

The ECB and the implications of the sovereign debt crisis

**Francesco Drudi, Alain Durré and Francesco
Mongelli**

European Central Bank

*EU Studies Institute (EUSI) Conference on
“Who will provide the next Financial Model? Asia's Financial Muscle and
Europe's Financial Maturity”*

Tokyo, 10 December 2011

1. Considerations on fiscal dominance
2. The approach of the ECB
3. The crisis and the measures of the ECB
4. The rationale for the measures of the ECB

Interaction between monetary and fiscal policies

- History includes many episodes during which public deficits were financed by the central bank...
 - Either directly by issuing money
 - Or by transfers from the central bank resources (in any form) to the Treasury account
 - Or both
- ...with potential negative implications
 - Risky for the objective of price stability
 - Undermining the budget discipline of the State
 - Erosion the independence of the central bank in the medium term

1. Considerations on fiscal dominance
2. **The approach of the ECB**
3. The crisis and the measures of the ECB
4. The rationale for the measures of the ECB

The European context – Treaty provisions

- Prohibition of Monetary Financing (Art. 123): legal situation regarding the ban of overdraft facilities, other types of credit facilities and direct purchase of debt instruments
- Circumventions are ruled-out. Key test in assessing circumventions is effect on price stability, independence of central bank, fiscal discipline
- Prohibition of privileged access (Art. 124): ban of any measure, not based on prudential considerations, establishing privileged access by any public authorities at large to financial institutions
- Clear mandate to the ECB in terms of price stability (Art. 126)

- Closely follow Treaty Provisions
- Adopt measures to ensure that the transmission of monetary policy is not impaired
- This is essential to control inflation and maintain price stability
- Protect balance sheet: Collateral framework, Financial buffers

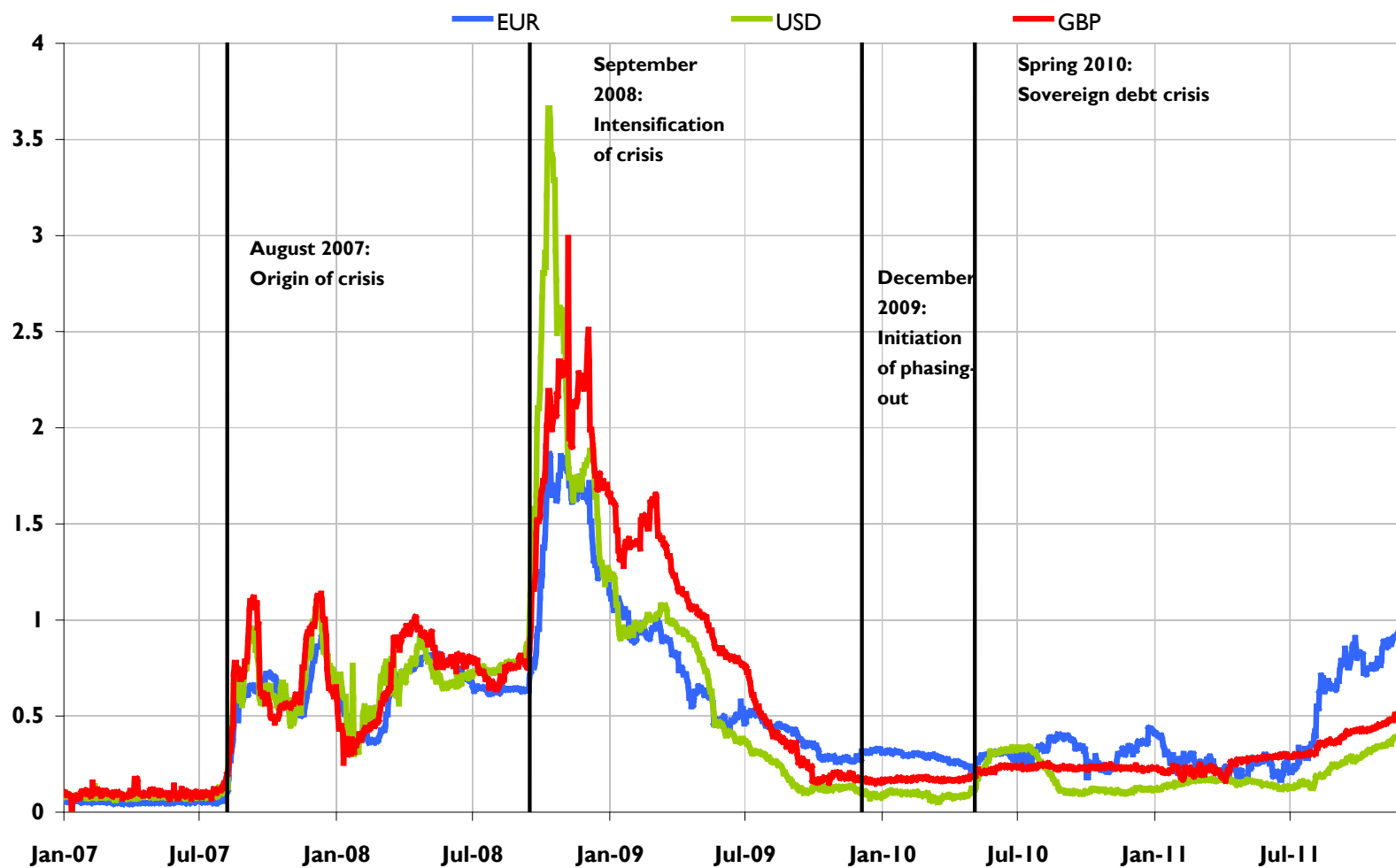
1. Considerations on fiscal dominance
2. The approach of the ECB
3. The crisis and the measures of the ECB
4. The rationale for the measures of the ECB

Chronology of the crisis

- Phase I (August 2007 – September 2008)
 - Liquidity crisis within a (still) robust economic environment
 - Action: Increases of liquidity provision in domestic money and foreign currencies without changing the monetary policy stance
- Phase II (October 2008 - November 2009)
 - Deteriorating economic environment together with intensification of liquidity crisis (both in MM and covered bank bond market)
 - Action: Extension of non-standard measures while changing the MP stance through standard measures
- Phase III (November 2009 - ...)
 - New tensions on banks' liquidity position through sovereign debt crisis
 - Action: Accommodative stance and extension of non standard measures

Money market spreads in the euro area, UK and US

(weekly averages, basis points)



Notes: Spreads are the difference between the 3-month EURIBOR/LIBOR and the Overnight Index Swap rates.

Source: Reuters and ECB calculations

Non-standard measures taken by the Eurosystem

Phase I: As money markets froze up (due to US subprimes)

- ECB was first to react, lending unlimited amounts overnight to banks on 9 August 2007
- Why? Because of the critical role of money markets:
 - The smooth transmission of the monetary policy intentions to money market rates depends on the functioning of the interbank market (where banks exchange liquidity).
 - Through the money markets, the ECB influences the outlook for price stability.

Non-standard measures taken by the Eurosystem

Phase 2: After the collapse of a US financial institution, which threatened the stability of the financial system, and thus the economy and price stability

Enhanced credit support

- Fixed-rate full-allotment

- Expansion of eligible list of collateral (that the Eurosystem takes against liquidity lent to banks)

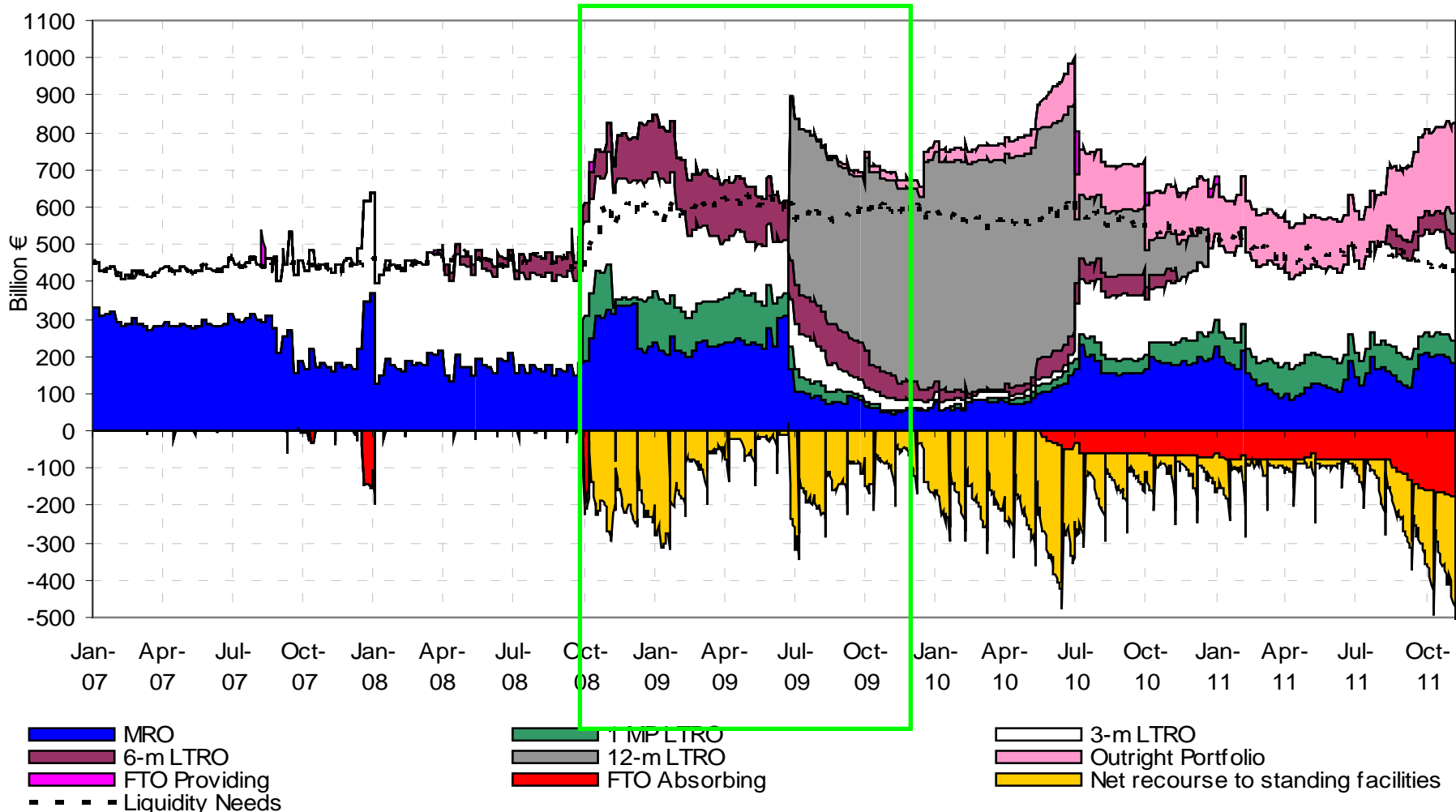
- Longer-term liquidity provision (up to 1 year versus 3 months normally)

- Liquidity provision in foreign currencies

- Covered Bond Purchase Programme

Some of those measures were taken already in late 2007, most in October 2008, and some have been phased out or reintroduced since then.

Outstanding open market operations and recourse to the deposit facility from January 2007 to October 2011

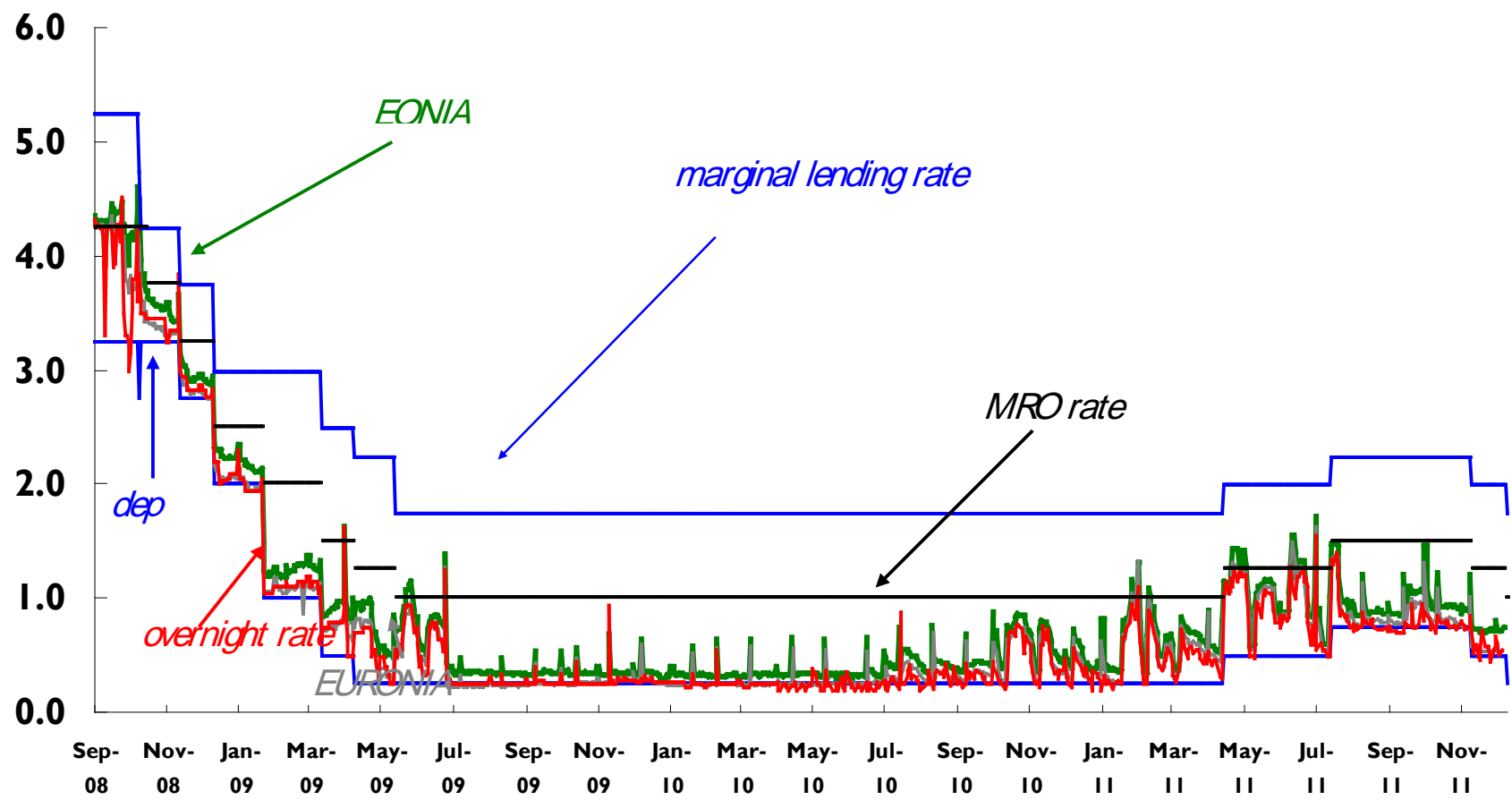


Phase II

Source: ECB (EUR billion)

ECB interest rates and money market rates

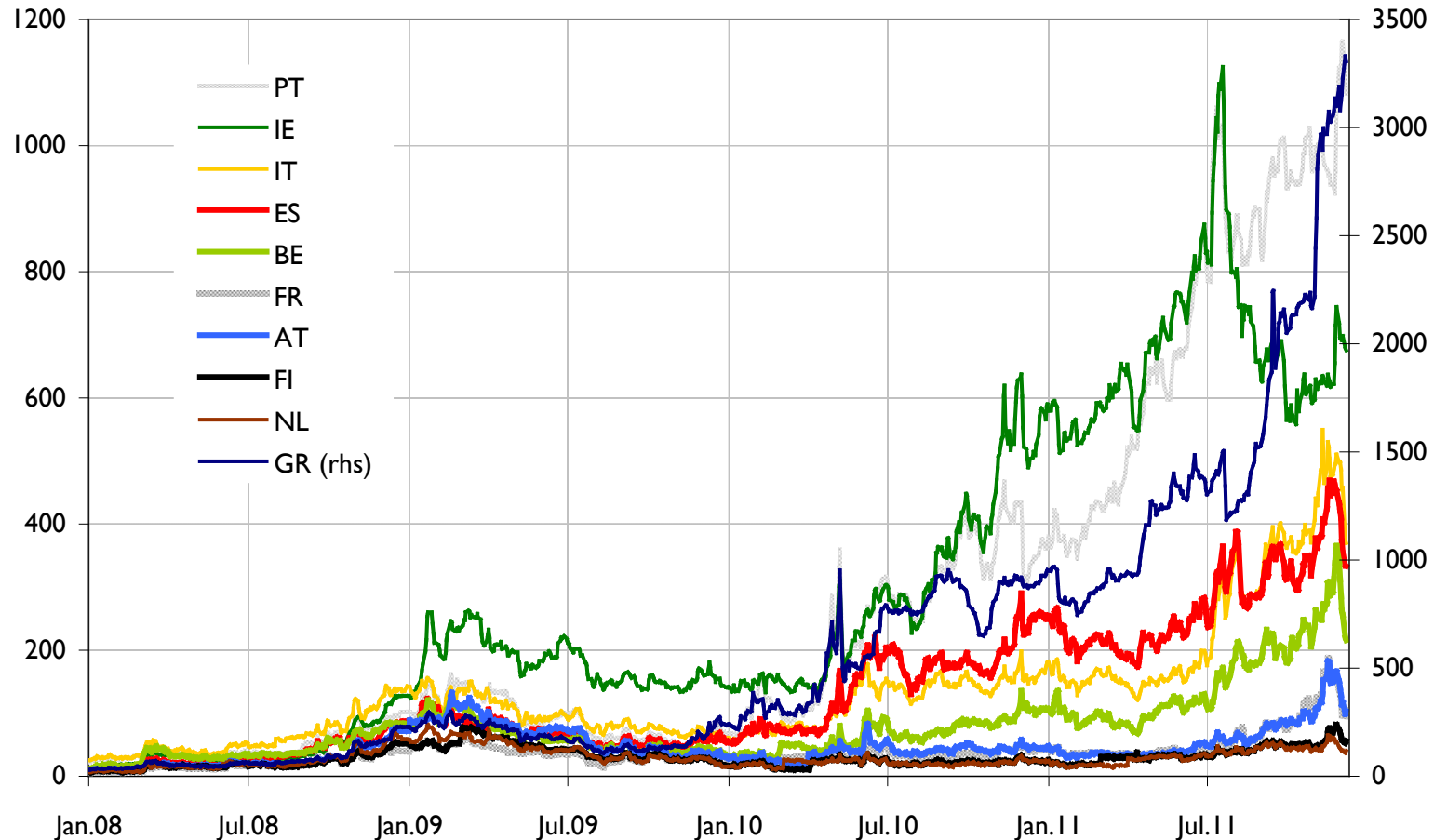
(percentages per annum; daily data)



Source: ECB, Reuters

Third Phase-Sovereign debt Crisis

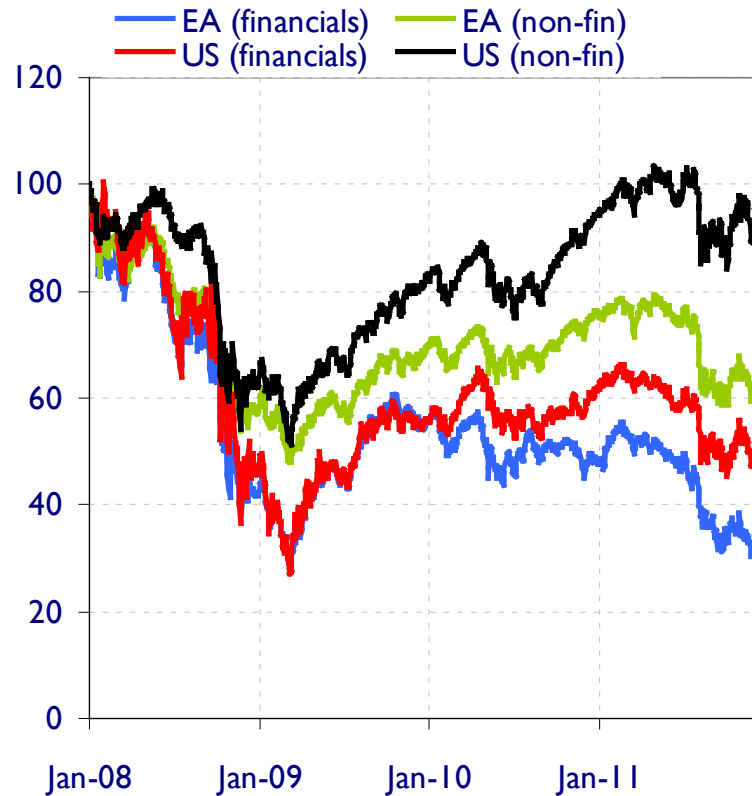
10-year Government bond spreads against German



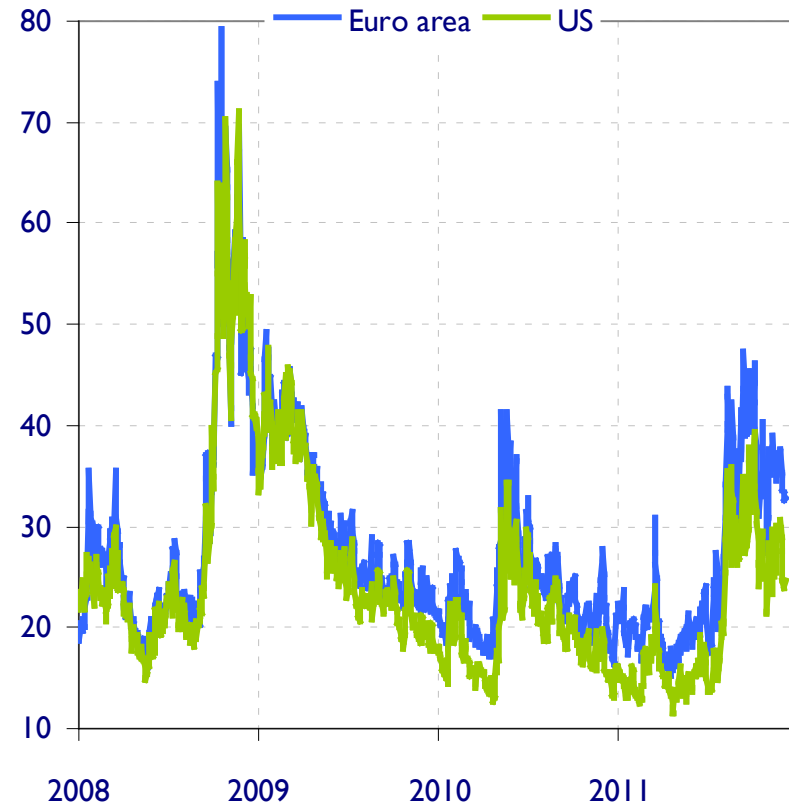
Source: Bloomberg, Thomson Reuters, ECBc

Asset Prices: Stocks affected by the spreading of the crisis

Sectoral stock price indices



Implied stock market volatility



Source: Datastream, Bloomberg. Latest observation: 6 Dec 2011. Notes: Stock price indices calculated by Datastream. Rebased on 1 January 2008.

Non-standard measures taken by the Eurosystem

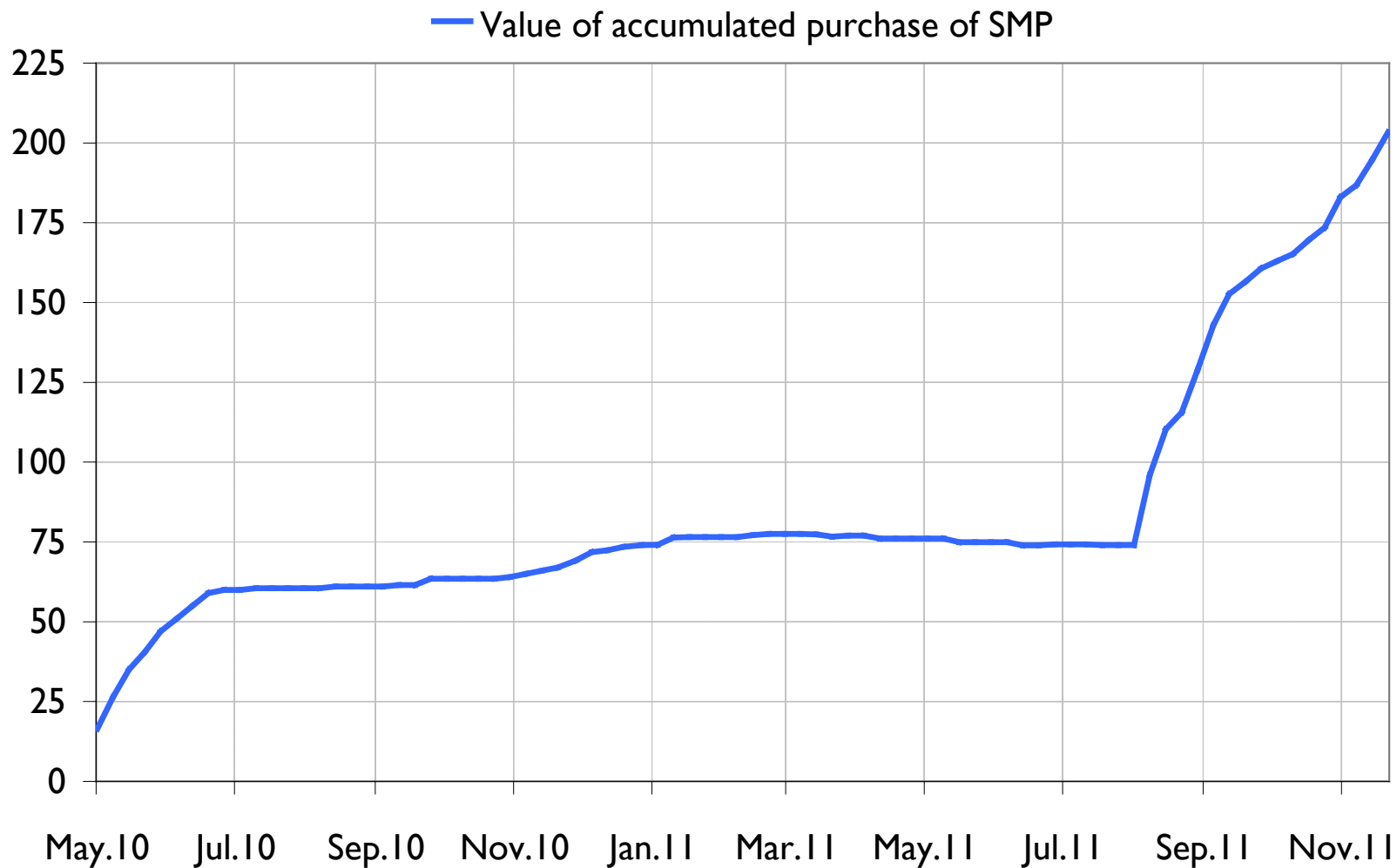
Phase 3: Sovereign debt crisis, with some euro area countries at the epicentre since May 2010

- Started the SMP in May 2010
- ‘Active implementation of SMP’ August 2011
- Extension of FRFA-October 2011
- New 1-year operations-October 2011
- New Covered bond purchase programme (CBPP2)-October 2011

Measures to support bank lending and money market activity

1. Additional LTROs with 3-year maturity (and opt-out)
 - Increases menu of ECB refinancing offers
 - Aims at limiting negative impact of tensions in bank funding markets on bank lending
2. Broadening of collateral framework, increased eligibility of credit claims and lowering of rating threshold for ABS
 - Increases share of euro area banks' balance sheet eligible for central bank refinancing
 - Targeted at instruments particularly close to lending activities of banks in order to support these activities
3. Reduction of required reserve ratio to 1% (from 2%)
 - Increases money market activity by reducing highly remunerated liquidity buffers banks hold with Eurosystem
 - Frees up collateral as banks can reduce their demand in central bank operations accordingly
4. Discontinuation of end-of-period fine-tuning operations
 - Increases incentives for money market trades, operations are currently not needed

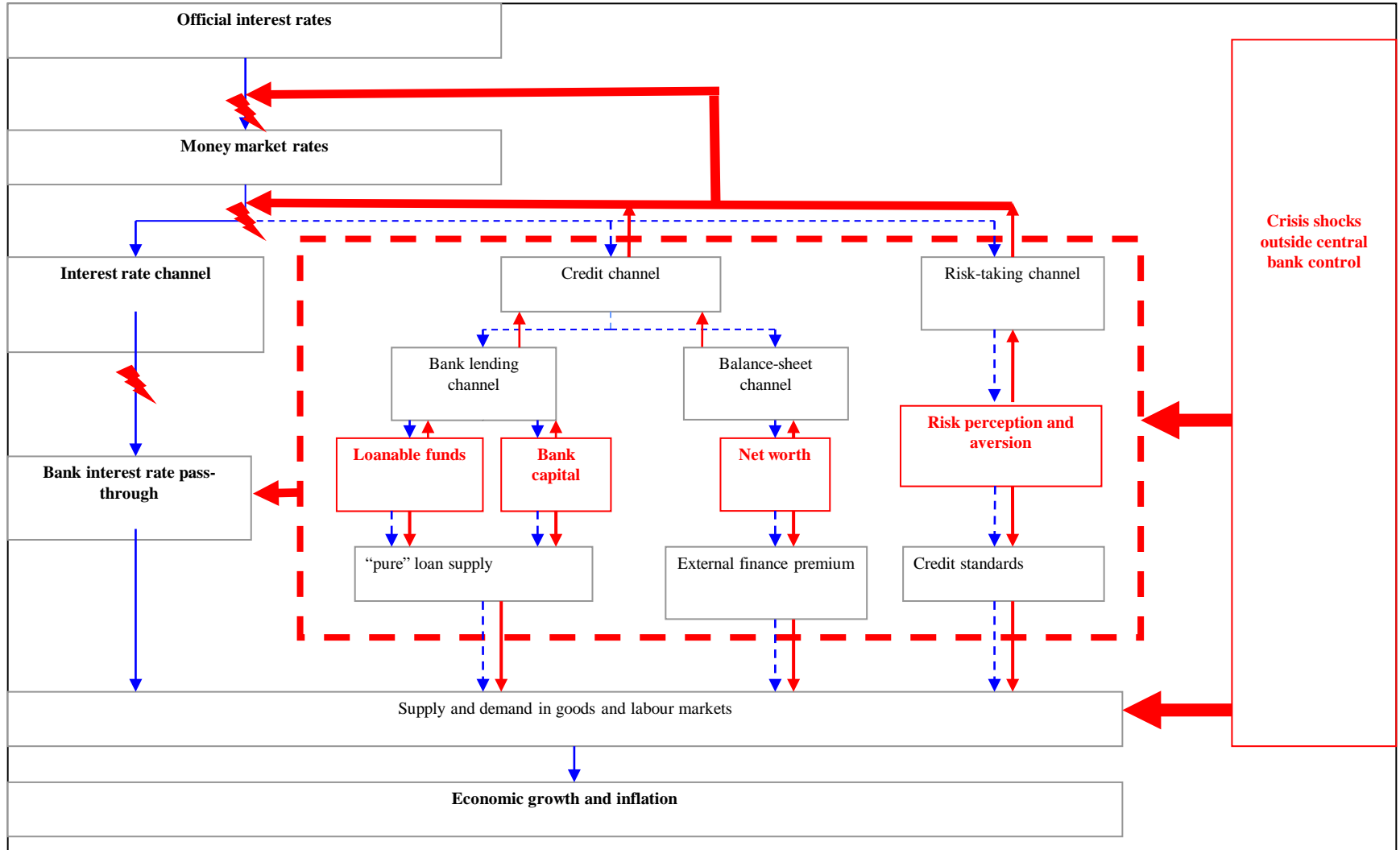
Value of accumulated purchase of SMP



Source: ECB

1. Considerations on fiscal dominance
2. The approach of the ECB
3. The crisis and the measures of the ECB
4. The rationale for the measures of the ECB

The main potential impairments in the monetary transmission mechanism



- Government bonds play an essential role in the transmission of monetary policy:
 - Liquidity channel: large use of government bonds as collateral in repos
 - Balance sheet channel: valuation of assets (government bonds and others) matter for strength of balance sheet, with consequences for financing conditions
 - Price channel: Prices of assets (e.g. corporate bonds) determined by the government-bond based yield curve
 - These effects, if not addressed, could lead to reduce the flow of credit to the economy and increase its cost-
 - Effectiveness of monetary policy could be severely hampered

- Key condition: no purchases in primary market, interventions in line with art. 123

- Key condition: Clear evidence of mis-pricing based on:

Market Indicators: Bid-ask spreads, transaction volumes

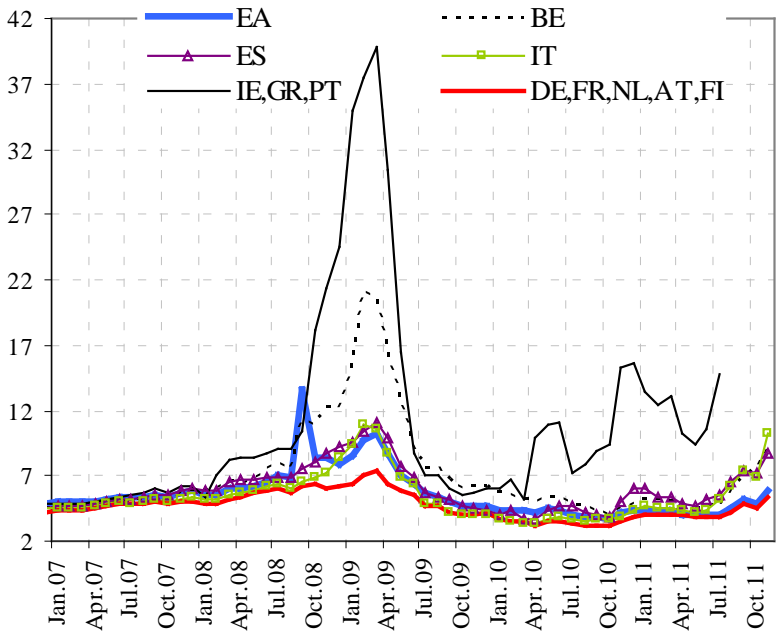
Assessment of fundamentals of countries

- Key condition: Maintain sound balance sheet

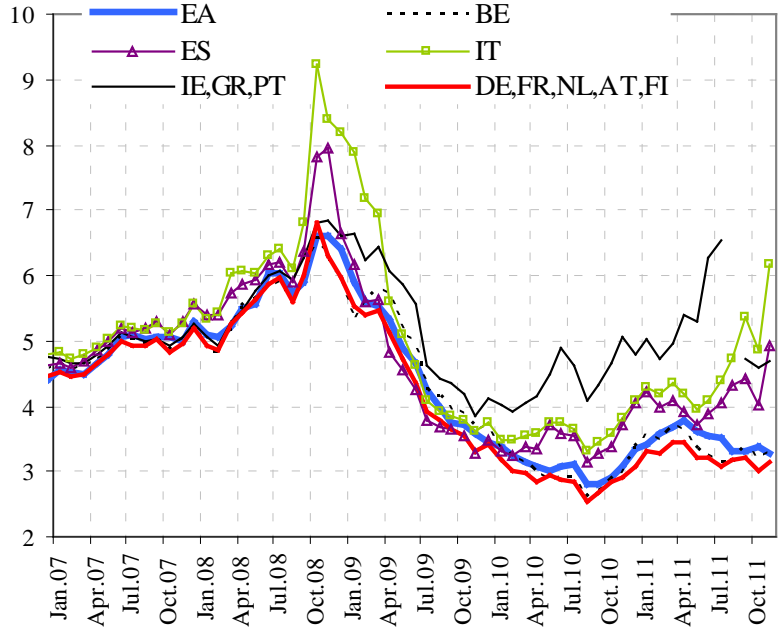
Nominal cost of market based debt for the corporate sector: Investment grade bonds: Cross country developments

(% p.a.; average yields; Jan. 2007 to November 2011)

Banks



Non-financial corporations



Sources: Merrill Lynch Global Index, Eurostat and ECB calculations.

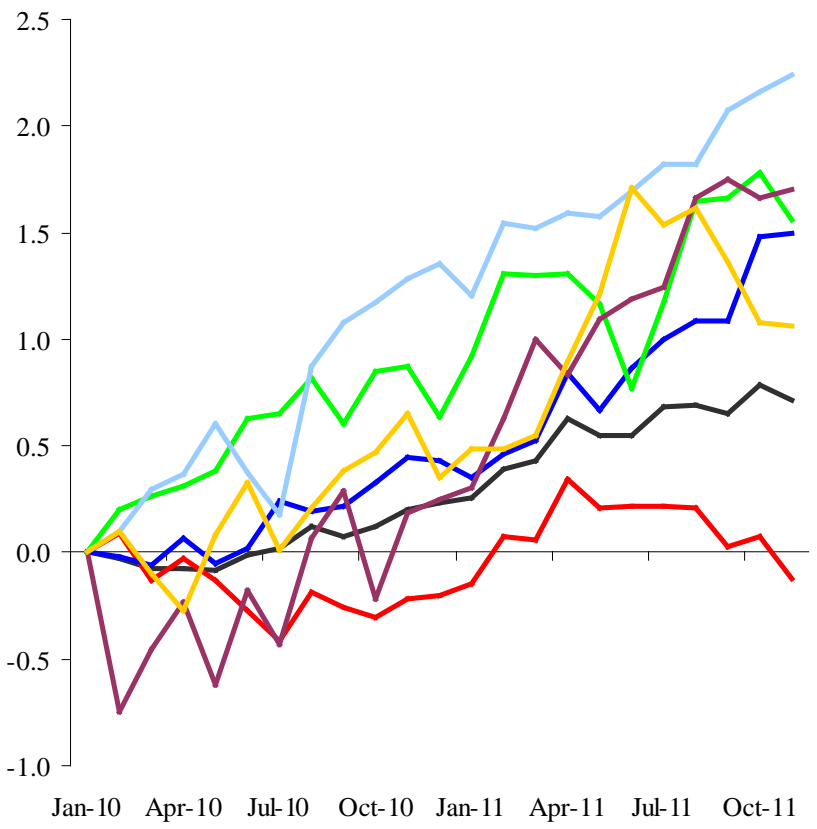
Note: Country aggregations are calculated using nominal GDP weights. Investment grade bonds issued by banks are no longer available for Greece, Ireland and Portugal since July 2010, May 2011 and August 2011, respectively. Investment grade bonds issued by NFCs are no longer available for Greece and Portugal since July 2010 and August 2011, respectively.

Bank lending rates: Cross country developments

Non-financial corporations

(% p.a., realised values, difference between the current value and Jan 2010)

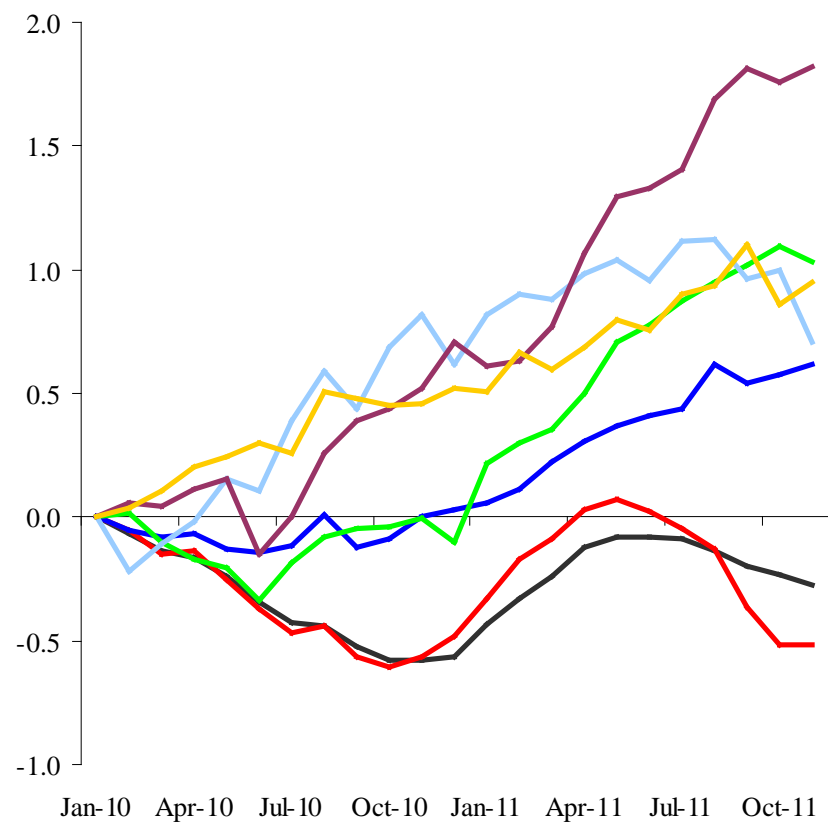
— EA — DE — IT — ES — GR — PT — IE



Households for house purchase

(% h.a., realised values, difference between the current value and Jan 2010)

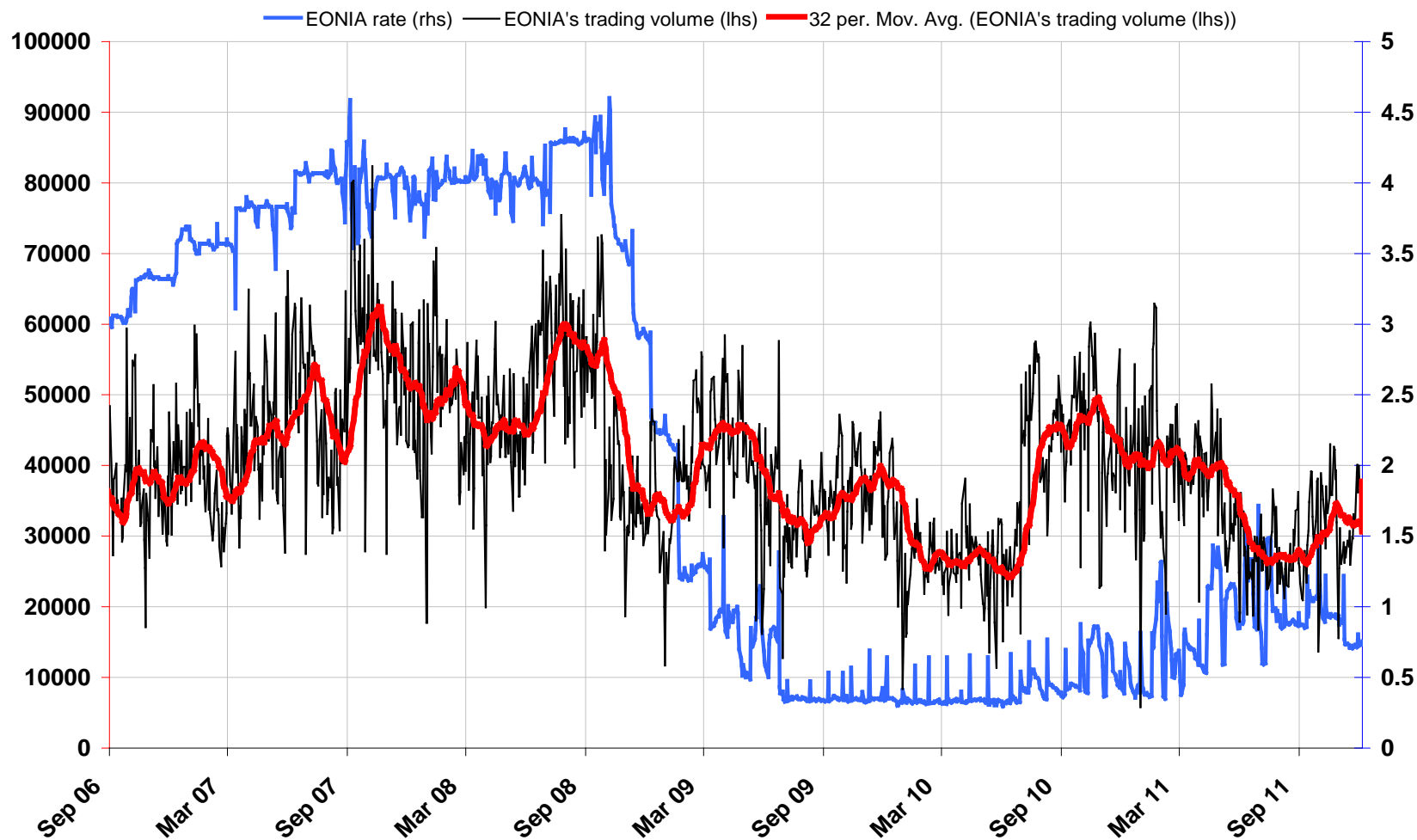
— EA — DE — IT — ES — GR — PT — IE



Sources: ECB calculations.

Note: Lending rates are based on data up to October 2011. The composite lending rate is a weighted average based on outstanding volumes of loans and assumption of floating rate share in long-term loans.

Activity and pricing in the EONIA market (daily averages)

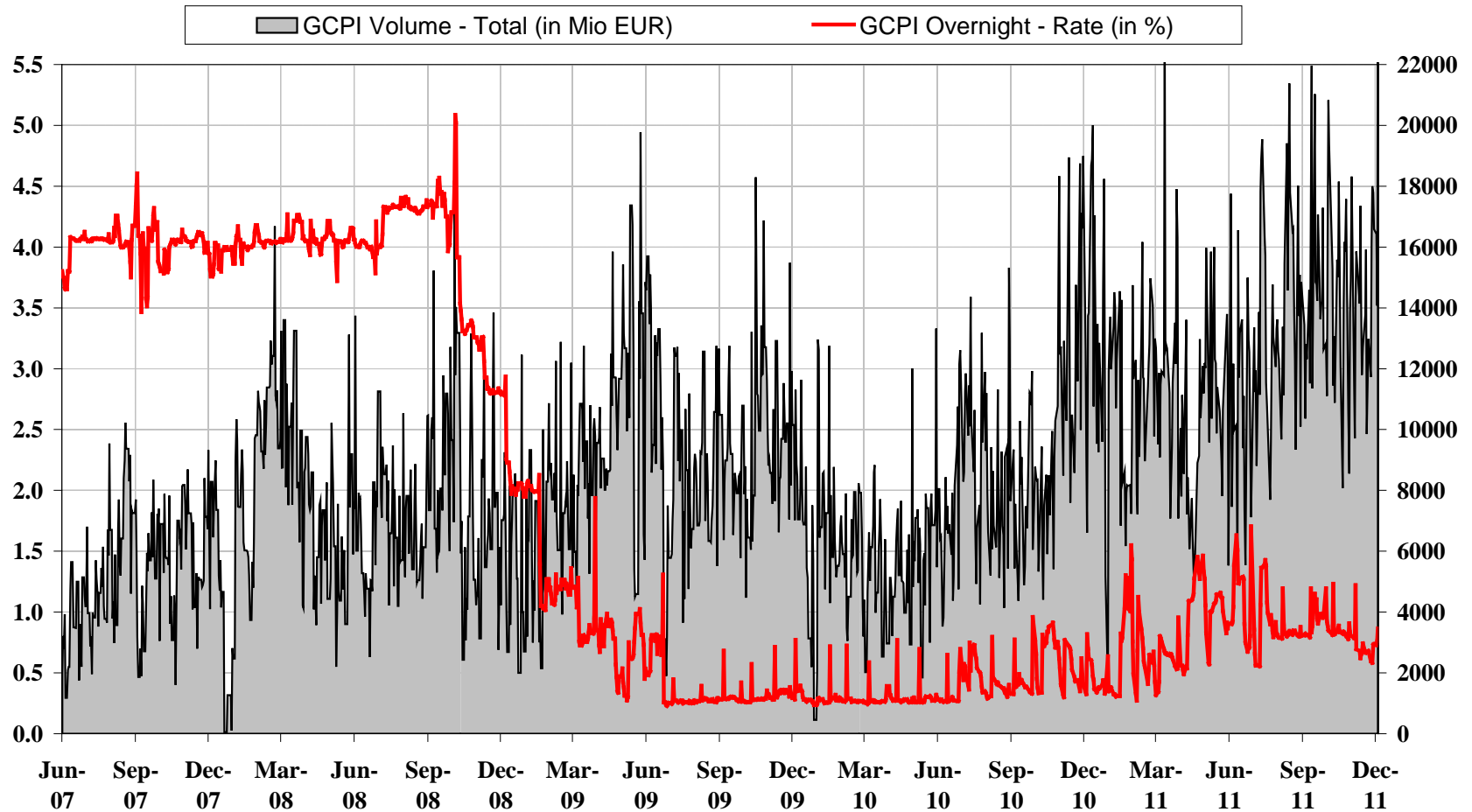


Source: ECB, Reuters

Activity and pricing in the overnight Repo market

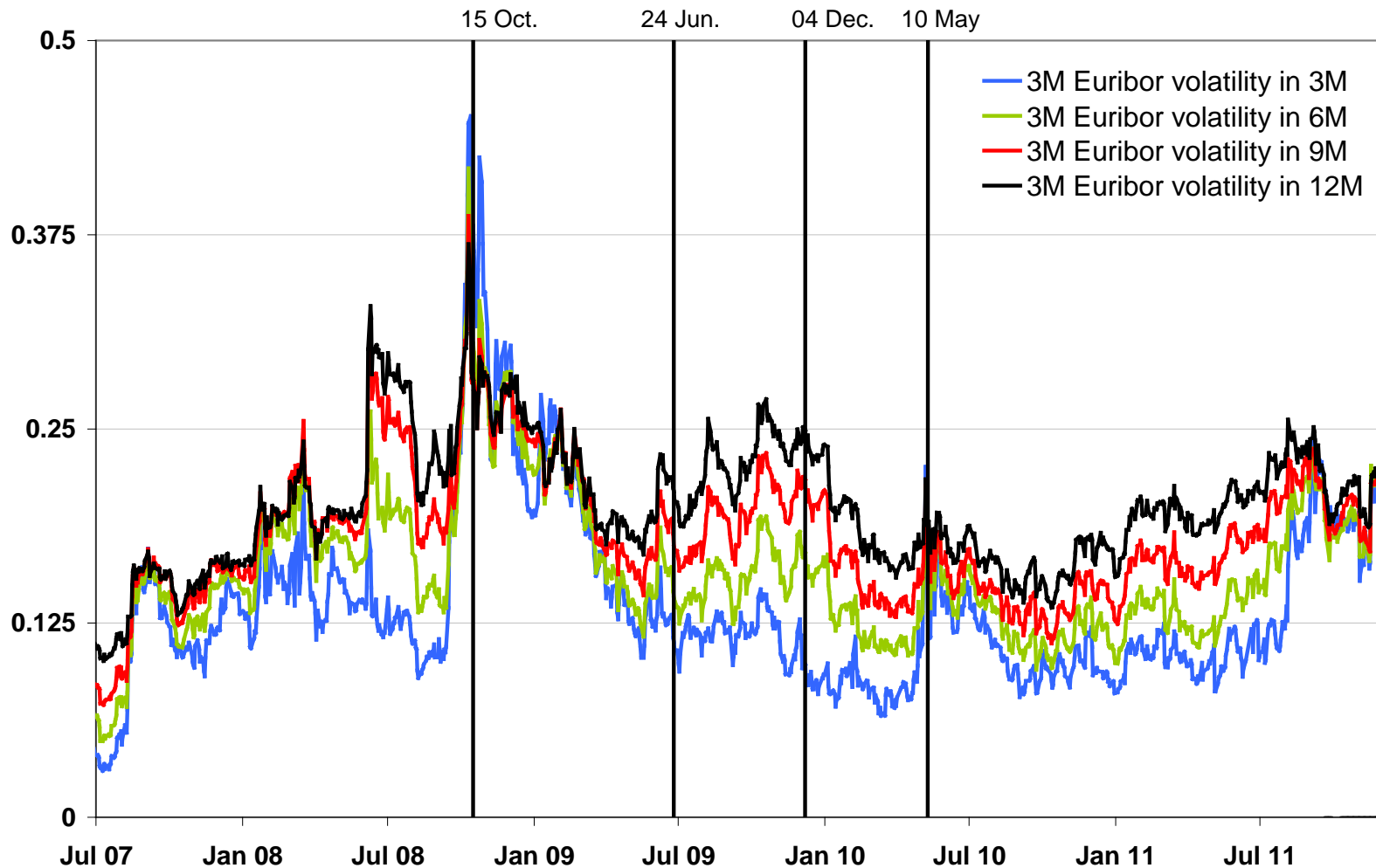
(daily averages)

GC Pooling EUR Overnight Index: rates (RS) and volumes (LS)



Source: ECB, Reuters

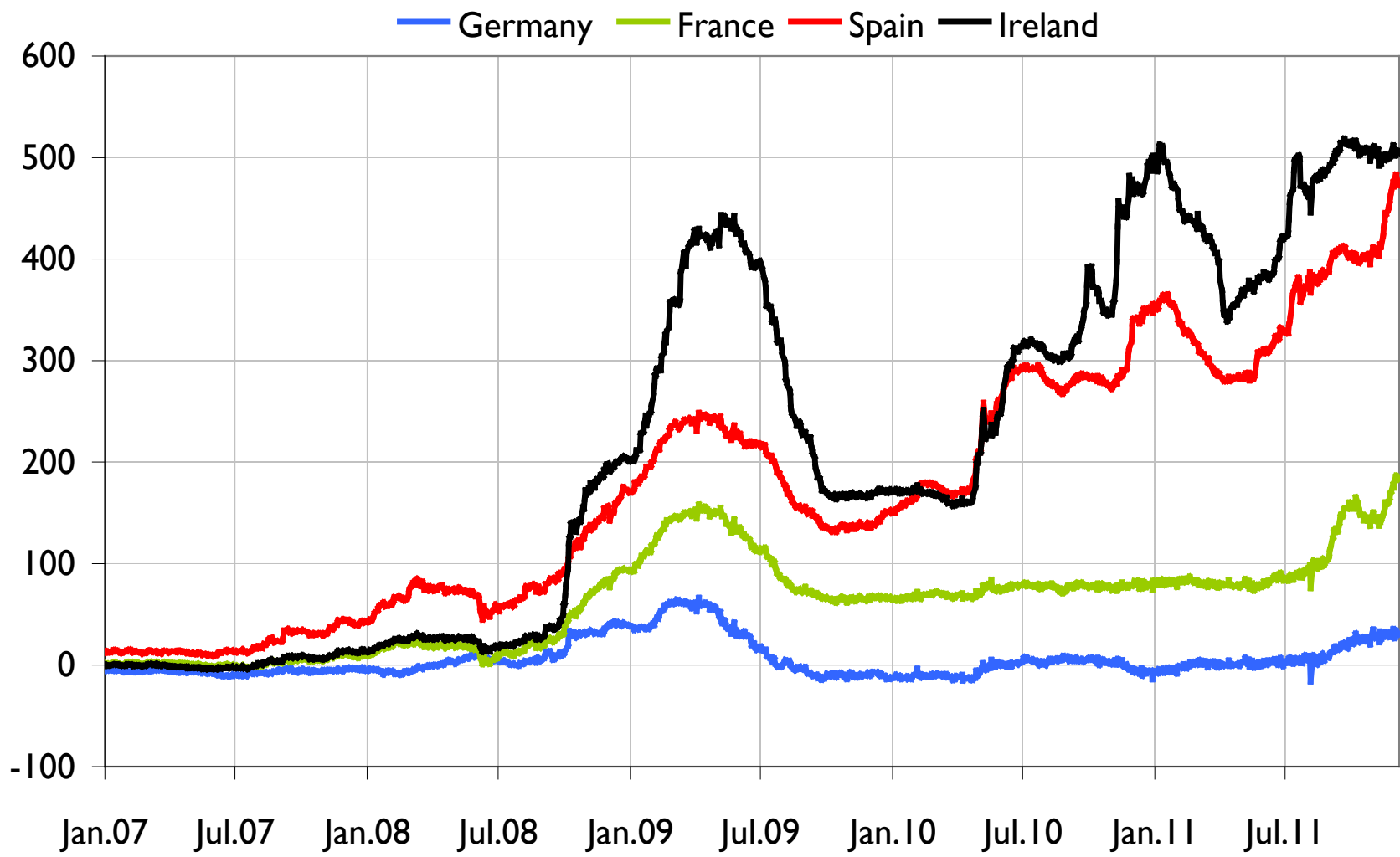
Volatility in the term EURIBOR market (daily averages)



Source: Reuters and ECB calculations

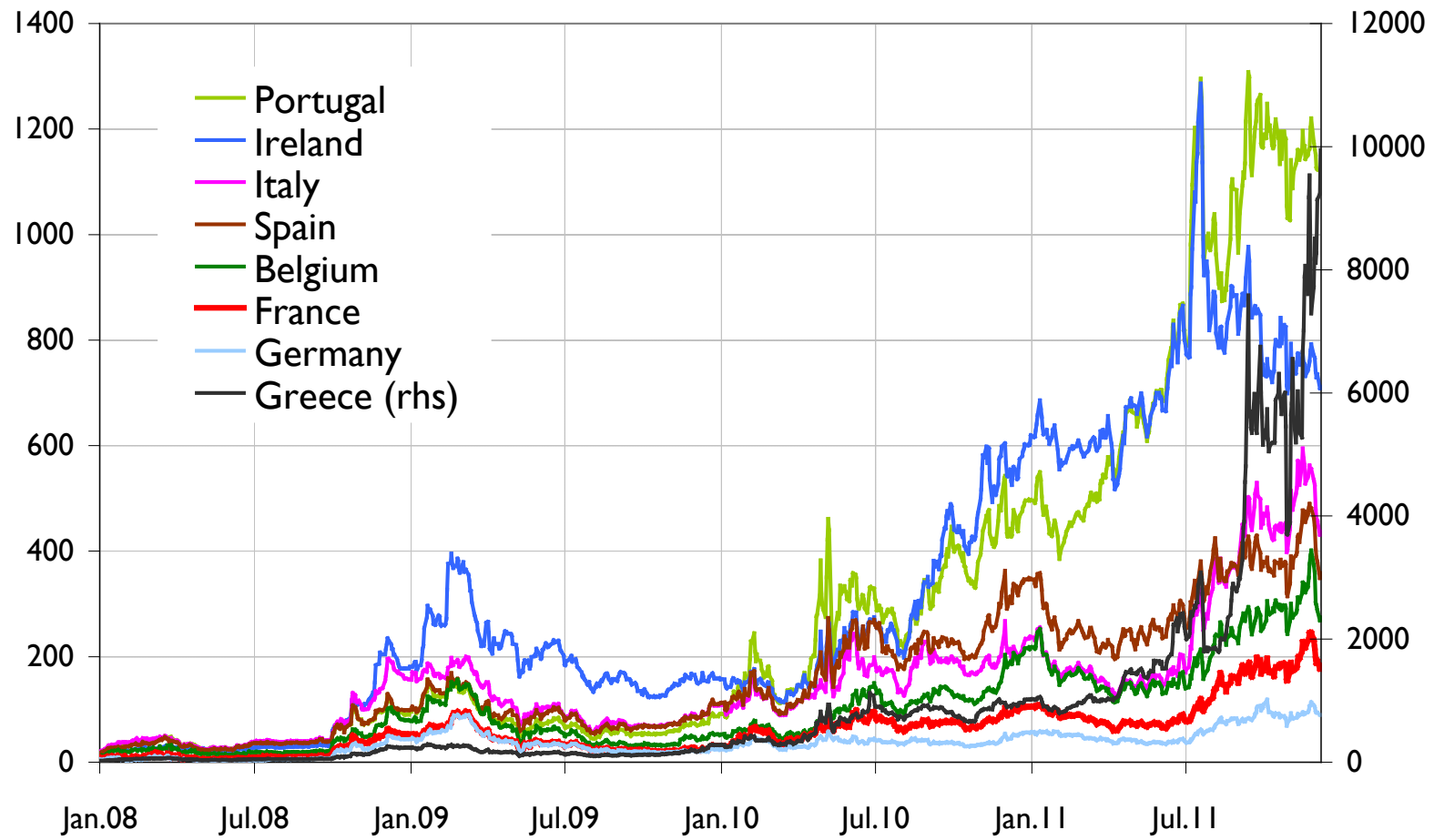
Covered bond spreads against 5-year swap rate

(daily, basis points)



Source: Reuters and ECB calculations

Sovereign CDS premium (daily, basis points)



Source: Reuters