THIRD CHAPTER (Excerpt)

Monetary policy and fiscal consolidation in the Euro-area

V. The new world of OMT: No basis for the Redemption Pact

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250. The **crisis in the euro area has receded** since the summer of 2012. This is due to the joint effect of conventional and unconventional **monetary policy measures** and **fiscal policy consolidation** efforts. The euro area was thus able to overcome the recession in the second quarter of 2013, which had lasted more than eighteen months. Moreover, growth in 2014 is currently expected to be comparable to the potential growth rate.

The **yield spreads** on sovereign bonds of major euro area member countries – above all Spain and Italy – decreased considerably. Considerable easing was also observed on the **interbank market**. The heretofore strongly diverging balances between national central banks in TARGET2, the Eurosystem's settlement system, shrank significantly. The Deutsche Bundesbank's TARGET2 claims fell by over a quarter; Italy's TARGET2 liabilities decreased by a fifth and Spain's by more than a third.

The fact that the liquidity generously supplied by the ECB at the turn of the year 2011/2012 under its **LTRO programme** was quickly repaid by many banks also indicates the improved refinancing opportunities on the interbank market. Not least for this reason, the ECB balance sheet declined considerably compared to those of central banks of other large economies. Ultimately, the ECB's **Emergency Liquidity Assistance (ELA) credit lines** issued to affected banks in crisis countries decreased considerably. Many euro-area banks, nevertheless, continue to have insufficient capital bases. These banks hold a large number of non-performing assets, and the uncertainty about the recoverability of their assets remains high (no. 365).

251. However, the debt-to-GDP ratios of most euro area member countries have still risen substantially. Thus the **need for consolidation** in the entire euro area remains great as without ECB support, risk premiums and thus the interest burdens for several euro member countries will quickly climb again. However, some progress in budget consolidation has indeed been made in some member countries. Moreover, the current account deficits of the crisis countries have drastically declined; some are even expected to report current account surpluses this year. Moreover, the consolidation programmes implemented by member countries prior to announcement of the OMT programme seem, at least in principle, to be in a position to reduce their debt-to-GDP ratios (no. 241). This is naturally only the case when plans are actually put into action and the deficits are permanently reduced.

252. On the whole, the euro area crisis has receded temporarily even if it has not been permanently overcome. At least some of the **efforts undertaken** by the member countries in the relevant areas of action have **contributed to the calm-down**, in budget consolidation and structural reform, and with the first steps to solving the banking problems. It is impossible to specifically attribute the effect of the individual measures, however it appears that consolidation and reform efforts made only a minor contribution.

Instead, the development over time of the yield spreads of Spanish and Italian government bonds to German government bonds indicates that the ECB's **announcement of the OMT programme** was a **major contributing factor** to the calming. For the major euro member

states Spain and Italy, the extent of these yield spreads declined drastically immediately following the OMT announcement. However it cannot be denied that this at best bought additional time to actually overcome the euro area's fundamental problems.

The world of OMT: The ECB between monetary and fiscal policy

253. With its **OMT programme**, the ECB has dared to foray into the grey area between monetary and fiscal policy, having, in principle, declared itself willing to make targeted purchases of unlimited quantities of government bonds from those euro area member countries which subject themselves to an ESM programme. Regardless of the answer to the question as to whether the OMT programme has already advanced too far into fiscal policy territory, the OMT announcement had **three effects**: (i) the situation on the bond markets has tangibly stabilised, (ii) the boundary between monetary and fiscal policy has been blurred beyond recognition and (iii) the incentive structures for fiscal policy decision-makers have been altered considerably.

Although advocates of the OMT have stressed the **short-term stabilisation effect**, and critics the **long-term risks** of price and financial stability in the current political discussions about the programme, it is actually the third effect that should be discussed. Whether the decisions taken to address the **three key areas of action** – consolidation of public budgets, reform of the banking sector and the strengthening of potential growth – are actually put into practice depends primarily on the OMT's incentive effect. The adamant pursuit of this reform agenda is the only credible way out of the crisis.

254. The ECB did indeed calm the situation which had escalated in summer 2012. The announcement alone has thus far been sufficient to reduce euro area **yield spreads** as the ECB has not bought any sovereign bonds under the OMT programme yet. The acute concern that major euro area countries such as Italy and Spain could lose their financial market access had led to concerns about the **continued existence of the euro area**. If the corresponding redenomination risks actually did play a major role in creating the risk of **self-fulfilling prophecies** about euro area disintegration at the peak of the crisis last year, it appears the OMT has addressed this problem. Since the announcement, the remaining yield spreads have only reflected the differences in fundamental economic conditions.

One could be of the opinion that, under the high pressure of autumn 2012, the fiscal policy decision-makers would eventually have coordinated themselves, without ECB intervention, in such a manner that would have also resulted in lower yield spreads. Or one may believe, as does the ECB, that without its intervention it could possibly have come to an uncontrolled break-up of the monetary union against the wishes of all parties involved. However which of these opinions provides an accurate assessment of the situation then, is **now quite irrelevant**. The OMT programme is now reality and due to the short-term stabilisation effects linked to it, will not be cancelled in the foreseeable future.

255. The long-term risks of ECB intervention are nonetheless obvious. Specifically, the ECB's willingness to purchase targeted government bonds of the euro-area countries under finan-

cial market pressure could be interpreted as a willingness to actually start **direct government funding** to save the integrity of the euro area. The ECB however denies this. In fact, direct financing of member countries lies beyond the scope of the ECB mandate. A heavy discussion broke out against this backdrop about whether the OMT programme is compatible with the European treaties – and in particular with the German Basic Law.

The main implications of the OMT programme, however, lie in the deterioration of the **incentive structures** for member country governments, because the OMT programme establishes the ECB's role as **lender of last resort** to euro area countries. It will hardly be able to withdraw from this role even if the conditions that led to the OMT programme no longer exist. And this is true even in a case of emergency in which the conditionality it demanded as quid pro quo for the OMT would not apply. The ECB is now a fixed component in fiscal policy considerations and has made its own actions dependent on member countries' fiscal policy decisions. This will at least be the case until it rejects such use of fiscal policy, and thereby regains credibility.

Whether the ECB has damaged its credibility as the guarantor of price level stability with the measures it has taken thus far to combat the crisis cannot be definitively assessed on the basis of current forecasts of inflation, which nevertheless indicate stable inflation expectations. There is at least a lot of evidence to show that the ECB's monetary policy reaction over the course of the past year is consistent with decisions made before the crisis began and is based on fundamental economic data of the euro area (no. 182).

Liability without strict control: The OMT incentive problems

256. The **stalled negotiations** between member countries on the long-term architecture of the monetary union and about who assumes what portion of liability for legacy debts already contributed to the crisis worsening in the first half of 2012. For all their opposing interests, the member countries involved did have one thing in common: All involved believe that the shift of risks to the ECB likely means the lowest (political) costs, because it is not transparent and thus voters cannot directly identify it as the acceptance of even higher risks.

With the OMT programme it is barely necessary to negotiate an international **allocation of liability risks** on which basis the main areas of action actually subject to national responsibility can be addressed. This applies equally to creditors and debtors. This thus concludes a **collectivisation** of risks. It is implicitly but **clearly** formulated in the ECB capital key. However this path implies that the principal player, Germany, was not able to establish any additional conditions.

257. Moreover, the incentives for consolidation and structural reforms have shrunk considerably under the easing pressure exerted by the financial markets. The costs of such measures are usually generated instantly while the results often only appear in the medium to long term, after the decision-makers have left office. It can thus be assumed that the member states will now pursue a **weaker reform agenda** in view of the **substantial domestic resistance** all their reform efforts are destined to face.

Thus there is a danger that low GDP growth rates will set in in the euro area countries while the central bank remains highly committed. Whether or not this scenario manifests itself in reality is now exclusively dependent on the **national policies** of euro member countries. Continuous progress is necessary in fiscal consolidation, restructuring of the banking sector and market structure reforms.

It cannot be denied that efforts in these main areas of action will turn out to be less dedicated in the era of the OMT programme than they would in an alternative environment. To what specific extent this will be the case cannot be predicted with any certainty. The planned and partially already implemented fiscal consolidation steps in the euro area seem generally appropriate for restructuring public budgets, stopping the rising debt-to-GDP ratios and reducing the latter (no 241). However, it is not the plans that will decide the euro area's fate, but the energy with which they are implemented.

The fact that the rules for **fiscal policy surveillance and coordination** as included in the Stability and Growth Pact (SGP), the two-pack and the six-pack, have become much stricter, must be taken into account in answering the question as to whether the ECB will be becoming subject to fiscal dominance (no. 317 et seq.). The fiscal compact also introduced obligatory national debt brakes, which provide incentives for solid public budgets as long as their binding effect remains strong enough. The GCEE's concept of a European redemption pact had also provided for such national debt brakes, which were to be permanent, unlike other elements of this pact.

258. The German federal government did not take the opportunity to adopt this idea of a redemption pact at the peak of the crisis. With such a step, it would have explicitly determined the **balance** between acceptance of elements of **joint liability** and **countervailing national obligations** to reform. Thereby, in an extension of its current quid-pro-quo strategy, it could have been able to lead the euro area out of the crisis with determination. A return to the quid-pro-quo strategy is only possible in a less desirable situation now, i.e. if member countries do not even demonstrate a minimum degree of willingness to reform. Such slack could result in another – likely even more pronounced – escalation of the crisis. If the ECB then stands by its announcement and demands an ESM programme for a member country whose bonds it is going to purchase, the German federal government could again demand concrete reforms: If a member country applies for an adjustment programme from the ESM, the funds provided by the member countries to the ESM should be used for this purpose and private creditors be held accountable so that activation of the OMT would not be become necessary.

Liability with more control: The Redemption Pact as an alternative

259. In contrast, the GCEE's proposal to create a **European Redemption Pact** was a proactive instrument (Annual Report 2011, Special Report 2012, Annual Report 2012). This concept combines preventive reform and consolidation requirements with a debt redemption fund in a comprehensive treaty binding euro area member countries for many years. The German federal government has achieved remarkable progress in the past few years with the strategy of combining **individual steps** in the reform of the common currency area architecture with

individual acts of solidarity. However these efforts were unable to effectively prevent the crisis from worsening, which resulted in the ECB intervening in the form of the OMT programme.

260. From the point of view of the new era rung in with the advent of the OMT programme, the fact that it would have been advisable to enter into such a redemption pact instead of allowing ECB intervention to happen is **no longer important**. Entering this pact, it would have become transparent explicitly how government debt is reduced and how more stringent conditions have to be adhered to in the process. In particular, the risks of such a strategy would have been lower than with the ECB intervention. After all, this engagement implies a tacit collectivisation of risks without a conditionality formulated by the ECB itself. In drafting its proposal, the GCEE wanted to keep Germany from such implicit collectivisation. However the discussion no longer needs to be held against the backdrop of the incentive structures of a deepening crisis. It is instead to be held in the current context in which the crisis has been temporarily calmed by the OMT programme, but still not overcome.

In this new world of the OMT programme, it is extremely unlikely that the member countries which should actually consolidate their budgets, restructure their banking sectors and comprehensively reform their factor and goods markets, feel enough pressure to enter into negotiations of such a pact. Ultimately, **the initiative** for such a pact now lies with the ECB as this is the only way that it could free itself from utilising fiscal policy. The implementation of the pact however is disproportionally more difficult than in the period prior to the OMT programme. The OMT programme has already generated relief for crisis countries, which would only be replaced by the pact. There would, however, be additional conditions, which is why it is unrealistic to believe that such a pact would be politically enforceable in place of the OMT programme.

261. This results, firstly, in the fact that the **Redemption Pact** remains an **alternative to the OMT programme**, but **in no way an addition to it**. The GCEE already rejected solidarity instruments such as Eurobonds and Eurobills, which were intended from the start as long-term risk-sharing instruments.

Secondly, strengthening the disciplinary function of financial markets by means of **regulatory measures** is all the more important. This would require risk weightings for government bonds and the extension of large exposure limits for loans to public creditors. Restructuring of the banking sector is necessary for banks to be able to comply with the new requirements. For this reason, the German federal government should actively advocate concrete debt sharing agreements (no 377 et seq.).

Thirdly, Germany must set a good example and contribute to implementation of the reformed rules of **fiscal policy surveillance and coordination.** These include, in particular, that the debt brake and its related institutions, such as the independent fiscal council, fully meet the requirements of the Fiscal Compact.