DIRECTORATE GENERAL FOR INTERNAL POLICIES

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The ECB and Non-Standard Policies: Too Little Too Late?

NOTE

Abstract

The ECB has been slower to cut interest rates and to consider asset purchase programmes than the other major central banks even though the euro area economy has performed worse than its comparators. This failure to act has not stemmed directly from the ECB's price stability mandate. Indeed, by not acting sufficiently strongly, the ECB is now failing to meet its own definition of price stability. The measures introduced at the ECB's June Governing Council meeting will have only a modest positive effect on the euro area economy. Large asset purchase programmes – of both sovereign bonds and private asset-backed securities – are overdue.

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AUTHOR

Karl WHELAN, University College Dublin

RESPONSIBLE ADMINISTRATOR

Dario PATERNOSTER
Policy Department A: Economic and Scientific Policy
European Parliament
B-1047 Brussels
E-mail: Poldep-Economy-Science@ep.europa.eu

LINGUISTIC VERSIONS

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ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its monthly newsletter please write to:
Poldep-Economy-Science@ep.europa.eu

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EXECUTIVE SUMMARY

- The ECB has been slower to cut interest rates and to consider asset purchase programmes than the other major central banks even though the euro area economy has performed worse than its comparators.

- This failure to act has not stemmed directly from the ECB's price stability mandate. Indeed, by not acting sufficiently strongly, the ECB is now failing to meet its own definition of price stability.

- The measures introduced at the ECB's June Governing Council meeting will have only a modest positive effect on the euro area economy.

- The negative deposit rate will have a small effect in reducing money market rates and yields on low-risk sovereign bonds but will do little to boost bank lending. Indeed, it may have a slight negative effect as banks raise interest rates on loans to offset the negative effect of the ECB charging them for their deposits.

- The Targeted LTRO is not particularly well targeted and many banks will treat it as an unconditional two-year LTRO.

- While some banks will consider using TLTRO funds to provide loans to the private sector, this programme will do little to counter strong pressures on banks to deleverage and to establish stable private funding sources.

- Large asset purchase programmes – of both sovereign bonds and private asset-backed securities – are overdue.

- The ECB should not wait until all of the regulatory issues with SME-loan-backed bonds are resolved and a large market for these instruments established. It should announce a programme of ABS purchases as soon as possible.

- An programme of sovereign bond purchases would also reduce long-term interest rates and send an important signal to the public that the ECB intends to meet its price stability target. Such a programme would not violate the Treaty's monetary financing clause.

1. INTRODUCTION

The period since the beginning of the global financial crisis in 2008 has been an extraordinary one for central banks around the world. Short-term interest rates have been brought to historic lows and central banks have introduced a wide range of new operations that would have considered almost science fiction little more than a decade ago. Traditional methods for providing central bank liquidity have been overhauled and central banks such as the Federal Reserve and the Bank of England have undertaken significant large-scale asset purchases (LSAPs) and as well as a range of special programmes targeted at specific sub-sectors of the financial system.

The ECB has played some role in this global movement away from traditional central banking but its embrace of so-called "non-traditional" monetary policies has been slower and less enthusiastic. Like other central banks, the ECB responded to the crisis in 2008 by providing large amounts of liquidity to the banking system and simplifying its rules by moving towards full-allotment fixed rate operations. Indeed, the ECB's existing comprehensive collateral framework meant that it was better positioned than some of the other large central banks to respond to the initial phases of the global crisis.

Since 2008, however, the ECB has been consistently slower to respond to the weakness in the economy and the financial system than either the Federal Reserve or the Bank of England. While these central banks quickly cut interest rates to near zero, it has taken the ECB almost six years to do this with this period including a mistaken tightening of policy in 2011. Unlike the Bank of England or Federal Reserve, the ECB has not undertaken significant LSAPs – its asset purchase programmes were limited to small purchases of covered bonds and the SMP programme of reluctant and temporary sovereign bond purchases. Where the Bank of England and the Fed have experimented with new approaches to "forward guidance", the ECB has limited itself to bland (and probably impact-free) assurances that current monetary policies will be in place for some time to come.

With the ECB now acknowledging that it has effectively run out of room for further rate cuts, the debate about which "non-standard policies" it should adopt has intensified and the June Governing Council meeting saw some new measures introduced. This paper discusses the new measures introduced by the ECM. It also argues the case for asset purchase programmes and discusses a number of specific issues that complicate their application in the euro area.

This structure for this paper is as follows. Section 2 makes the case that the ECB has not reacted strongly enough to the economic weakness in the euro area and that, rather than just considering them now, it should have already introduced large-scale asset purchase programme. Section 3 then discusses the actions taken by the ECB Governing Council in June – most importantly, a new targeted long-term refinancing operations (TLTRO) and a negative deposit rate – and argues that these decisions TLRTO will have a limited impact. Finally, Section 4 focuses on two types of programmes that could be introduced: A programme of purchasing bonds backed by loans to small and medium-sized enterprises and a sovereign bond purchase programme.

2. THE CASE FOR LARGE-SCALE ASSET PURCHASES

This section outlines the rationale for LSAPs by a central bank, compares the actions since 2008 of the Federal Reserve with those of the ECB and then argues that the ECB is failing to meet its mandate by its failure to pursue effective LSAP programmes.

2.1. Why Employ LSAPs?

In normal recessions, central banks respond to economic weakness by cutting the short-term interest rates that they control. These cuts end up being passed through to the rates that private sector firms and households can borrow at. In a low inflation environment, however, nominal interest rates tend to be relatively low on average and a severe recession may lead the central bank to cut interest rates to zero.

Once interest rates have been cut to zero, the central bank's traditional transmission mechanism for monetary policy is exhausted. This is not because the central bank cannot set a negative interest rate: It is perfectly possible, for example, for the ECB to offer negative interest rate loans to banks i.e. to loan money and then allow the borrowing bank to return less than the amount borrowed. However, under normal circumstances, it will not be possible to get private sector financial institutions to provide loans with negative interest rates – they would be better off simply to keep the money as cash in the bank (or under a mattress) than making loans of this type.

In addition to cutting interest rates to zero, central banks can also communicate to the public their intention to keep these rates very low for a long time – this will tend to reduce longer-term interest rates which are heavily determined by the expected future path of short-term rates.

Beyond this kind of "forward guidance", central banks can choose to influence private sector interest rates by intervening directly in financial markets. By purchasing large quantities of securities, central banks can raise their price, which reduces their yield. These reductions in yield may then be passed on to other key interest rates in the economy.

This latter point about LSAPs, or "quantitative easing" as it is sometimes known, is important. Most of the commentary about these programmes characterises them as "printing money" and it is often suggested that their purpose is to expand the broader money supply and thus increase the availability of credit in the economy. However, this is not how either the Federal Reserve or Bank of England have viewed these programmes. While the textbook "money multiplier" model describes how increases in the monetary base are automatically translated into increases in the broader money supply, this model does not provide an accurate description of money creation in a modern economy in which banks make decisions about credit creation based on a wide range of macroeconomic and regulatory factors.[1]

Instead of focusing on the idea that these programmes boost the broader money supply, research from the Federal Reserve and the Bank of England such as D'Amico at el (2012) and Joyce et al (2010) has clearly highlighted the reduction of bond yields as the objective of LSAPs. In particular, these studies have emphasised that they view the main purpose of LSAPs as being the reduction of "term premia", i.e. that part of long-term interest rates that is unrelated to expected future short-term rates. In other words, while LSAPs may

[1] The recent paper McLeay, Radia and Thomas (2014) is effectively an official explanation of this viewpoint by the Bank of England.

play a role in providing forward guidance on future short-term rates, this is not seen as the principal channel through which they operate.

There is a growing empirical literature on the impact of LSAPs on bond yields. The message from these studies is somewhat mixed: LSAPs work to reduce bond yields but the effects are relatively limited and obtaining these limited effects requires a very large amount of money creation. For example, D'Amico et al (2012) state their results as follows

> *For longer-term Treasury securities, the first LSAP program (undertaken in 2009) consisted of $300 billion of Federal Reserve purchases, while the second program (in late 2010 tomid-2011) consisted of $600 billion of purchases. Our preferred estimates suggest that, taking scarcity and duration together, the first program of LSAPs reduced longer-term Treasury yields by about 35 basis points; the second program, larger in dollar amount but smaller in its impact on duration, reduced longer-term Treasury yields by about 45 basis points.*

So while LSAPs do work, they are a poor substitute for the ability to cut short-term interest rates by another couple of percentage points. This illustrates one of the downsides of operating in a low inflation environment.

2.2. Comparison of the ECB and Federal Reserve

When compared with the actions taken by other central banks, the remarkable thing about the ECB's current situation is that it has taken so long (and things have had to get so bad) for it to cut its policy rates towards zero and to consider asset purchase programmes.

The graphs over the next few pages compare aspects of the euro area and United States economies over the past few years. They illustrate categorically that the ECB's weaker and slower response over the past few years has occurred despite the euro area economy performing far worse than the U.S. economy.

Figure 1 compares real GDP in the euro area and the United States, indexing both series to 100 at their 2008 peak values. Despite a widespread perception that the 2008 recession was driven by the events in the United States, the decline in GDP was larger in the euro area with GDP falling about 6 percent, compared with a decline of about 4 percent in the United States.

The euro area has continued to underperform the United States in the years following the severe global contraction. Despite widespread dissatisfaction in the U.S. with a relatively slow pace of growth, the U.S. economy has grown steadily since the middle of 2009 and real GDP in the first quarter of this year was 6 percent above its previous peak in 2008. In contrast, the euro area economy began a sluggish recovery in 2009 which petered out in 2011 as the economy entered back into recession (see Figure 1). While four quarters of very slow growth have now been recorded, euro area real GDP in the first quarter of this year remained 2.5 percent below its pre-crisis peak.

The euro area's experience with unemployment has also been more negative than that of the United States. The initial increase in unemployment in 2008/9 was larger in the U.S., with its unemployment rate rising from well below the European level to matching the euro area rate in late 2009. However, from that point onwards the U.S. unemployment rate gradually eased to reach 6.3 percent in May 2014. In contrast, unemployment in the euro area rose in 2008 and 2009, plateaued in 2010, and then began increasing again during the second recessionary dip. At 11.7 percent, the current unemployment rate in the euro area is still two-thirds higher than it was prior the global economic crisis (see Figure 2).

Figure 1: Real GDP in Euro Area and the United States

Indexed to 100 at 2008 Peak

Source: ECB SDW and Federal Reserve FRED Database

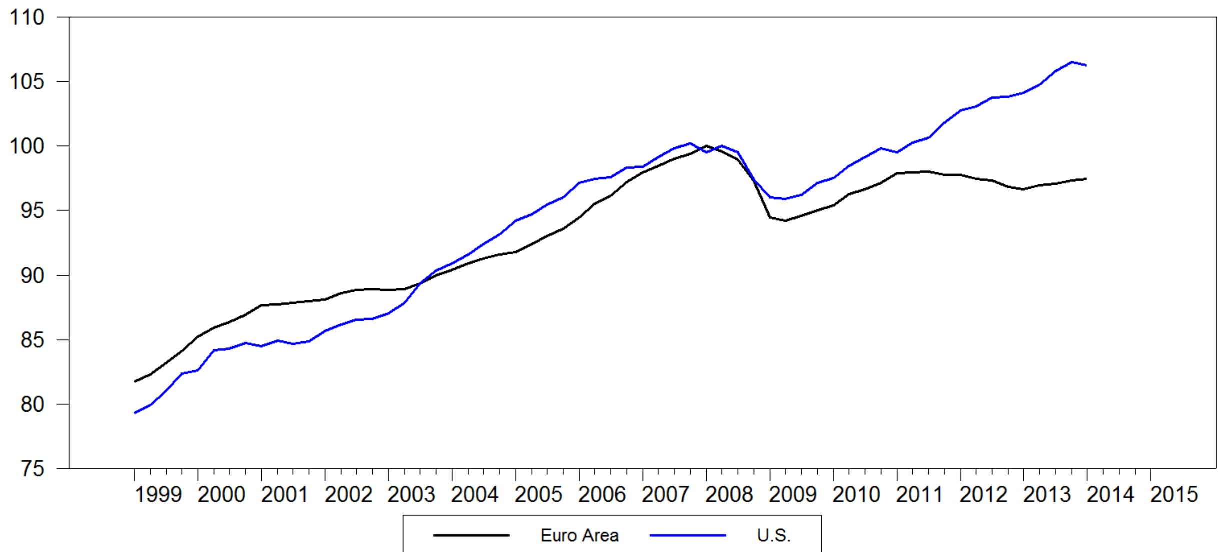
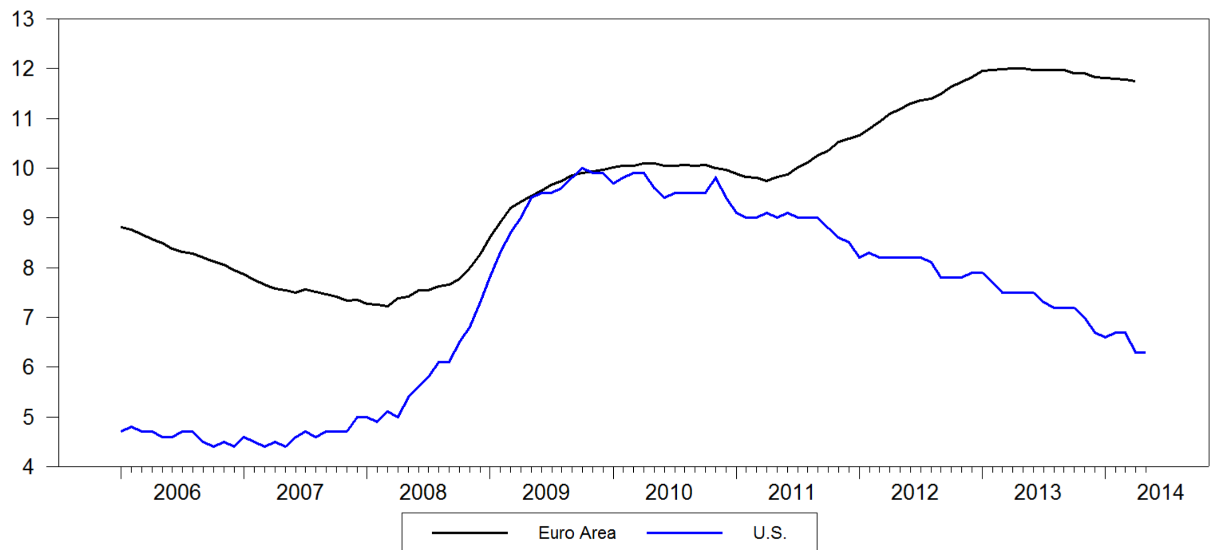


Figure 2: Unemployment Rates in Euro Area and the United States

Source: ECB SDW and Federal Reserve FRED Database



Despite this significantly inferior economic performance, the ECB has been consistently more reticent to use its powers to promote economic activity. The ECB raised interest rates in July 2008 at a time when (we now know) the euro area economy was in recession. The ECB was then slower to cut interest rates than the Fed. While the Fed had cut its policy rate to effectively zero by the end of 2008, the ECB only gradually cut rates to one percent in May 2009. The ECB then raised rates in Spring and Summer of 2011, just as the euro crisis was intensifying and leading the euro area back into recession. Only at its most recent meeting has the ECB finally reached the point where its key policy rate is close to zero.

The ECB's approach to expanding its balance sheet has also been far more conservative. There have been two types of bond-purchasing programmes but both were relatively small and are now over: A limited set of covered bond purchases and the mysterious and opaque stop-start bond purchases associated with the now-defunct Securities Market Programme. The ECB did provide additional liquidity to the European banking system after 2008 and its balance sheet had more than doubled after the second large LTRO in early 2012. However, from then until the most recent Governing Council meeting, there were no new initiatives to actively use the ECB's balance sheet and it has now shrunk in size by about €1 trillion due to banks repaying their LTRO borrowings. Figure 4 illustrates the ECB's lack of use of its balance sheet relative to the Federal Reserve, which has expanded its assets by a factor of almost five.

2.3. The ECB: Meeting or Failing to Meets Mandate

One argument for the less active approach is that the ECB differs from the Federal Reserve in having a primary mandate for price stability and this mandate has forced it to act in a more conservative manner. I disagree with this position for a number of reasons.

First, it should be noted that the Federal Reserve has performed well in meeting its inflation mandate despite pursuing policies such as LSAPs. Indeed, in the period since August 2008, average consumer price inflation has been almost identical in the euro area and the United States.[2] Nor has there been any sign that years of the simulative "non-standard" monetary policies are producing any delayed impact on U.S. price inflation, which has remained close to target over the past few years. The idea that the ECB could not afford to risk programmes such as LSAPs because of their inflationary impact simply does not match the evidence.

Second, in the absence of more vigorous monetary policies, the ECB is actually failing to meet its own definition of price stability. The ECB's current staff projections envisage HICP inflation of 0.7 percent this year, 1.1 percent in 2015 and 1.4 percent in 2016. Following on from last year's HICP inflation rate of 1.4 percent, this projection represents a significant cumulative shortfall from the price level path consistent with the ECB's interpretation of its own mandate.

This shortfall is particularly dangerous given the current economic conditions in the euro area. Many European governments, firms and households are struggling with high debt burdens and below-target inflation slows the process of adjusting these burdens downwards via nominal wage increases. An important part of this process is the recovery of competitiveness in peripheral economies but a low average inflation rate for the euro area as a whole makes it difficult for these countries to improve their competitiveness without experiencing a deflationary cycle that exacerbates existing debt burdens.

[2] CPI inflation in the U.S. has averaged 1.65 percent while HICP inflation in the euro area has averaged 1.66 percent.

Overall, I believe that the ECB is failing to meet its own mandate by acting too cautiously and that it bears an important element of responsibility for both the failure to meet its own inflation target and the poor state of the euro area economy.

In my opinion, these arguments suggest that a more radical approach to monetary policy, such as new LSAP programmes, is long overdue. The ECB, however, does not agree. In an important speech in April, Mario Draghi mentioned the conditions under which he believed the ECB should adopt various new approaches.[3] He noted that a "*targeted LTRO or an ABS purchase programme*" would be the appropriate if there was *"a further impairment in the transmission of our stance, in particular via the bank lending channel"* and stated that "*a worsening of the medium-term outlook for inflation … would warrant a more broad-based asset purchase programme."*

I am a bit puzzled by this approach to asset purchase programmes.

First, given that the euro area economy is already in very poor shape and inflation is falling well short of target, it is unclear why it is that the ECB needs to wait for a further worsening medium-term outlook for inflation before introducing LSAPs.

Second, it is unclear why the ECB believes that this condition had not already been met. The ECB itself admits that it anticipates undershooting its own price stability target for at least four successive years. This constitutes an unsatisfactory medium-term inflation outcome and I hope the ECB will accept this over the coming months. For this reason, I would anticipate that some form of large asset purchase programme is likely to be implemented before the end of this year.

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[3] This speech "Monetary policy communication in turbulent times" can be found at http://www.ecb.europa.eu/press/key/date/2014/html/sp140424.en.html

Figure 3: Policy Rates in Euro Area and the U.S.

Black Line is Main Refinancing Operation Rate and Blue Line is Fed Funds Rate

Source: ECB SDW and Federal Reserve FRED Database

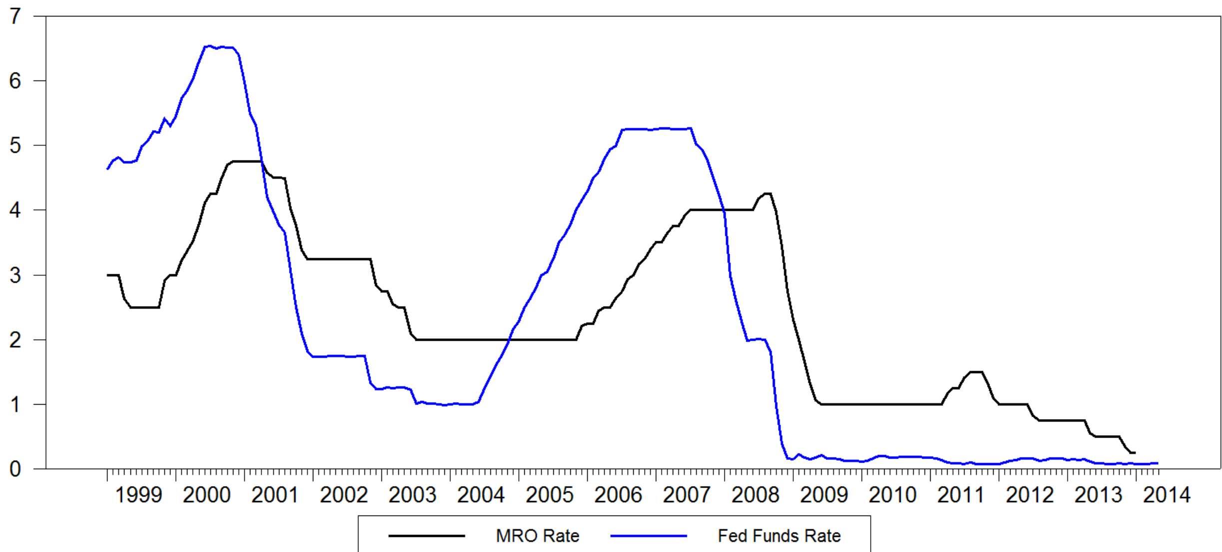


Figure 4: Balance Sheet Expansions of ECB and Federal Reserve

Index: January 2008=100

Source: ECB SDW and Federal Reserve FRED Database

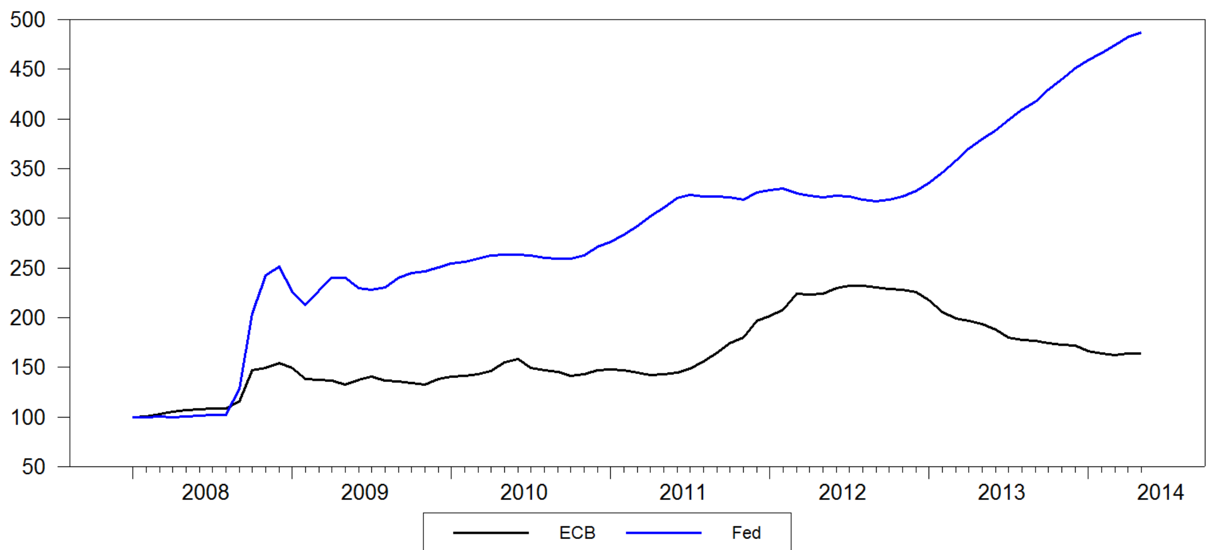
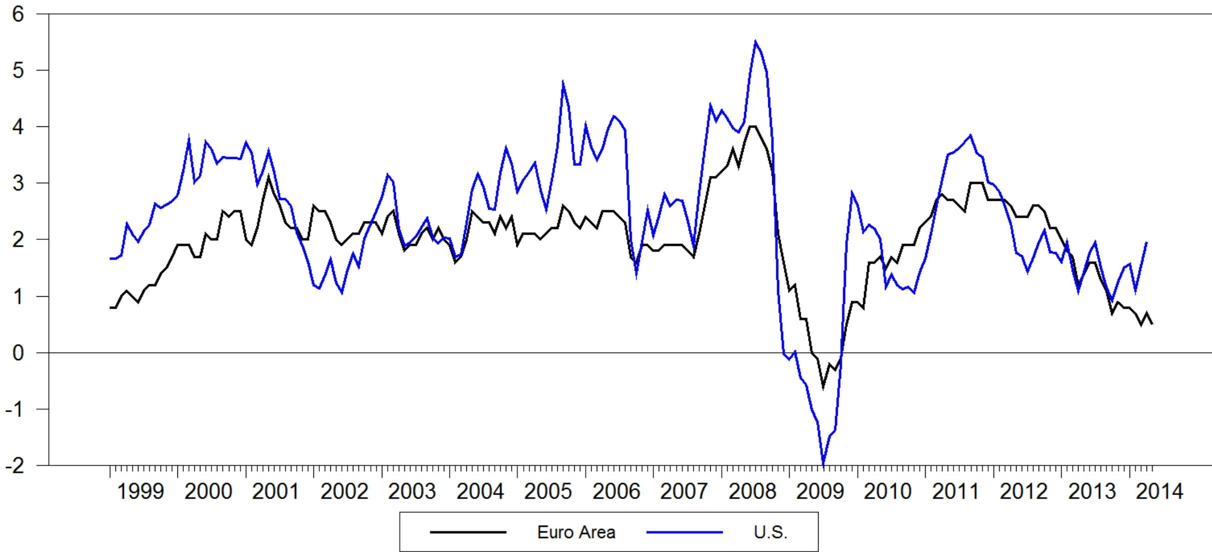


Figure 5: Consumer Price Inflation in Euro Area and the U.S.

Black Line is Euro Area HICP, Blue Line is US CPI

Source: ECB SDW and Federal Reserve FRED Database



3. THE ECB'S JUNE GOVERNING COUNCIL DECISIONS

Though it stopped short of adopting an asset purchase programme, the ECB announced a range of new monetary policy measures at its June meeting. In addition to cutting its Main Refinancing Operation rate by 10 basis points to 15 basis points, the ECB announced other measures including

- Lowering the "remuneration rate" on excess reserves and deposits held with the Eurosystem to a negative ten basis points, so that banks need to pay a charge to the ECB for such deposits.
- Ending the "fine-tuning operations" for sterilisation of SMP bond purchases.
- Announcing that three-month long-term refinancing operations (LTROs) would continue on a fixed-rate full-allotment basis until December 2016.

The ECB also announced a new Targeted Long-Term Financing Operation (TLTRO). This is a relatively complex operation with the following features.

- It allows banks to borrow for four years at a fixed rate. In this year's two operations that rate will be 25 basis points.
- The amount that a bank can initially borrow from this operation is 7 percent of their loans to the euro area non-financial private sector, excluding loans to households for house purchase.
- Subsequently, from March 2015 to June 2016, banks will be able to borrow additional amounts that can reach up to three times their net lending to the non-financial private sector (excluding loans for house purchase) from April 2014 onwards in excess of a specified benchmark. The benchmark will be an institution-specific calculation based on each bank's net lending in the year prior to April 2014.

While I would have preferred to have seen the announcement of large-scale asset purchase programmes, these measures will have a small positive impact on the euro area economy by lowering interest rates somewhat. I am less optimistic that they will generate a significant increase in bank lending to the real economy.

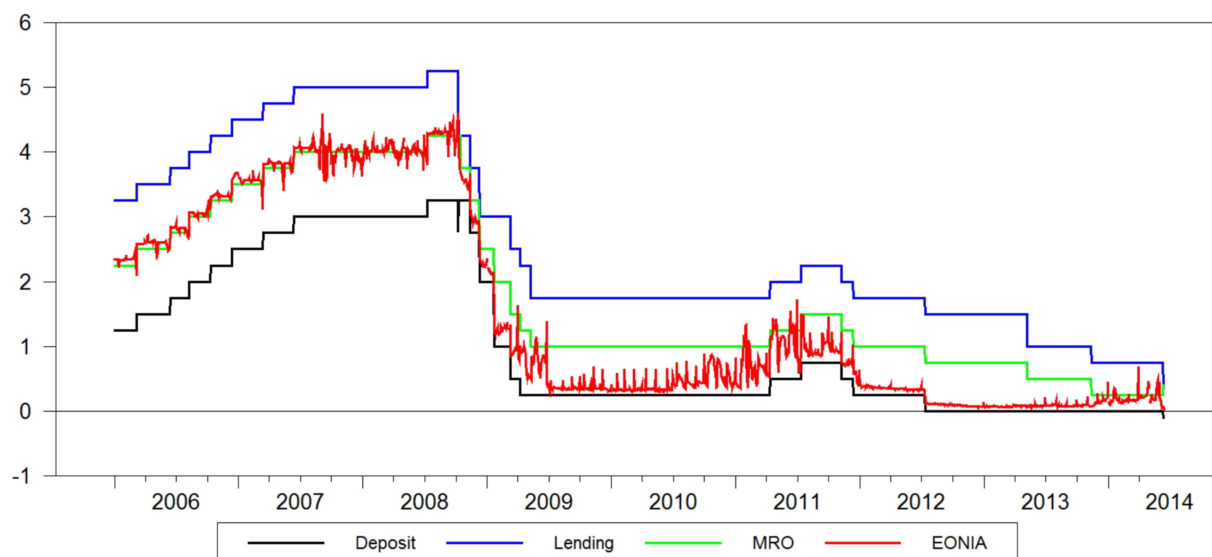
3.1. The Negative Deposit Rate

In relation to interest rates, the move to negative rates on the deposit facility will have some effects on money market rates and on higher-quality government bonds. The interaction between monetary policy and money market rates has changed in recent years. Figure 6 illustrates the "corridor" system by which the ECB traditionally controlled euro area money market rates. Prior to 2008, EONIA, the average overnight money market rate, generally stayed very close to the ECB's MRO rate and fluctuations in this rate were bounded above by the marginal lending facility rate and below by the deposit rate.

In recent years, however, many banks that are perceived as higher-risk have been excluded from short-term unsecured money markets. While these banks can borrow at the MRO rate, the traditional arbitrage relationship between this rate and the money market rate has effectively broken down. Instead, money market borrowing has been limited to lower-risk banks and the low rate earned on these loans is seen as an alternative for lending banks to leaving the money at the ECB and earning the deposit facility rate.

Figure 6: EOINA and the ECB's Interest Rates

Source: ECB SDW



For these reasons, EONIA has tracked the deposit facility rate rather than the MRO rate over the past few years. The move to a negative deposit facility rate will thus move money market rates downwards, a pattern that can already be seen in the week since the negative rate was introduced on June 11.

The reduction in the deposit facility rate will also have a small impact in reducing the yield on low-risk sovereign bonds. With money market rates falling towards zero and banks paying a fee for having deposits with the Eurosystem, the demand for holding these short-duration low-risk sovereign bonds as an alternative investment will increase, thus driving down yields.

The "hot potato" effect on asset yields – driven by a desire by banks to have liquid assets instead of deposits with the Eurosystem – will intensify somewhat because of the additional liquidity entered into the system by the Governing Council's decision to stop sterilising its SMP purchases and also by the TLTROs in September and December of this year.

This liquidity-boosting effect may be temporary, however, because the ECB's current operational policies mean that the supply of central bank liquidity is effectively demand-driven: With full-allotment policies in place and banks allowed to repay LTRO borrowings, the total amount of liquidity in the system will be determined by the actions of private banks rather than the ECB. Indeed, once the two original large LTROs are repaid next year, it is not clear that TLTRO will actually boost liquidity to much above current levels.

One potential goal of the negative deposit rate is to increase the supply of bank credit. One theory is that the charge on Eurosystem deposits will encourage banks to make loans instead of having deposits at the central bank. It is very unlikely, however, this this mechanism will do much to add to credit growth. European banks are focused on building up regulatory capital ratios and are still very cautious in their assessment of private sector credit risk. While the negative deposit rate may boost demand for liquid securities, it is unlikely to do much for the supply of loans to the private sector.

Indeed, with banks focusing on raising profit margins, it is possible that the negative effects on banking system income of the charge on deposits may end up being passed through in the form of slightly higher interest rates on loans. In this sense, the negative

deposit rate could actually prove harmful to credit conditions for firms and households in the euro area.

3.2. The TLTRO

Unlike the negative deposit rate, the TLTRO is intended to act directly to raise the supply of bank credit to the private sector.

The scheme offers a number of incentives to banks to borrow from the ECB and use the funds to lend to the private sector. The cost of this credit is very cheap: This year's TLTROs will have a fixed interest rate of 25 basis points and subsequent LTROs will have an interest rate that is only 10 basis points above the prevailing MRO rate. In addition, the four-year maturity for these loans is helpful to banks that are concerned about satisfying regulations on net stable funding ratios: It is hard to make four-year loans to customers on the basis of short-term funding from the central bank.

Despite these positive elements, I have a number of doubts about whether TLTROs will have much impact on bank lending to the private sector.

First, despite the name, the "targeted" nature of the TLTROs is weak. There is no fine or punishment for banks that take TLTRO funds and then don't satisfy the lending benchmark. Instead these banks just have to pay back the funds after two years. In this sense, the TLTRO also operates like a regular LTRO with a two-year maturity. For this reason, it is likely that some banks will use the TLTRO to run two-year carry trades in which cheap ECB funding is used to purchase sovereign bonds and other securities. That said, even this element of the TLTRO is not particularly important because of the announcement that three-month LTROs will be continued unto December 2016. The interest rate on these three-month LTROs is currently 10 basis points below the TLTRO and rolling over these loans may prove cheaper than the TLTRO over the next two years.

Second, the availability of cheap funding of this sort does not change the strong longer-term incentives that European banks have to deleverage. A bank that is concerned about the current ECB-led stress tests (and likely follow-up exercises over the next few years) is unlikely to aggressively expand its balance sheet simply because it can borrow cheaply for a few years from the ECB. Compliance with Basle 3 and market-driven demands for higher capital ratios are also playing an important role in restraining credit growth as is the perception that risk in areas like SME lending remains very high.

Third, while a four-year TLTRO may look like a good deal and may qualify as stable funding for regulatory purposes, it does not change the fact that many banks wish to minimise the amount of funding they get from the ECB. This is partly due to a "stigma" effect in which a bank is viewed as being in weak condition if it borrows a lot of money from the ECB. It is also due to the negative "encumbrance" effect that comes from having to pledge collateral to the ECB to obtain funding.

Taking these points together, I expect the TLTRO to have a relatively modest effect on bank lending.

4. POTENTIAL EURO-AREA LSAP PROGRAMMES

The ECB is not currently undertaking any asset purchase programmes. Here I discuss two different possible types of asset purchase programme, one that the ECB is openly considering (purchasing asset-backed securities) and one that it is not yet considering (a programme of sovereign bond purchases).

4.1. Asset-Backed Securities

The idea that the ECB could use asset purchases to boost bank lending via purchasing asset-backed securities (ABS) has featured in European policy discussions for at least a few years now. Indeed, the impact of the ECB purchases of ABS was discussed in a series of Monetary Dialogue papers written in June 2013.

The economic case for such a programme is strong. Unlike programmes that focus on providing cheap funding, a sufficiently-large ABS purchase programme by the ECB could play a significant role in promoting lending. Banks could make money (via fees) for originating loans to SMEs without triggering the funding or capitalisation concerns associated with expanding their balance sheets.

During 2013, the ECB admitted it was considering a programme of ABS purchases, with the securities backed by loans to SMEs. It set up a task force with the European Investment Bank (EIB) to examine how such a scheme would work. At the June 2013 Governing Council press conference, Mario Draghi said[4]

> *there is a task force working on this together with the European Investment Bank, and if they produce something, it will be collateralised, it will be guaranteed by other institutions.*

In other words, any ABS purchases by the ECB would have to be guaranteed by the EIB.

When I considered this issue in my June 2013 Monetary Dialogue paper, I was pretty downbeat about the prospects of a successful programme emerging and wrote "I suspect the proposal for the ECB to purchase ABS will turn out to be a damp squib given the ECB's lack of enthusiasm for asset purchases and a reluctance to use up much shared European public money to provide the required guarantees."

Unfortunately, this prediction turned out to be correct. The ECB-EIB task force appears to have ended in failure. European Investment Bank President Werner Hoyer stated in April[5]

> *It is the EIB's job to provide financing for growth and jobs. Offering large-scale guarantees to revitalize the ABS market would not be in accordance with this*

The ECB are again talking about ABS purchases but they are still in "preparation" mode. The recent announcement stated

> *The Governing Council has decided to intensify preparatory work related to outright purchases in the ABS market to enhance the functioning of the monetary policy transmission mechanism, given the role of this market in facilitating new credit flows to the economy. Under this initiative, the Eurosystem will consider purchasing simple and transparent ABS with underlying assets consisting of claims against the euro area non-financial private sector, taking into account the desirable changes in the regulatory environment, and will work with other relevant institutions to that effect.*

[4] See http://www.ecb.europa.eu/press/pressconf/2013/html/is130606.en.html
[5] See https://mninews.marketnews.com/content/eib-hoyer-not-ready-large-scale-guarantees-abs-press

The "intensification of preparatory work" may seem like a positive development but I am still not optimistic that an ABS programme will emerge any time soon.

While it appears that the ECB has perhaps given up looking for some other European public body to insure its ABS purchases (an unnecessary and time-wasting exercise) it seems to me that its new approach is to signal a willingness to purchase ABS backed by SME loans only when these instruments are designed and regulated in a way that produces a large and well-functioning market.

This will not be a matter of amending a few small regulations. Even when issuance of ABS was at its peak prior to the financial crisis, SME-backed bonds accounted for only a very small percentage of these assets. SME loans have a number of features that make them less compatible with securitisation than, for example, household mortgages. SME loans contain a large amount of idiosyncratic risk; a much larger fraction of the risk associated with mortgage loans can be summarised through a few observable household characteristics. SME loans are also less homogenous in their terms and conditions, including collateral requirements and underlying interest rates. With small firms more vulnerable to economic conditions than large ones, the income flows underlying these securities will generally feature more correlated risk than mortgage-backed securities.

A sense of the complexity of this issue can be seen from the range of issues covered in the ECB's new joint paper on this topic with the Bank of England. The paper covers a very wide range of issues, including the need for a simple and transparent design for ABS, the need for credit register data and the role of the European Union in certifying and regulating these securities.

My sense is that two separate issues are being conflated here. The first issue is a longer-term one of how to create a large and successful market for ABS in the European Union. This is a good policy objective but it is a complex and long-term project. The second is whether the ECB can do something soon to boost bank lending to SMEs in the euro area. I believe the ECB should act on the second issue before the first issue is resolved.

The ECB has now done a large amount of preparatory work on the kind of ABS that it wishes to see as a popular investment – ABS that are "simple, real, transparent" to quote Mario Draghi from the June Governing Council meeting. It would certainly be possible for the ECB to announce in the next few months that it is willing to purchase a set amount of ABS designed in specified fashion.

An announcement of this sort would probably help to develop the market for these instruments and the ECB may well be able to sell them on a later date once this market is more fully developed. However, for now, this should be seen as a secondary development. Again, I'm afraid I am not optimistic. With its earnest talk of the need for various regulatory changes, the ECB has given itself a very large fig-leaf to justify continued inaction.

4.2. Sovereign Bonds

Finally, the ECB could consider a much broader programme of asset purchases. In theory, such a programme could involve corporate bonds and equities. However, I will restrict myself here to discussing a potential programme of sovereign bond purchases.

We know a lot about how programmes of large-scale sovereign bond purchases work from the experiences of the Federal Reserve and Bank of England. This provides a range of empirical evidence to draw on to illustrate how such a programme would reduce long-term interest rates. Inevitably, though, things are more complicated in the euro area and an

LSAP programme of sovereign bond purchases would face a series of issues relating to operational design as well as legal questions.

In terms of design, the most obvious type of programme would be one that purchases the same fraction of the public debt of each euro area member. However, such a design could lead to objections that it somehow incentives countries to have large amounts of debt. An alternative design would see the allocation of bonds purchased set according to some other indicator such as the country's ECB capital key.

Based on evidence from the UK and US, a programme of this sort, focused on long-term bonds, could be expected to reduce long-term interest rates in all euro area countries. One complexity when comparing the euro area with the UK and US, however, is that the public debt of those countries is effectively priced free of default risk. In contrast, a number of euro area countries still have significant amounts of default risk priced into their public debt. These risk spreads may well be more sensitive to demand factors that the "term premia" through which LSAPs have worked in the UK and US. If so, the impact of a sovereign bond LSAP in the euro area could be larger in countries such as Italy, Spain, Greece and Portugal.

In my opinion, an LSAP programme of this type is overdue and will have a modest positive effect on the European economy. Perhaps even more important than its impact via lowering long-term interest rates would be its signal to the public that the ECB is serious about meeting its inflation target. This would help to raise inflation expectations and thus act to bring about the desired outcome.

One predictable aspect of an LSAP programme of sovereign bond purchases is that it will trigger various claims that it is illegal under the European Treaty's monetary financing clause. In truth, these arguments have long since been settled. If the SMP programme of secondary market purchases was legal, then a broader programme aimed at purchasing the bonds of all euro area member states should also be seen as legal. Indeed, since this programme would apply to all states rather than simply a small number deemed to be in trouble, it not be subject to a critique of providing "special treatment" to certain member states, a critique that lies at the heart of the recent German Constitutional Court objection to the OMT programme.

One issue raised in the German court judgment which is worth a few final words is the issue of pari passu or equal treatment of bond purchases. I believe this is an area where the ECB's statements have added unnecessary confusion. When a central bank purchases a bond in an open market operation, the terms and condition of this bond give the central bank the exact same rights as any other purchaser of this bond. No special legal act needs to be passed to place the ECB on the same footing as other investors – this is simply how things are. If, for example, a government passes a law changing the terms and conditions of its public debt, then this applies also to the debt owned by the ECB.

In practice, the ECB used its considerable power and influence to avoid taking any losses on its portfolio of Greek bonds (bought on the market at a low price due to the substantial default risk that was priced in). My reading of the so-called pari passu "feature" of the OMT is not that this is a special legal feature of OMT purchases but that it was an implicit promise from the ECB to avoid behaving a "holdout" investor and using threatening behaviour to avoid taking losses. If so, this is to be welcomed – private investors deserve to know they stand on an equal footing with all other purchases of a particular security. This implicit promise should also apply to any potential future sovereign bond purchase programme.

Time will tell if the ECB is actually willing to undertake such a programme.

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