial markets would be willing to finance – not the European fiscal rule per se – that basically imposes a binding constraint on the fiscal policies of some countries at this point in time. As for those countries that decide to adhere to nominal targets while having fiscal space, clearly – and I must state this explicitly – they are not obliged to do so by the EU fiscal rules.

Allow me to briefly consider this issue of "perverse consolidation"; the idea that, in some cases, consolidation can simply make matters worse. Why? This is because consolidation is relatively more costly during the crisis. There are a number of reasons why this may be the case. Basically, these all boil down to the multipliers being likely to be larger. Consequently, if the risk premia react to the fact that, even if the deficit is reduced, the debt ratio goes up, because of the impact of consolidation on growth, a perverse spiral may transpire. What is our position on this issue? One can build a simple model to illustrate this process, as we have, but we believe that for this to be a realistic risk, considerable myopia is needed on the part of the financial markets. It is also required that the effects of the debt ratio on risk premia are beyond those suggested by the literature. Perhaps a more simple explanation of what looks like perverse consolidation is that it is relatively easy to stylize a consolidation as being permanent in a model. But, of course, in the real world, the public and the financial markets may question whether or not an effort is permanent and, thus, whether or not the current increased primary surplus will be maintained and will ultimately lead, when the multipliers have run their course, to a decrease in debt. In this case, the key issue is to make the consolidation more credible and not to avoid it altogether.

I would now like to make a point that I think is important about the composition of fiscal consolidation. If you permit, I would like to take issue with a statement made by President Draghi, which may have given the impression that consolidation is mainly coming from the revenue side. That may be the case for some countries. Countries that are most pressed typically tend to have recourse to measures of lower quality. In reality, if one looks at our data for 2012 and our forecast for 2013, consolidation seems to be of relatively good quality: most of the measures are permanent (there may always be political doubts, but the type of measures taken are ostensibly permanent) and they are more or less spread equally between tax increases and lower expenditures. On the revenue side, the type of revenue that is generally regarded as less distortionary, namely indirect taxes, takes the lion's share. And on the expenditure side, it is true that in some places there has been a pronounced reduction in public investment, but the bulk of interventions are focused on public consumption and transfers.

Pessimism about fiscal consolidation is often associated with pessimism about external adjustment. External adjustment is perhaps not taking place as fast as the market would like, but I very much agree with what was said earlier by Vítor Gaspar on the presence of a dynamic here. Thus, as the data would tend to show, the boom has been reversed. Moreover, we believe that fiscal and external adjustment go hand in hand. It is impossible to basically avoid the fiscal components of external adjustment, and we do have some new tools to deal with these. Apart from that, we can promote investment-led growth through a number of European initiatives. Here, I would perhaps stress the possibility of reprogramming structural funds.

We do have an entirely new set of tools; admittedly, focused so far on the fiscal side to better enforce the rules, which, at the same time, have also become more flexible, as I have tried to show. These tools are being supplemented at the national level by the Fiscal Compact. I think that it is important to stress the issue of the Fiscal Compact, because although it may be seen as somewhat duplicating (as it perhaps was by even us), at the national level, other rules may exist; some of which should be present at the European level. The fact is – and this has also been my experience – the moment that countries are directly involved and obliged to introduce some rules by changing their constitution or adding laws of equivalent value, there is a clear increase in ownership and a lively, healthy debate. There are also a number of efforts to promote more balanced growth, and some of these have already been implemented. In addition, some crisis resolution tools are available.

Is something missing? I think a lot has been said on the subject of a fiscal union. I personally am relatively skeptical about more coordination of the fiscal stance – for reasons that would be too long to elaborate, but essentially involve the question of fine-tuning and moral hazard. I am also somewhat doubtful about the oft-quoted idea of an interregional insurance mechanism. I think that this is a fine idea in theory, but it would be very difficult to make it work in practice.

What about the issuance of common sovereign debt? There are some issues to be considered here. The development of a shared debt instrument and possessing a "safe" asset could help, but the conditions for this would have to be right, and I think we need to reflect on the fiscal conditions. I would rather like to stress another point: what about the fiscal risks related to implicit contingent liabilities? This is a very important issue and I think that having the right kind of banking union – there were some very good presentations on this topic earlier today – would also be very important in terms of reducing the overall fiscal risks.

In conclusion, what we basically need is an articulated vision for the future. I think that we would all agree on this; President Draghi has addressed this point most eloquently. In the immediate future, steps should be taken in the direction of a fiscal and financial union. My stance on this is that it is imperative that we reflect harder on the fiscal prerequisites for the banking union, and leave the other aspects of the fiscal union to a later stage. We clearly have to implement in full what has been agreed in terms of governance. Furthermore, debt mutualization schemes must be proportionate to the level of integration and political legitimacy that can realistically be achieved.

Stefan Gerlach [1]

Fiscal Consolidation

Today, I will talk about the importance of fiscal consolidation. As everybody knows, the financial crisis has led to a severe, if not catastrophic, deterioration of public finances in some countries, both in the euro area and beyond. In thinking about how stability of public finances might be restored, it is useful to review recent fiscal developments and governments' responses to them.

There are two principal reasons for why debts have become so problematic. First, the marked weakness of economic activity has had a large impact on tax revenues. This effect is partially temporary, however, and tax revenues will rise again as economies recover. Secondly, in some countries, notably in Ireland, large-scale public support for the financial system has been necessary, leading to sharp increases in public debt.

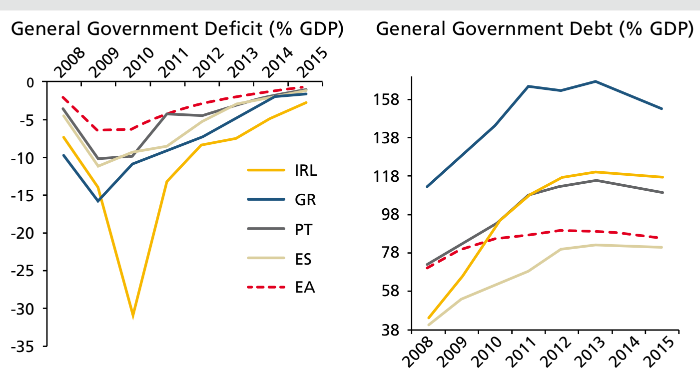
Before I go on, let me point to two lessons we have learned from the financial crisis. The first is that there is serious potential for fiscal tensions to develop also in the euro area. In 1990, when the Maastricht Treaty was negotiated, no doubt many observers felt that this risk had been exaggerated. As a consequence, the rules on debt and deficits embodied in the Stability and Growth Pact were not taken seriously by some governments. We are now experiencing the consequences of this policy failure.

The second lesson we have learned is that adhering to the Maastricht rules offered little protection against a fiscal crisis. Before the property bubble burst, Ireland had seen many years of budget surpluses and a rapid decline of the debt-to-GDP ratio to about 25%, much below the Maastricht criterion of 60%. Nevertheless, as a consequence of the crisis, the debt-to-GDP ratio has now reached almost 120% and Ireland is unable to borrow in financial markets.

Given the large deterioration in public finance in many countries it is clear that fiscal consolidation is now essential. To assess how much is needed, let us look at some data and forecasts out to 2015 for deficits and debts for Ireland, Greece, Portugal and Spain and for the euro area average, taken from the April 2012 Stability Program Updates of the European Commission. Figure 1 shows that these countries had deficits of about 10% or more in 2009. The deficit in Ireland in 2010 was about 30% of GDP, of which about two-thirds came from measures adopted to stabilize the financial system. While these deficits will persist, they are forecasted to improve.

Figure 1 also shows that general government debt in Ireland, Greece and Portugal is much above the euro area average. Spain, which recently agreed to a limited program to deal with its banking problems, has a debt-to-GDP ratio below that average, and remained much below the Maastricht limit before the crisis broke. This is yet another indication that adhering to the Maastricht criteria, while helpful, was not sufficient to avoid problems developing.

Turning to estimates of structural balances in **Figure 2**, we can see that Portugal is projected to achieve a structural primary surplus (excluding interest and temporary factors related to the business cycle) this year. Spain is



Source: April 2012 Stability Programme Updates for IRL, PT, ES, PT. IMF Staff Report March 2012 for GR.
Note: GR debt figures account for portion of € 198bn PSI which is gross debt improving. Greater improvements offset by banking recap (€ 50bn) and other outlays. PT figures exclude 3.9% GDP bank recap. ES figures exclude € 100m (9.4% GDP) bank recap.

Figure 1: Deficits and debts

[1] *The views expressed are solely my own and not necessarily those of the Central Bank of Ireland. I am very much indebted to Laura Weymes for her help in preparing these remarks.*

expected to enter surplus in 2013 and Ireland is expected to do so by 2014. Although Ireland is abiding by all Troika commitments, the fiscal situation still remains very serious.

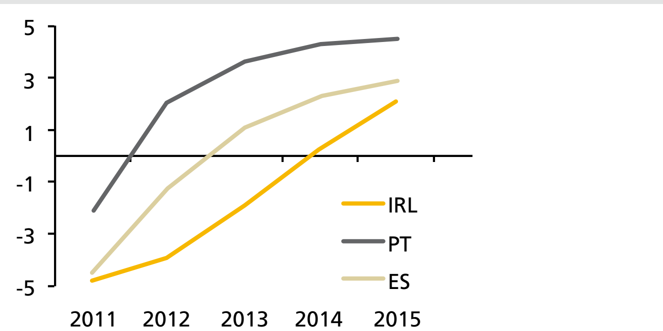
Why do these countries have these fiscal problems? Looking at general government revenue and expenditure ratios, we note that while public spending is marginally below euro area averages, government revenues are much below the average **(Figure 3)**. Their fiscal problems thus seem related to the fact that they have historically collected a relatively small fraction of GDP in government revenue.

There may be at least two reasons for this. The first is that tax rates are simply too low in these countries. That is certainly possible, but I doubt it provides the entire explanation. The second is that their tax systems are poorly designed for revenue raising purposes. An obvious explanation is that their design makes it easy to avoid paying taxes or evade them. Another possibility is that it creates a high excess burden for a given level of taxation, preventing governments from raising tax rates to levels in other euro area countries.

A particular problem in Ireland was that during the boom years when government revenues were plentiful, reliance on stable revenue sources such as income tax was reduced and instead cyclically-sensitive sources of revenues gained relative importance. When the bubble burst, there was therefore a dramatic fall in tax revenues, exposing a large public deficit.

The point here is that if deficits are the result of poorly designed tax systems, then there will be no simple, quick solution to the fiscal problems. To make progress in this case, tax codes may need to be rewritten, the authorities' capacity to collect taxes improved and their ability to combat tax evasion strengthened. While it is essential that this should be done, it is a long-term project.

Let me next turn to the crucial issue of the effectiveness of fiscal consolidation[2]. Historical evidence suggests that it depends critically on the monetary policy stance. Thus, consolidation episodes during which central banks have cut interest rates by large amounts have been more successful than ones in which they have not done so. The problem, in the current setting, is that many, if not most, central banks have already reduced interest rates to unprecedented low levels. Further monetary easing is not easy to achieve, a factor which will make it more difficult to



Source: April 2012 SPU documents. Not available for GR.

Figure 2: Structural Primary Balance (% GDP)

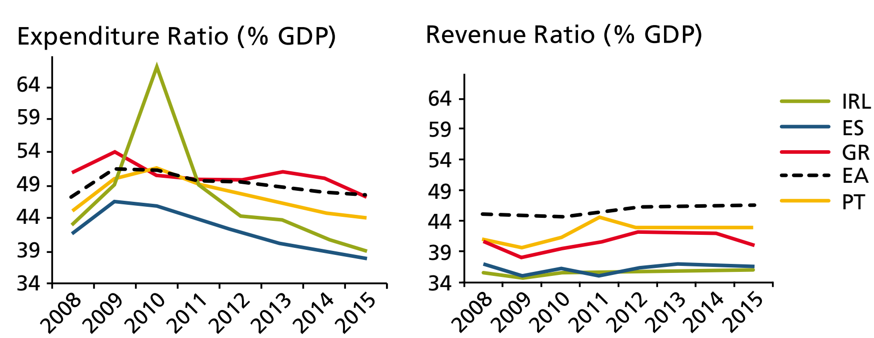


Figure 3: Expenditure and Revenue Ratios

[2] *World Economic Outlook, October 2010; Ch. 3 "Will it hurt? Macroeconomic effects of fiscal consolidation." See also IMF, "The Good, the Bad and the Ugly: 100 years of debt overhang", Ch. 3 WEO 2012 'Coping with High debt and Sluggish growth'.*

deliver rapid debt reduction.

History also suggests that fiscal consolidation is easier to achieve if the exchange rate is depreciated and exports are stimulated. This observation, naturally, means that highly open economies with a floating exchange rate whose trading partners are growing rapidly will have an easier time reducing deficits than others. The fact that a large number of countries are now simultaneously undertaking fiscal consolidation, has of course dampened economic growth and therefore export demand.

How can fiscal consolidation be measured best? This can be done in several ways. One can ask whether governments are delivering on their fiscal plans. In this regard, the Irish government has excelled having abided by all of its Troika commitments since the beginning of its program in late 2010. Alternatively, one can look at the improvements in the structural balance, that is, the underlying fiscal position disregarding the temporary effects of movements in the business cycle. Relative to the amount of correction effort, Ireland looks likely to secure limited improvement in the structural deficit. Finally, one can focus on the evolution of the debt-to-GDP ratio over time, a measure which I tend to prefer.

The debt-to-GDP ratio depends on four factors **(Figure 4)**. First, the primary (non-interest) budget deficit. Second, other factors that change the debt-to-GDP ratio not already captured in the fiscal deficit[3]. Third, the difference between the interest rate on the public debt and GDP growth, which drives the change in real debt servicing burden. Fourth, any measures to support the banking sector.

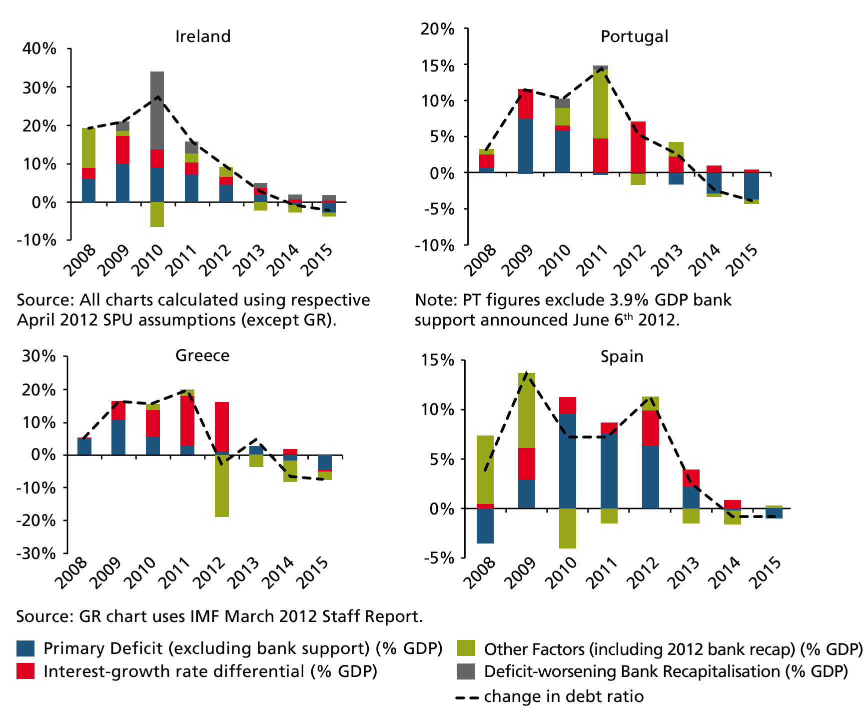


Figure 4: Contributions to General Government Debt Ratio (% GDP)

Figure 4 shows that this difference has played a crucial role for debt dynamics in some countries. One mechanism has been that fiscal consolidation has slowed GDP growth and increased the debt-to-GDP ratio. The importance of this factor indicates that in order to resolve these public debt problems quickly it is essential to return to growth.

Growth depends on many factors. Among them is domestic fiscal policy. In the short-term, domestic consolidation is likely to slow the economy and therefore put further strain on public finances. Similarly, growth depends on the extent of uncertainty about the economy and future economic policy. In the Irish case, uncertainty arises largely from the outlook for house prices and the consequent link to mortgage arrears. High uncertainty delays spending and house purchases, and therefore tends to exacerbate fiscal problems and other macro-financial imbalances.

[3] *Examples of that are things like the Greek PSI, which reduced the Greek stock of debt but did not lead to fiscal surplus, or a central government's decision to assume the debts of local or regional governments.*

Of course, prospects for the housing market depend also on the outlook for the broader economy. Since Ireland is a highly open economy, if the external environment improves, so will the Irish economy and housing market. In order to promote recovery, removing uncertainty about future economic policy is essential.

Before proceeding, let me note that the sensitivity of growth in Ireland to economic conditions in our trading partners has been and will continue to prove a major difficulty in reducing the fiscal deficit. If one compares forecasts made in late 2010 for growth in our trading partners in 2011 and 2012 with outcomes, it is readily apparent that the external environment has been considerably more adverse than expected. Of course, this has made it much harder to achieve rapid consolidation.

Returning to **Figure 4**, it is clear that in Ireland large persistent primary deficits and bank support have caused the build-up of debt. In Portugal, by contrast, the difference between the interest rate and the economic growth plays an important role. This difference has also been highly relevant in Greece, as the economy is shrinking whilst the interest burden remains high. In Greece, the March 2012 PSI reduced the debt ratio, but that improvement was fully offset by drag from the difference between the interest rate and the growth rate of GDP. This illustrates again why returning to growth is so important.

How has fiscal consolidation been divided between expenditure cuts and revenue increases? The IMF survey mentioned earlier argues that historical evidence clearly shows that consolidations based on expenditure cuts are more effective in restoring fiscal balance than those based on revenue increases. One reason is that consolidations based on revenue increases tend to raise inflation (typically because they involve increases in VAT). In response, central banks tend to raise interest rates and increase the debt servicing costs. Higher interest rates of course also slow the real economy and further complicate fiscal consolidation.

Figure 5 shows that, in practice, countries have tended to heed the IMF's advice in that the consolidation programs in the EU are generally balanced slightly in favour of expenditures.

What about timing? Should we frontload consolidation?

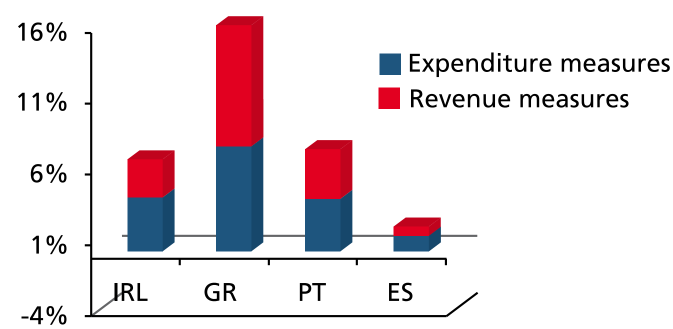


Figure 5: Planned Consolidation 2012-2014 (% GDP)

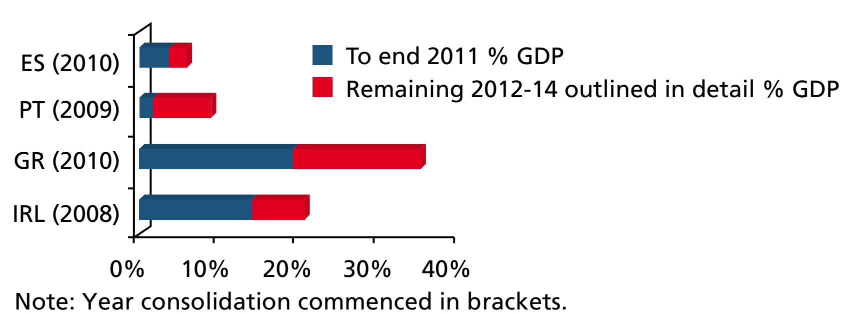


Figure 6: Timing of Consolidation 2008-2014

Or should we delay the adjustment? All else equal, I think it is desirable to do this gradually. To engage in rapid fiscal consolidation, governments may pick all the low-hanging fruit. These cuts are not always the most appropriate and may actually reduce growth. For instance, rapid cuts may fall disproportionally on public infrastructure which, as it depreciates over time, may raise private sector costs and hold back growth.

In practice, however, it is essential to carry out most of the adjustment early since any delay means that public debt will continue to rise, raising risk premiums and debt service costs, slowing economic growth and making the consolidation effort more likely to fail. Figure 6 shows that Ireland has in fact already undertaken a large part of its fiscal consolidation commitment. The Irish crisis erupted in 2008 and the program came two years later, so for two years as the Government was battling the crisis on its own, a range of measures were adopted attempting to restore fiscal balance.

To summarize, fiscal consolidation is necessary because debts have grown unsustainably large and as a result, markets have become worried. In order to stabilize and reduce debt-to-GDP ratios, a return to growth is crucial. That means that we have to calibrate the timing and composition of these consolidation efforts carefully. We also need to take whatever measures we can take to reduce the level of uncertainty in the economy, in particular uncertainty about future policies, both at the national and at the European Union level. Thank you very much.

Helmut Siekmann and Volker Wieland

From the OMT Announcement to the 2013 Hearings of the German Constitutional Court

In lieu of a conference summary and outlook of the remainder of 2012 we instead review one of the key developments in ECB policy making after June 2012, namely the announcement of a new framework for public debt purchases, that is the so-called Outright Monetary Transactions (OMT). Much has been written already about the economic impact of this announcement in terms of a reduction of sovereign financing costs in stressed euro zone countries since then. Instead, we focus on the ongoing inspection of the legal foundations of such public debt purchases by the ECB in form of the case under review at the German Constitutional Court. With this note, we hope to elucidate the intricacies of the jurisdiction of the German court in this matter and the likely focus of its deliberations to an international, non-lawyer audience.

1. The OMT controversy and how it became central to the German Constitutional Court's deliberations in summer 2013

The European Central Bank's August 2, 2012 announcement that it would be willing to buy government bonds without limit in certain scenarios constitutes perhaps the most controversial decision in its 15-year history. Already the limited purchases of euro crisis countries' sovereign bonds under the ECB's Securities Markets Programme (SMP) since May 2010 were publicly critized by Axel Weber, then-President of the Bundesbank and member of the ECB Governing Council.[1] They were also suggested as one major reason for the resignations of Axel Weber and Jürgen Stark, then the ECB Board Member in charge of its Directorate General Economics, during the course of 2011.[2] The 2012 announcement of potentially unlimited future Outright Monetary Transactions (OMT) was publicly opposed by Jens Weidmann, Weber's successor as Bundesbank President,[3] and has been criticized heavily by former ECB Board Members Otmar Issing and Jürgen Stark,[4] while Stark's successor, Jörg Asmussen, has turned out to be a staunch supporter of this policy. Weidmann and Asmussen have been called to testify during the hearings of the Federal Constitutional Court on June 11-12, 2013 on the legitimacy of the OMT. In this note, we review the legal issues and concerns regarding the OMT that will be the focus of the Court's deliberations and discuss potential outcomes.

As explained by ECB President Mario Draghi in the statement for the August 2, 2012 ECB press conference, the ECB was concerned at the time that exceptionally high risk premia embodied in government bond prices for some euro area member countries were hindering the transmission of monetary policy in that part of the monetary union. Specifically, he considered risk premia that are related to fears of the reversibility of the euro as the currency of these countries as unacceptable. While emphasizing that governments would need to push ahead with fiscal consolidation, structural reform and European institution-building in order for those risk premia to disappear, Draghi also called on them to request support by the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) in the bond market when exceptional financial circumstances and risks to financial stability exist. In those circumstances, the ECB would then be willing to buy sovereign bonds in the quantity needed to reduce the above-mentioned risk premia. Such interventions would thus be subject to the conditionality imposed on the respective government by the EFSF/ESM. Importantly, the ECB would forego seniority status and its holdings of these sovereign bonds would be subject to the same losses as privately-held bonds in the event of a sovereign default. The technical features of the OMT are described in the ECB Press Release of September 6, 2012 that is also found in the appendix to this note.

In the judgement of critics of the OMT, the ECB has ventured too far into the terrain of fiscal policy by announcing such potentially unlimited government bond purchases. The announcement itself is likely to cause delays in the

[1] *DIE WELT, 31.05.2010: „Bundesbank-Chef Weber kritisiert EZB".*

[2] *Der Spiegel, issue 7/2011, 12.02.2011: Weber Interview „Die Glaubwürdigkeit leidet", and Spiegel Online, 14.01.2012: „Brandbrief: Ex-Währungshüter Stark attackiert EZB-Kurs".*

[3] *Financial Times, 06.09.2012: "Weidmann isolated as ECB plan approved".*

[4] *DIE WELT, 26.09.2012: Issing Interview „Geldpolitik stößt an ihre Grenzen", and Die Presse, 21.09.2012: Stark Interview „EZB bewegt sich außerhalb ihres Mandats".*

implementation of necessary fiscal and structural adjustments by national governments, because it has reduced market pressures via government financing conditions. Furthermore, such purchases may violate the prohibition of monetary financing of sovereign entities in the EMU. ECB critics question whether the OMT and earlier SMP comply with the general prohibition of granting loans by the European Central Bank or national central banks in favour of any type of government entity or public undertaking (Article 123 paragraph 1, Treaty on the Functioning of the European Union (TFEU)). The critics emphasize that subsidizing interest rates of selected countries' government debt or even saving insolvent governments transcends the powers and competences given to the European System of Central Banks (ESCB). Furthermore, they call into doubt the ECB's assessment that the transmission of monetary policy is disturbed by unfounded or irrational fears of investors that need to be counteracted by such interventions. Importantly, critics of the OMT argue that the current membership of the euro-zone cannot be guaranteed as long as Member States remain sovereign, at least not by the European Central Bank. If the justification of these measures as an act of monetary policy is rejected, they must be considered acts of economic policy that are not conferred on the Union. They are reserved for the Member States (Article 119 paragraph 1 and 2, Article 127 paragraph 2 and 5 TFEU). Finally, critics fear that the independence of the ECSB and of the members of their decision-making bodies is jeopardized by the large-scale transfer of credit risks from the private and public sector to the ECSB. Their independence is guaranteed by Article 130, 282 paragraph 3 clause 2 TFEU, Article 7 of the Statute of the European System of Central Banks and of the European Central Bank, and by Article 88 clause 2 of the German Federal Constitution.

The subject matter of the case presently pending at the Federal Constitutional Court of Germany was initially focusing on the EFSF/ESM support mechanism set up by Member States of the EU and its legal foundation. More specifically, three legal acts of the German legislature to transform the agreements on the European level into German law had come under scrutiny of the court:

1. Consent to the creation of a basis in the primary law of the Union for setting up a support mechanism (amendment to Article 136 TFEU)
2. Implementation of the compact on enhanced fiscal stability
3. Putting into effect of the agreement on the (permanent) European Stability Mechanism (ESM)

The actions of the ESCB and the ECB to assist Member States with financial problems were originally not central to the petitions.

A preliminary injunction had been requested in order to prevent the international acts to become effective before the Court could decide the case. The injunction was denied under certain provisions by the decision of the Court of September 12, 2012. In its opinion, the Court mentioned that ECB purchases of sovereign bonds on secondary markets with the aim of financing government budgets independently from capital markets would violate the prohibition of monetary financing. However, the Court left the question whether this prohibition applies to the SMP or OMT open for the final decision that was then expected to be handed down in July 2013 (Judgement of September 12, 2012, text numbers 202 and 278). Subsequently, petitioners have extended their petitions and asked the court explicitly to review the measures of the ECB and ECSB member central banks as well.

The Court has asked both the ECB and the Deutsche Bundesbank to deliver an opinion on aspects of the controversy. The Bundesbank has submitted a statement dating from December 21, 2012. This statement has been leaked to the public and raises many of the concerns mentioned above. The ECB has asked a German law professor, Frank Schorkopf, to prepare a statement as its representative. A comprehensive oral hearing took place on June 11 and 12.

2. What is the German Constitutional Court deliberating and deciding on?

2.1 Jurisdiction

The Federal Constitutional Court of Germany has been installed to enforce the norms of the Basic Law ("Grundgesetz"), the federal constitution, and to review the conformity of all German state actions with the federal constitution. That is why the court is restrained to apply the norms of the Basic Law. The conformity of actions with the laws of the European Union, and specifically with the European Treaties ("primary law"), does not fall into the German Court's competence. In fact, if the Court finds that the interpretation of the Treaties is concerned or that the validity and interpretation of acts of the institutions, bodies, offices or agencies of the Union is in question, it has to refer it to the European Court of Justice (ECJ) for a ruling, Article 267 paragraph 1 TFEU. However, such a referral is only needed if such a clarification by the ECJ is of substantial relevance for the adjudication of the case by the national court, Article 267 paragraph 2 TFEU. This rule holds for all courts or tribunals of Member States against whose decision there is no judicial remedy under national law; Article 267 paragraph 3 TFEU. Thus, in principle, also the Federal Constitutional Court of Germany would have to refer a case to the ECJ. However, such a referral has never taken place so far. It would be a novelty in the history of the Court.

There are, however, exceptions: The Court has reserved the right to review itself— without referral to the ECJ— whether a particular act of an organ or institution of the EU stays within the limits of the competences and powers conferred on the EU (BVerfGE 89, 155 [188]; 123, 267 [353 et seq.]). To its opinion such a transgression is not covered by the parliamentary consent to the transfer of sovereign rights and is considered to be „ultra vires", that is, beyond the legal power or authority of the European institution ("ausbrechender Rechtsakt"). Moreover, the court examines if the transfer of sovereign rights to the European Union level maintains the unalienable core of the constitutional identity ("unantastbarer Kernbereich der Verfassungsidentität") of the Basic Law (BVerfGE 123, 267 [268, 354]; restated in BVerfGE 129, 124 [177] in view of the democratic rights of the electorate. These caveats have been theoretical so far. The Court has not yet invoked them in a specific case. Already in its decision on the Lisbon Treaty it demanded that the transgression of competence must be clearly visible ("ersichtlich"). In the ensuing Honeywell case it has further specified that the act challenged in court must be grave and have the quality to lead to a structural shift in the design of competences at the expense of Member States (BVerfGE 126, 286). It also concedes to perform such a review only in a cooperative manner with the ECJ, which would mean to ask for a prior opinion of this court.

Aside from the above considerations that are centered around European Union law, there is also a direct way to a judicial review by the court applying German constitutional law. Article 88 clause 2 of the Basic Law deals with the transfer of the monetary authority to a European institution. It could be directly used as a yardstick for judging the measures of the ESCB. The provision requires that the European monetary institution must be independent and committed to the superior goal of price stability. Whether this requirement has been obeyed has to be scrutinized by the Court itself. The Court's jurisdiction, in principle, only covers actions of German authorities. However, the participation of the Bundesbank within the framework of the ECSB may be sufficient for a decision that the review of this action falls into the competence of the Court.

2.2. Application

(1) In any case, the Court first has to decide whether an individual complaint pursuant to Article 93 no. 4a of the Basic Law challenging the conformity of the measures of the monetary authorities with Article 88 clause 2 of the Basic Law is admissible. This might be questioned with good reasons as it has to be demonstrated that individual rights of the petitioners are possibly infringed. An infringement of property rights—protected by Article 14 Basic Law—is unlikely, at least at the present situation. In recent cases concerning acts on the European level, democratic participation has, however, been judged as a sufficient cause of action by the court (BVerfGE 123, 267; BVerfGE 129, 124).

Looking at the merits of the case, so far price stability has been interpreted as "consumer price stability" (Siekmann, in: Sachs [ed.], Grundgesetz, 6. Auflage, Art. 88 Rdn. 89). As the harmonized consumer price index (HICP) which is generally accepted as a metric, lingers at a historically low level a verdict will probably not be based on this part of Article 88 clause 2 Basic Law. Endangering independence by the envisaged – almost symbiotic - cooperation of the ECB with administrative agencies could, however, be an issue.

(2) As the seriousness of an infringement of European Union Law is decisive for the ensuing procedural steps, it ought to be assessed in the first place.

Already the Securities Market Program is difficult to justify with the goal of addressing malfunctioning or non-functioning in the channels of transmission of monetary policy as the ECB has claimed. Questions such as what exactly are the appropriate risk premia and what is the necessary degree of intervention by the ECB in light of the many factors influencing such premia, including the statements and actions of many national and other European policy makers, have remained largely unanswered. With the Outright Monetary Transactions, the ECB officially „aims at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy" (ECB press release of September 6, 2012). They do not fall into the domain of the generally accepted standard open market operations which are in accordance with Article 18.1 of the Statute. They do not serve as a tool to gauge the interest rate for risk free loans. Effectively, they imply subsidies in favour of specific countries and institutions by lowering risk premia demanded by the market. Importantly, standard open market operations are designed as an instrument aimed at fine-tuning the monetary environment for the complete area of a currency and not for specific regions of the area or single credit institutions. Of course, the financial crisis and threat of deflation has also led other central banks around the world to purchase government debt. However, this debt has been federal or national debt rather than debt of regional authorities. For example, the Federal Reserve System of the United States has bought federal debt but it has not bought state debt and has not used government debt purchases to mitigate financial problems of troubled states such as, for example, California. In Germany, neither the Bundesbank nor the Reichsbank have historically used debt purchases to mitigate financial problems of one of the member states (Länder).

„Strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme" is referred to by the ECB as a necessary condition for any Outright Monetary Transaction. However, this provision, which implies close cooperation with executive authorities in administering support programs by making them a prerequisite for OMT measures, can also be interpreted to indicate that the envisaged measures fall outside the area of monetary policy as these conditions serve to achieve other economic and fiscal objectives. Similarly, the unlimited volume of the measures points in that direction.

By tethering the support to decisions of a government agency (EFSF/ESM) the ESCB may also endanger the autonomy in its decision making. The primary law of the Union assesses this independence as crucial. A mutual dependence of central bank action and administrative decisions would not conform to the design of the Monetary Union and its distribution of powers. Additionally, it can well be questioned whether the conditionality will in effect work as a safeguard against an inacceptable transfer of risks to monetary institutions. In the case of Greece, for example, private sector investors had to accept haircuts on government debt in a more or less voluntary private sector involvement. If the ECB does not insist on seniority status in such a case as promised with the OMT, losses on its portfolio would have to be borne either by the ECB or assumed by other government agencies.

(3) Turning again to the procedural aspects of the pending case, the court has to decide whether the (possible) infringements of the primary law of the Union by the measures of the central banks of the Euro system are so serious that they lead to a structural shift in the design of competences at the expense of Member States (BVerfGE 126, 286). Article 3 paragraph 1 lit. c TFEU transfers the (exclusive) competence for the monetary policy to the Union. This is a structural decision. Further tasks may only be conferred to the ECB under the narrow preconditions and within the close limits of Article 127 paragraph 6 TFEU which has not been activated so far. Most importantly, a mandate to secure financial stability has not been given to the ESCB. According to Article 127 paragraph 5 TFEU (Article 3.1. of the statute) it has only been charged with contributing to the "smooth conduct" of the measures taken by the "competent authorities". This can only mean that the other authorities are competent and have to take up the actions deemed to be necessary. The ESCB is restricted to an ancillary role in this field (for the strict separation of "monetary policy" and "economic policy" by the primary law see Siekmann, Einführung No. 121 et seq., Art. 119 No. 22 et seq., in: Siekmann (ed.), Kommentar zur Europäischen Währungsunion, 2013).

The other leg of the court's reservation: unalienable core of the constitutional identity ("unantastbarer Kernbereich der Verfassungsidentität") of the Basic Law is basically aimed at further transfers of powers and is not touched sufficiently in substance.

Looking at the overall system of the distribution of competences, the transgression gets close to the line the court has drawn in its previous decisions. It remains, however, doubtful, if it will really invoke its reserved right to review an act of an institution of the EU.

(4) If the court sees a (possible) breach of the law of the Union and does not decide to review the acts in question by itself, it has to consider a referral to the ECJ. The necessary act of an organ or institution of the Union is given. But it is not sure that a judgement on the conformity of the measures taken by the ESCB, and of the ECB specifically, is a necessary prerequisite for a decision on the three original subject matters of the case, that is, (i) amending the primary law of the Union by inserting a paragraph 3 in Article 136 TFEU dealing with support measures of Member States, (ii) agreement of Member States on fiscal soundness – new fiscal compact and (iii) agreement on establishing the support mechanism ESM.

These questions, especially the amendment of the TFEU, do touch on the conformity with European Union law but a compelling junction with the measures of the monetary institutions is not apparent. It could also be argued that the mere design of OMT is not decisive for the pending case but only the actual purchase of bonds. If the court follows this line of thinking, it could once more refrain from invoking Article 267 TFEU and leave the questions of European Union Law open as it has done in the previous cases.

2.3. Consequences

(1) Provided the court comes to the result that former bond buying programs or OMT are not in conformity with Article 88 Basic Law or transgress competences of the Union in the required serious scope, German authorities would not be allowed to participate in any actions performing or promoting them. As the national central banks play a key role in executing the purchases implied by these programs, the Bundesbank would in this case not be allowed to participate in these actions any further. Normally, the Bundesbank is required to follow instructions of the ECB (Article 14.3 of the statute of ECSB and ECB). However, if the ECB's instructions were to be judged illegal by the German Federal Constitutional Court, the Bundesbank would not have to implement them anymore. Possibly it would even be obliged to use all legal instruments to fend off measures that have been judged as illegal by the German Federal Constitutional Court. Specifically, the Bundesbank would have to resort to litigation before the ECJ following

Article 263 paragraph 4 TFEU. It is an open and undecided question whether acts of the ESCB or the ECB that have been judged as a breach of German constitutional law are void and thus legally not existing.

(2) Provided the court comes to the result that a breach of the primary law has taken place and a ruling is necessary for adjudicating the case, it has to refer it to the ECJ. This will usually lead to a considerable delay of the final decision.

(3) Provided the German court would either not see a breach of European Union Law or refrain from a referral to the ECJ, the final judgement of the case may well be handed down in the next few months.

3. Potential outcomes of the Court's deliberations

The Court could still deny the admissibility of the complaint regarding the measures of the ESCB. This result appears to be fairly unlikely since the Court has put on its agenda for the hearing that took place on June 11, 2013, detailed questions concerning actions of the ECB, specifically OMT. Additionally, one part of the court action has been petitioned in a specific procedure by the members of the Bundestag of the party "The Left/ Die Linke". Such a procedure concerning a conflict between high-level state institutions regarding their constitutional rights (the so-called "Organstreitverfahren") follows reduced requirements for admissibility. Thus, it can be expected that the Court will decide on the merits of the case.

But even if the Court judges SMP and OMT to violate the provisions of EU-law, there are high hurdles to come to the result that the measures are "ultra vires" and violate as such German constitutional law. In this case a referral to the ECJ has to be considered. It would, however, be a novelty in the Court's history and appears to be fairly unlikely.

An outcome in the form that has been used fairly frequently by the Court is more likely a "yes, but". It could underline its concerns but not adjudicate the measures in question as illegal on their face and could emphasize the limits for actions of the ESCB. Specifically the (future) implementation of measures in the framework of OMT may be constrained, for example by stating which bonds cannot legally be purchased as they are not marketable, or by setting limits in respect of duration and volume, or by not allowing to take a haircut in restructuring the debt as this might be judged an economic policy action outside the realm of monetary policy.

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ECB Press Release of 6 September 2012 - Technical features of Outright Monetary Transactions

As announced on 2 August 2012, the Governing Council of the European Central Bank (ECB) has today taken decisions on a number of technical features regarding the Eurosystem's outright transactions in secondary sovereign bond markets that aim at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy. These will be known as Outright Monetary Transactions (OMTs) and will be conducted within the following framework:

Conditionality

A necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. Such programmes can take the form of a full EFSF/ESM mac-

roeconomic adjustment programme or a precautionary programme (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 programme.

The Governing Council will consider Outright Monetary Transactions to the extent that they are warranted from a monetary policy perspective as long as programme conditionality is fully respected, and terminate them once their objectives are achieved or when there is non-compliance with the macroeconomic adjustment or precautionary programme.

Following a thorough assessment, the Governing Council will decide on the start, continuation and suspension of Outright Monetary Transactions in full discretion and acting in accordance with its monetary policy mandate.

Coverage
Outright Monetary Transactions will be considered for future cases of EFSF/ESM macroeconomic adjustment programmes or precautionary programmes as specified above. They may also be considered for Member States currently under a macroeconomic adjustment programme when they will be regaining bond market access.

Transactions will be focused on the shorter part of the yield curve, and in particular on sovereign bonds with a maturity of between one and three years.

No ex ante quantitative limits are set on the size of Outright Monetary Transactions.

Creditor treatment
The Eurosystem intends to clarify in the legal act concerning Outright Monetary Transactions that it accepts the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through Outright Monetary Transactions, in accordance with the terms of such bonds.
Sterilisation
The liquidity created through Outright Monetary Transactions will be fully sterilised.

Transparency
Aggregate Outright Monetary Transaction holdings and their market values will be published on a weekly basis. Publication of the average duration of Outright Monetary Transaction holdings and the breakdown by country will take place on a monthly basis.

Securities Markets Programme
Following today's decision on Outright Monetary Transactions, the Securities Markets Programme (SMP) is herewith terminated. The liquidity injected through the SMP will continue to be absorbed as in the past, and the existing securities in the SMP portfolio will be held to maturity.

For your notes

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