



**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES**

**ECONOMIC AND MONETARY AFFAIRS**

**The Euro, the ECB and the  
European Sovereign Debt Crisis**

**NOTE**

**Abstract**

The past few months have seen decisions taken that will affect the shape of European policy making for years to come. The European Financial Stability Mechanism may help to prevent a further round of destabilisation of the banking sector but it may do so at the cost of setting some unfortunate precedents. While sold as "saving the euro", the institutionalisation of eurozone bailouts may, in the end, increase the chances of a major country leaving the euro. The ECB's change in collateral rules for Greek bonds has been a damaging blow to its credibility and many questions remain about its new sovereign bond purchase programme. The bond purchases present the potential for further serious threats to the ECB's reputation, so it is imperative that a better communication strategy is adopted in relation this programme.

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## **1. INTRODUCTION**

The past few months have been a profoundly challenging period for those charged with crafting Europe's fiscal and monetary policies. Financial markets have been in turmoil and sovereign debt markets' conditions have drastically worsened. Governments and the ECB have taken extraordinary steps that will set precedents that will affect the landscape of European macroeconomic policy for many years to come.

It has been widely accepted for some time that the Stability and Growth Pact failed to ensure fiscal stability in the eurozone. However, the crisis of the past few months has exposed just how poorly prepared European governments were to deal with the consequences of this failure. The policy process of recent months has been chaotic and the credibility of key institutions has been undermined, as lines in the sand have been drawn and then re-drawn elsewhere.

In this paper, I first briefly review what has become known as "the euro crisis" and attempt to outline what exactly the crisis is and what it is not. I then discuss the rationale for the new eurozone stabilisation fund and its implications. I argue that overheated language from European politicians has contributed to the crisis atmosphere and that some of the actions taken have been knee-jerk responses that will only serve to damage European financial markets.

I then discuss the ECB's role in the crisis thus far. Recent events have undermined much of the credibility that the ECB had spent years earning. The ECB needs to fully articulate its strategy and improve transparency in relation to sovereign bond purchases as soon as possible if it is to avoid further, more serious, damage to its reputation.

## **2. WHAT IS "THE EURO CRISIS"?**

### **2.1 A concentrated sovereign debt crisis**

Europeans have been bombarded in the past few months with media references to the "the euro crisis." However, it is worth stopping for a moment and asking what exactly this crisis is and what role the euro has played in it.

One might be tempted to say that the euro area faces a severe sovereign debt problem. However, the public finances of the euro area as a whole are in better shape than those of, for instance, the UK or the US. The European Commission's Spring 2010 forecasts project a budget deficit of 6.6 percent of GDP for the euro area for 2010 compared with 10.1 percent for the US and 12.0 percent for the UK. The debt to GDP ratio for the euro area for 2010 is projected to be 85 percent, which puts the area in between the UK's ratio of 79 percent and the US's ratio of 94 percent.

This budgetary position is not a good one and fiscal retrenchment will be required in the coming years. However, it is not a crisis. The crisis relates to a number of peripheral eurozone economies that are running large deficits and are either currently, or are projected to be in the near future, saddled with very large debt ratios.

### Projected Deficit and Debt Ratios for 2010 for Selected Countries

Country\Area	Deficit / GDP Ratio	Debt / GDP Ratio
<i>Euro area</i>	6.6	88.5
<i>UK</i>	12.0	79.1
<i>US</i>	10.1	94.1
<i>Greece</i>	9.3	124.9
<i>Ireland</i>	11.7	77.3
<i>Italy</i>	5.3	118.2
<i>Portugal</i>	8.5	85.8
<i>Spain</i>	9.8	64.9

Source: (European Economy Statistical Annex, Spring 2010)

The figures in the table make it clear that the fiscal situations in countries such as Ireland, Italy, Portugal and Spain are very serious. However, in terms of overall debt and deficit numbers, one could argue that the fiscal situation in the UK is worse than the situation in some of these countries.

This is where the euro fits into this crisis. The UK is not part of the euro. It has its own monetary policy and, should it choose to do so, the Bank of England can pursue a monetary policy that would see the pound depreciate against the euro. Devaluation helps with dealing with a large fiscal deficit in a number of ways. First, it can provide a competitive boost for the UK's exporting sector which can offset the negative effects on growth of fiscal contraction. Second, the inflationary effects of devaluation can contribute to growth in nominal tax revenues, which can boost the solvency of the state.

Euro area countries do not have access to the option of devaluation. In addition, the ECB's high level of independence and focus on price stability means that it is highly unlikely to help those countries in trouble by generating high levels of inflation in the euro area. Thus, euro area countries with serious sovereign debt problem need to tackle them the hard and politically unpopular way, via spending cuts and tax increases.

Of course, the devaluation tool is not a panacea. The competitive gain for exporters tends to get eroded over time as import price inflation feeds into wages, with this process being particularly relevant for smaller, more open, economies. More generally, the time-honoured route of inflating one's way out of a deficit is hardly costless: Effectively it pays for the debt by levying an inflation tax on the population. Those who advocate that certain countries leave the euro to allow for devaluation should perhaps acknowledge the limited gains that devaluation can bring. However, there is no denying that it is a tool that is often used to deal with a fiscal crisis and its absence is putting serious pressure on certain euro area countries.

## 2.2 An existential threat?

So euro membership has made dealing with fiscal problems more difficult for some countries. Does that translate into an existential crisis? Is this the beginning of the end of the euro, as one might believe from the thousands of columns of news ink that have been spilt? I think a sober and reasonable answer is: No, that this is not an existential crisis. This is for a number of reasons.

To start with, it's often unclear what people mean when they discuss "the end of the euro". For example, the idea that Greece may leave the euro is often mentioned. Will this be the end of the euro? Clearly not: Greece joined the euro in 2001, two years after the launch of

the euro, so the single currency has existed before without Greece and could do so again without it or a number of other member countries.

Even recent contributions from those who are sceptical about the euro generally concede that it can carry on after the departure of a number of member countries. For instance, euro-sceptic Martin Feldstein of Harvard writes<sup>1</sup> that “current strains within the euro zone show why it may not last for another decade without at least some of its members leaving. If that happens, the remaining euro zone could be stronger and more cohesive and the countries that leave would be able to avoid the problems that they face in the current crisis.”

Will countries like Greece leave the euro? The debate among professional economists about this issue has, over the years, focused on the serious legal and technical difficulties associated with pulling out of the single currency: Barry Eichengreen’s 2007 paper “The Breakup of the Euro Area” is regularly cited as a key reference on these points.

The issuance of a new currency cannot be done overnight. And if the intention is to issue this currency and then devalue this currency, such a plan would trigger an immediate run on banks as depositors look to move their euro-denominated deposits to other countries, a run that would be hard to stem due to EU rules on free movement of capital. Indeed, under some legal interpretations, a country’s exit from the euro may require them to leave the EU altogether because a commitment to membership is a legal obligation of EU members.<sup>2</sup>

Paul Krugman has recently argued that while he had always considered exit of a country from the euro to be unlikely, he now thinks it could happen because a country that is already experiencing crisis conditions may have less to lose from taking the momentous decision to leave the euro.<sup>3</sup> I still suspect, however, that most governments in the middle of a financial crisis would not choose to add additional problems and further stoke up the prevailing uncertainty by choosing that moment to leave the common currency.

## 2.3 The value of the euro

The recent period has seen a sharp drop in the value of the euro, from about \$1.50 late last year to below \$1.20 as I write. Because this has taken place against the background of the sovereign debt crisis and discussion of the possible end of the single currency, many have interpreted the decline in the value of the euro as a bad thing. In truth, this is not the case. The decline is a *consequence* of the negative events in the eurozone but, of itself, the decline is to be welcomed.

Economists don’t have a very good track record in explaining movements in exchange rates. However, the basic model that most of us have in mind is one in which the value of a currency is largely determined by the demand for and supply of financial assets denominated in that currency.<sup>4</sup> Viewed from this perspective, the euro’s decline is hardly a surprise.

The sovereign debt problems of Greece and other eurozone economies have forced international investors to reconsider the idea that European government debt securities are risk-free. To the extent that sovereign defaults could have knock-on effects on European banks, there has been an increased level of concern about the safety of European financial debt. With governments across Europe focusing on fiscal retrenchment, investors are also

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<sup>1</sup> See Feldstein’s contribution to the Economist’s online debate about the euro at <http://www.economist.com/debate/debates/overview/174>

<sup>2</sup> See Athanssiou (2009).

<sup>3</sup> See Krugman’s blog posts <http://krugman.blogs.nytimes.com/2010/05/04/default-devaluation-or-what/> and <http://krugman.blogs.nytimes.com/2010/04/28/how-reversible-is-the-Euro/>.

<sup>4</sup> Olivier Blanchard, Francesco Giavazzi and Filipe Sa (2005) is an excellent guide to portfolio balance models of the exchange rate.

anticipating an extended period of weak growth and thus that the ECB will be keeping interest rates at low levels.

Taken together, these factors of higher risk premia and lower expected interest rates have reduced demand for European assets and this has led to a decline in the value of the euro relative to the dollar. However, despite the widespread presumption that this weakness in the euro is somehow a bad thing, the truth is that it should not be a cause for concern. At a value of about \$1.20, the euro is no more in crisis than it was when it was at this value in 2006, or in 2003, or when it was founded in 1999.

The decline in the value of the euro is good news for exporters and good news for an economy that is currently performing poorly. The European Commission are projecting real GDP growth of 0.9 percent in 2010 and 1.5 percent in 2011. These are extremely disappointing growth rates for an economic area stuck with an unemployment rate over 10 percent, three percentage points above the levels prevailing prior to the financial crisis. The only negative aspect of euro depreciation is that it raises import prices and contributes to inflation. However, inflation is projected by the European Commission to remain subdued with little risk of going beyond the ECB's target of just below two percent. So there is little to fear at present from the decline in the euro.

### **3. THE FINANCIAL STABILISATION MECHANISM**

The crisis with the Greek public finances exposed a serious contradiction at the heart of European macroeconomic policy. On the one hand, we had been told for years that the "no bailout" clause was a central rock of European policy. On the other hand, once it became clear that Greece was at serious risk of sovereign default, leading European policy-makers repeatedly insisted that a default inside the euro area was unthinkable and that it was the responsibility of European policy makers to ensure that this didn't happen.

By February it was clear that the "eurozone countries can't default" line of thinking had won out over the "no bailout" lobby. Once Greece received its €110 billion bailout package, the precedent was set and on May 9<sup>th</sup> the European Union announced the introduction of a European Financial Stabilisation Mechanism with funding of €500 billion from eurozone countries and an additional €250 billion from the IMF.

Two principal rationales can be put forward to justify this deal: Maintaining financial stability in Europe and reducing the threat to the single currency. I will discuss each in turn.

#### **3.1 European financial stability**

There is little doubt that a default by a euro area government would have financial stability repercussions. Greece has about €307 billion in outstanding sovereign debt and much of this is held by European financial institutions. A Greek sovereign default could also lead to defaults on the bonds of Greek banks. We don't know exactly how much sovereign Greek debt is held elsewhere in the eurozone but the figures from the Bank of International Settlements tell us that €193 billion in Greek debt securities are held externally by European banks, that French exposure to Greek debt is €77 billion and that German exposure is €45 billion. Any restructuring involving write-downs in the value of this debt will have negative implications for the capital levels of German, and particularly, French banks.

As occurred during the sub-prime crisis, it is not known exactly which institutions are holding the debt of Greece and other troubled sovereigns and this has been contributing to uncertainty in European banking circles. For these reasons, one could argue that an

attempt to avoid a default by eurozone countries is an efficient way to intervene to prevent serious financial disruption and this is the route that European policy makers have chosen.

That said, in relation to some of the eurozone countries, particularly Greece, it may be that preventing default is too ambitious a goal. Even after the €110 billion bailout package, Greece is projected to be left with a debt-GDP ratio of 149%, making default of some kind still likely.

The spectre of the problems caused by the Lehman's default influences much thinking on the current European problems. However, a well managed restructuring for Greece and other countries need not prove disastrous. The Stabilisation Mechanism is currently being advertised as a way to avoid defaults in the eurozone. It may be better if it is used in some cases to provide the breathing space for restructurings to take place in a way that does the least damage to European financial stability.

### 3.2 Saving the euro?

Given that the debate amongst academics and those in policy circles has generally viewed the breakup of the euro as unlikely, even in the situation in which a member state defaults, it is perhaps surprising that euro area politicians have been so emotive in their language when discussing the Stabilisation Mechanism. Rather than dismiss media claims that sovereign debt problems in some member countries will lead to the end of the euro, leading politicians have effectively encouraged the media to keep reporting the story in this way.

To give a few examples, after the announcement of the €750 billion Stabilisation Fund, EU Commissioner for Economic and Monetary Affairs Olli Rehn said "We shall defend the euro whatever it takes."<sup>5</sup> President Sarkozy said "The euro is an essential element of Europe. We cannot leave it to speculators. We will not let others undo what generations have created."<sup>6</sup> Efforts to get political support for the package also focused on the idea that this was a "do or die" matter for Europe and the euro. Chancellor Merkel told the Bundestag during the debate on approving the package that "The future of Europe and the future of Germany within Europe is at stake."<sup>7</sup>

I believe that the "saving the euro" aspect of the Stabilisation Mechanism has been very much overhyped. That the media has exaggerated this aspect of the story is hardly surprising since dramatic stories sell newspapers. Politicians have had a different motivation.

I suspect that European politicians have chosen to stress "saving the euro" as the purpose of the Stabilisation Mechanism because this proposal is effectively another bailout fund at a time when the public is weary of bailouts. To gain popular support, it is necessary to sell the initiative as a bold initiative so save Europe. In addition, the Stabilisation Mechanism is a bailout that is partly (or perhaps mainly) motivated by the desire to protect the European banking sector, at a time when the public is sick to death of banking bailouts. Politicians may have decided that "Saving the euro" works better as a slogan than "Saving French banks (again)."

In truth, I think it is far too early to tell whether the Stabilisation Mechanism (and the precedents that it has set) will reduce the probability of a euro breakup or increase it.

The obvious sense in which the Stabilisation Mechanism will contribute to keeping all of the current members participating in the euro is that countries that have lost the devaluation tool as a response to fiscal crisis have now been given a form of support during a crisis

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<sup>5</sup> Source : [ec.europa.eu/commission\\_2010-2014/rehn/headlines/news/2010/05/20100511\\_en.htm](http://ec.europa.eu/commission_2010-2014/rehn/headlines/news/2010/05/20100511_en.htm).

<sup>6</sup> Source : [www.guardian.co.uk/business/2010/may/08/debt-crisis-merkel-sarkozy-Euro-protection-plan](http://www.guardian.co.uk/business/2010/may/08/debt-crisis-merkel-sarkozy-Euro-protection-plan)

<sup>7</sup> Source : [www.telegraph.co.uk/finance/financetopics/financialcrisis/7680974/Angela-Merkel-EU-future-at-stake-in-Greek-crisis.html](http://www.telegraph.co.uk/finance/financetopics/financialcrisis/7680974/Angela-Merkel-EU-future-at-stake-in-Greek-crisis.html).



over and above what the IMF would be able to provide to European countries. If this avoids the scenario in which euro membership is associated in the public's mind with the dislocations associated with sovereign default, then this may put less pressure on governments to leave the euro in the event of severe fiscal problems.

However, this may be too optimistic an interpretation. The longer term consequences of this deal may, in fact, have a negative effect on the probability of keeping the common currency intact.

One can point to a number of issues related to the EU Stabilisation fund that may contribute to undermining the common currency:

1. Countries that avail of the EU Stabilisation fund will have to enforce severe budgetary adjustments. One might argue that, by definition, these adjustments would be required in the absence of a bailout fund. However, it is likely that the EU (and hence the euro) will get assigned much of the blame for the pain associated with the adjustment plan in the same way that the IMF often gets blamed for the pain associated with the adjustment plans to which it provides financial support.
2. If the Stabilisation Mechanism's goal of eliminating sovereign debt defaults in the eurozone was actually achieved, it would set up a serious moral hazard problem. European governments would no longer have any fiscal discipline imposed on them by bond markets, as these participants would consider eurozone bonds to be risk free because of the safety net. Whether the European Commission would be up to the job of applying sufficient surveillance to ensure the fund would not be needed again is not at all clear.
3. An increased role for the European Commission in budgetary formulation in eurozone countries is an inevitable consequence of the existence of the Stabilisation Mechanism. This development may be welcome in light of the poor budgetary management in many of these countries in recent years. However, the Commission's role in the budgetary process will be resented by some citizens as undemocratic and will be cited regularly by Eurosceptic groups as a reason to leave the Euro.
4. The Stabilisation Mechanism has been sold as a gesture of cross-country solidarity across the eurozone. The contributions to the Fund are to be provided in proportion to each member state's share of the ECB capital subscription. However, the truth is that the benefits of this approach are not evenly spread. Some countries are more likely to avail of the fund than others. In addition, because some countries have banks that are clearly more exposed to the debt, a fund to pay off this debt will disproportionately benefit those countries, most likely saving them from further expensive and unpopular banking system bailouts. The realisation that the benefits of the Stabilisation Mechanism are unequally distributed may have negative political consequences in the future.

Over the longer term, the biggest threat to the euro will not come from countries such as Greece choosing to establish a new currency. The biggest threat would come from citizens, and ultimately politicians, in a large EU country such as France or Germany deciding that they are not happy with the single currency. One scenario that could lead to such an outcome would be if membership of the single currency became associated in the minds of citizens of these countries with repeated bailouts of less disciplined peripheral members. While this is not a likely scenario over the coming few years, I suspect that the announcement of the Stabilisation Mechanism has pushed Europe a bit closer to this outcome becoming a reality.

For these reasons, despite the appeal of the idea of a fund that prevents eurozone sovereign defaults altogether, it is legitimate to ask whether a fairer approach would be to allow for orderly sovereign debt restructurings within the euro area with individual member countries then dealing with the problems created for their own banks. As Jacques Melitz has stressed in a recent perceptive contribution, the long-term future of the euro may be best protected by ensuring that it can survive sovereign defaults of its members rather than by creating controversial and ultimately unpopular new institutions to avoid this outcome.<sup>8</sup>

### **3.3 Disappointing political decisions and rhetoric**

Two other aspects of the political response to the crisis have been disappointing. The first has been the consistent tendency to blame malevolent financial market participants for problems that are of European governments' own making. The unilateral German ban on short-selling of various financial instruments may have been politically popular but it did little to ease the sovereign debt crisis and will have damaged Europe's reputation as a single financial market with common (and sensible) rules.

President Sarkozy's comment (noted above) about defending the euro from speculators may have sounded good delivered at the end of a microphone but, frankly, it makes little sense. The situation during the week prior to the Stabilisation Mechanism's announcement, in which sovereign bond markets for various euro area countries were effectively closed, had absolutely nothing to do with speculation and everything to do with legitimate concerns about the sustainability of the fiscal situation in these countries.

The second disappointing aspect has been the consistent discussion by politicians of the decline in the value of the euro in ways that suggest this is a serious problem. For instance, in her recent meeting with Russian President Medvedev, Chancellor Merkel is reported as responding to concerns about the decline in the value of the euro as follows: "I explained to him how the European Union feels committed to a stable euro, and therefore agreed on the rescue package."<sup>9</sup>

This statement directly characterises the stabilisation fund as a response to the decline in the value of the euro. This is not a helpful way to discuss this issue. If European leaders persist in using this type of rhetoric, then most likely they will continue to see stories about how the decline in the value of the currency is evidence that they are failing to "save the euro".<sup>10</sup>

## **4. THE ECB**

The past few months have been extremely damaging to the reputation of the European Central Bank. The ECB has spent years establishing its institutional credibility. While the focus during these years has largely been on the credibility of the ECB's commitment to low inflation, institutional credibility has many aspects to it.

Two key aspects of credibility are (a) Having a reputation for doing what you say are going to do and (b) Independence from political influence. The run-up to the Greek bailout has undermined aspect (a) of the ECB's credibility while the sovereign bond purchase programme has undermined aspect (b).

### **4.1 Greece and the ECB's collateral framework**

The ECB's eligible collateral framework has been one of its institutional strengths. Whereas the Federal Reserve needed to react during the financial crisis by setting up many new

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<sup>8</sup> See Melitz (2010).

<sup>9</sup> <http://www.reuters.com/article/idUSTRE65411S20100605>

<sup>10</sup> See for instance <http://www.reuters.com/article/idUSTRE64R22S20100528> for a typical example.

programmes for lending based on collateral that it had previously not accepted, the ECB already had a programme allowing repo lending based on wide range of financial instruments.

The ECB can incur losses on its loans if a bank cannot pay back and the collateral it has offered ends up not covering the value of its loan. Because these losses are split among euro area countries according to their share of the ECB capital subscription, it has always been important that the rules on eligible collateral be clear, that they represent an equal playing field for banks in all member countries, and that they protect the ECB as much as possible from incurring losses. In particular, the ECB had always been clear that it would have common standards on the independent ratings necessary to be included on the list of eligible collateral.

On January 14 of this year, President Trichet responded to questioning about Greece by saying that “we will apply our own rules without special treatment of any kind.” However, on May 3, the ECB announced that it had “decided to suspend the application of the minimum credit rating threshold in the collateral eligibility requirements for the purposes of the Eurosystem’s credit operations in the case of marketable debt instruments issued or guaranteed by the Greek government.” In other words, it had decided to give special treatment to Greece by ensuring that its government bonds would be eligible collateral for ECB loans even if they were further downgraded by the ratings agencies.

The ECB’s explanation for this decision was that the Governing Council had assessed the Greek adjustment programme and considered it “to be appropriate. This positive assessment and the strong commitment of the Greek government to fully implement the programme are the basis, also from a risk management perspective, for the suspension announced herewith.” In other words, the ECB has now decided that its judgment on the solvency of member state governments is what matters, not the independent judgment of ratings agencies.

Beyond the embarrassing damage to the ECB’s credibility that stems from doing exactly what it had said it would not do, and appearing to bow to political pressure, the Greek collateral decision clearly sets a precedent: All member states participating in the Euro will expect the ECB to accept their sovereign debt as collateral for loans, no matter how poorly it is rated. This has opened up the possibility of the ECB potentially making large losses on its refinancing operations in the future.

## **4.2 Sovereign bond purchases**

The decision on Greek collateral was a blow to the ECB’s credibility. However, the decision to embark on a programme of sovereign bond purchases has been even more momentous. I want to focus here on three aspects of this Securities Market Programme: The effect on the ECB’s reputation for independence from political influence, the rationale for the programme in relation to the monetary transmission mechanism and the programme’s lack of transparency.

### *Independence from political influence*

The ECB’s programme of sovereign bond purchases on the secondary markets was announced simultaneously with the Stabilisation Mechanism after a weekend of meetings of political leaders. The disruption of the previous week in European sovereign bond markets had led to speculation that the ECB would make an announcement that week about a bond purchase programme but no such announcement had been forthcoming. Indeed, President Trichet stated at his press conference that week that there had been no discussion of this idea at the Governing Council meeting.

Whether it is the case or not, the timing of the announcement certainly had the appearance of the ECB succumbing to political pressure. That the measure does not have the support of all Governing Council members—President Trichet has conceded that this is the case—is a sign that the decision was a very controversial one, given that body's well-established tradition of unanimous decisions.<sup>11</sup>

In a speech on May 31, President Trichet stated<sup>12</sup> that “the purchases made on the secondary market cannot be used to circumvent the fundamental principle of budgetary discipline.” However, there is a strong relationship between activity in the primary and secondary markets for debt. If a potential purchaser of government debt knows that there is no functioning secondary market for this debt, then they will be unlikely to want to buy the debt in a primary issue, since they may end up being required to hold the bond to maturity no matter what happens. The existence of a buyer with “deep pockets” in the secondary market will be a significant factor in keeping primary markets open.

Indeed, there is little doubt that the ECB's bond purchase programme is expected to make it easier for a number of countries to issue debt and thus run large budget deficits this year. Sovereign bond markets for countries such as Ireland and Portugal had essentially closed in the week prior to the May 9 announcement. The fact that the ECB is willing to purchase on the secondary bond market is generally accepted as being crucial right now for allowing these countries to continue with primary debt issues. So while the programme may not break the letter of the European Treaty's “no bailout” clause on monetary financing because the clause only prohibited direct purchases, it is widely interpreted as breaking the spirit of the clause.

President Trichet argued in his May 31 speech that the intervention was justified because “Bond spreads for several euro area countries widened beyond any reasonable level.” However, as with the Greek collateral decision, this again substitutes the ECB's judgment on fiscal sustainability for that of the markets. It also sets a precedent that the ECB's assessment of a country's fiscal position will be a crucial determinant of whether a country can continue borrowing when sovereign bond market sentiment moves against it.

Taken together, these factors show that the ECB has moved into taking quasi-fiscal policy decisions that benefit some member states more than others. This will have long-lasting consequences for the perception of the ECB's ability to withstand political pressure.

#### *Trichet on the monetary transmission mechanism*

Despite the clear fiscal implications of the sovereign bond purchase programme, the ECB has been determined to present it as a monetary policy programme. Its determination to do so has had a somewhat Orwellian feel to it. The programme is officially called the “Securities Markets Programme” (no mention of what type of securities are being purchased!) and the bond purchases are being listed in the ECB's Weekly Financial Statement under “Securities held of monetary policy purposes” rather than under the existing category of “General government debt denominated in euro.”

The official rationale for these descriptions was provided in President Trichet's May 31 speech. Trichet emphasised that government bonds play an important role in the transmission mechanism for monetary policy. He noted (a) that government bond yields often act as a reference point for other types of loans (b) that they are used as collateral in money market transactions (c) that lower bond prices erode the capital position of the banks that own them.

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<sup>11</sup> In an interview with Le Monde ([www.ecb.europa.eu/press/key/date/2010/html/sp100531\\_1.en.html](http://www.ecb.europa.eu/press/key/date/2010/html/sp100531_1.en.html)) M. Trichet has said that the decision was taken with an “overwhelming majority.”

<sup>12</sup> The speech is available at [www.ecb.int/press/key/date/2010/html/sp100531\\_2.en.html](http://www.ecb.int/press/key/date/2010/html/sp100531_2.en.html)

When applied to government bonds in general, these points are correct. However, I would question the idea that the *particular* government bonds that the ECB is now intervening to purchase are of systemic importance for the transmission of monetary policy in the euro area. What fraction of euro area loans have yields expressly linked to the Greek, Portuguese or Irish government bond yield? What fraction of euro area money market transactions use these instruments as collateral? Relatively few is likely to be the answer.

This leaves us with Trichet's third observation: Falling sovereign bond prices can weaken bank balance sheets. It is true that the influence on asset prices is a standard part of the textbook story about how central banks influence the economy when they change policy rates. However, boosting bank balance sheets is very rarely the direct objective of a central bank when it cuts its policy rate. In contrast, this operation will do little to influence lending rates around Europe but will greatly benefit the banks holding bonds that the ECB is now interested in acquiring.

Again, I believe the ECB is getting into dangerous territory here. If banks are holding bonds that are likely to be defaulted on, potentially triggering government bailouts, it is highly questionable whether the ECB should be intervening to relieve the banks of these securities. Ultimately, the market's scepticism about the value of these securities may prove justified. If this is the case, it will be the ECB, rather than the banks, that will end up losing money on these bond purchases.

### *Transparency*

The ECB has been keen to stress that the Securities Markets Programme differs from the Bank of England or Federal Reserve's Quantitative Easing programmes in which they purchased various types of bonds in an attempt to reduce yields on these instruments. The difference the ECB is emphasising is its new programme to take in one week term deposits to offset the effect of the bond purchases on the money supply. I'm not sure that this point is particularly important at the moment since the Eurosystem is still making essentially unlimited credit available in its standard refinancing operations.

The more important difference between the ECB programme and those of the Bank of England and the Federal Reserve is that the ECB's programme is being run in a secretive manner with very little transparency. The Fed announced its quantitative easing programme in its FOMC statement of March 18, 2009. The statement announced exactly which types of securities the Fed would be purchasing, how much it would be purchasing and a rough indication of the time horizon for these purchases. Similarly, the Bank of England has been very clear about what types of assets it is purchasing and how much.

In contrast, the only thing we know about the ECB's Securities Markets Programme is the amounts that it is purchasing, with these figures buried in the middle of its weekly financial statement. At the time of writing, the programme has purchased smaller amounts with each passing week: €16.3 billion during the week ended May 14, €10.4 billion during the week ended May 21, €8.8 billion during the week ended May 28 and €4.9 billion during the week ended June 4.

That's what we know. Here are some things we don't know about the programme:

- (a) The composition of the debt securities the ECB is buying.
- (b) The criteria being used to select bonds to purchase.
- (c) The ECB's bond purchase strategy during periods of primary issuance.
- (d) How long the programme is going to last and how much may be spent.

Information on which bonds are being purchased would be helpful for judging the purpose and impact of the programme. Different types of bond purchases will have different effects.

For instance, purchases of Irish or Portuguese bonds will help these countries to keep their primary issuance programmes going and perhaps prevent them having to avail of the Stabilisation Fund.

Purchases of Greek bonds, however, do little now to help the Greek government since it is already out of the sovereign bond market. Instead, the principal beneficiaries of purchases of Greek bonds are the banks that had been losing money on these bonds prior to the announcement of the ECB's programme. Market commentary and the large reduction in Greek government bond yields on the secondary market point to the ECB having concentrated much of its programme on acquiring Greek debt.

I think it is in the best interest of the European public that the ECB announce two things as soon as possible. First, the exact composition of the bonds that it has purchased. Second, if they will not announce exactly when the purchases will end, they should at least explain clearly the strategy that they will adopt in deciding to end the programme. This latter matter may require more discussion: Public comments from Axel Weber of the Bundesbank and Mario Draghi of the Banca d'Italia both indicate a greater enthusiasm to end the programme than is evident from the comments of other members of the Governing Council.

With so many important questions unanswered and so many risks to the ECB's reputation, it is imperative that a better communication strategy is adopted in relation to this programme.

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