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**OMFIF Intervention**

## The ECB: How do we move forward – and where are we going?

Central banks are not renown for their agility and audaciousness. Still during the crisis a number of central banks, including the Fed, the ECB, the Bank of England, the Swiss National Bank and, to a more limited extent, the Bank of Japan have shown both characteristics in quite remarkable amounts.

One way to visualize this is that, traditionally, central banks provide liquidity:

- in national currency to the national banks
- in carefully calibrated quantities and
- at positive cost.

During the crisis, instead, they have provided:

- unlimited amount of liquidity,
- in national and foreign (through the swaps) currency to national and foreign banks (again through the swaps),
- practically at zero cost.

The agility and the audaciousness were necessary to avoid that the negative impact of the crisis, which started in August 2007 and turned for the worse in September of 2008 with the failure of Lehman Brothers, would fully unfold, which would most likely have led to us now talking about a Great Depression Mark II instead of a blander Great Recession.

While there was a lot of commonality in the actions of the different central banks, it is fair to say that the ECB was a shade more cautious, or timid if you want to put a negative slant to the adjective, than the FED, the BoE and the SNB. The growth of its balance sheet was somewhat less in relative terms, the policy rate was kept a bit further away from the zero bound, the bulk of the liquidity was provided by means of temporary repos rather than permanent outright operations, the willingness to extend swaps to other central banks was a bit more tepid. In addition, the idea that at a certain point one would need to exit from the extraordinarily loose monetary policy now prevailing was kept somewhat more alive than in other jurisdictions, where the utmost preoccupation has been to send out signals that the exit is beyond the foreseeable future.

I am not ready, at least while I am still sober, to say whether the noun “caution” or “timidity” applies best to the ECB, i.e. whether it was right or not to maintain a more guarded attitude than some other central banks. What I would like to stress, instead, is that the ECB has done enough to cut the negative tail of events in the European phase of the crisis and has given time to governments, in stressed jurisdictions as well as in the core, to take the necessary measures in terms of fiscal and structural correction, firewalls and institutional innovations, like fiscal and banking union. The 2 three years LTROs have reduced to normal levels the risk, which had grown to extreme height, that a bank that was solvent under normal liquidity conditions would fail because of illiquidity. With the SMP and, particularly, with the announcement of the OMT it has offered a conditional put option to the market that has dealt to a large extent with redenomination risk and has reduced to more manageable levels the risk that a solvent sovereign would become insolvent because of illiquidity.

In current conditions, however, a new issue, which is not but could become over time a problem, is arising because of the fact that most of the liquidity has been provided by the ECB in the temporary form of repo. A little technical digression is needed here. Between the end of 2011 and the beginning of 2012 the ECB granted 2 three years LTRO to counterparties at a floating rate, resulting from the rate on Main Refinancing Operations, which is the main policy rate of the ECB. Banks were enthusiastic about the offer and took more than one trillion euro under the two operations. However, since they reduced the amounts taken under shorter operations, the net amount they took was about a half of that amount. In order to allow the maximum flexibility to counterparties, the ECB granted them the freedom to reimburse the borrowed amounts every week after one year of the concession of the funding. One year has now passed and banks have started partially reimbursing the funding. So far they have reimbursed some 230 billion, out of the 1 trillion gross and 500 billion net.

Of course, it is a good sign that reimbursement is happening: it means that banks are more confident of their ability to fund themselves in the market. And indeed we know that deposits are flowing back to banks in the periphery and that they even manage to get some funding from the capital market. Of course, there is also the desire to show themselves not needing funding from the central bank, which is pushing banks to reimburse the money. This is connected to the so called stigma phenomenon, whereby the non financial or reputation costs attached to funding from the central banks give an incentive to banks to borrow from the market rather than from the central bank for equal cost. Still, this is in my view, a less important factor and the most important reason why banks are reimbursing the LTRO money is because their funding situation has improved. Also the fact that the pace of reimbursement has slowed down recently, due to the uncertainty injected by the Italian elections, confirms this assessment.

However, the reimbursement of the money banks borrowed under the 2 3y LTROs inevitably brings an endogenous tightening of monetary policy. To understand why this is the case you have to realize that the money market rates are so much lower (at 5-10bp) than the MRO rate of the ECB (75bp) because of the huge amount of excess liquidity (still more than 400 billion, even after the reimbursement of money under the LTROs). If the excess liquidity gradually evaporates, because of further reimbursement of funds, the money market rate will creep towards the MRO rate, thus bringing a tightening of monetary policy. In a way there is room for the equivalent of 2 and a half quarter point increase of interest rates between 5-10 basis points of the short term money market rate and the 75 bp of the MRO rate. Observing that in normal times the EONIA rate was 5-10 points above the MRO rate, there is room for 3 quarter point increases of the market rate, from 5-10 to 80-85. Of course the reimbursement and the ensuing endogenous tightening will continue only as long as there will be an improvement in the funding situation of banks and would, therefore, somehow be justified. This observation is reinforced by the reimbursement will mostly depend on the ease with which banks in the periphery will see an ease of their funding conditions, since it is these banks that took the bulk of the two 3 y LTROs. However, one cannot be sure that the pace and the timing at which the endogenous tightening will take place will exactly match the needs of the real economy. Or, to put it differently, it is not clear that the pace of the endogenous tightening will be the same as the pace that would be chosen by the central bank if it would decide on it.

A further potential complication is that other central banks are continuing, in some cases enhancing their expansionary policies. This is clearest in Japan, where the government is de facto imposing a looser policy on the BoJ. In the UK, different messages have been heard, but there is the expectation that a Carney BoE will be even more generous than a King BoE. The FED, on its side, is continuing into its innovative conditional monetary policy, with little prospect of an exit either on the rate or on the purchases front.

Given an ECB which could see an endogenous tightening and given that the most important central banks in advanced economies are continuing with their expansionary monetary policies, there could be undesirable FX consequences. The term “currency wars” is definitely excessive, also in prospective sense, but the term currency tensions could become appropriate. The President of the ECB has seen the risk and dealt with it, albeit with soft words, in his penultimate press conference, but of course the problem could come up again. Words may become stronger and fend off again undesired moves. But, at a certain point, words may no longer be enough and the €-area could find itself with a strong currency and still a weak economy.

Any inference that at that point in time the ECB would automatically lower rates (MRO) is not warranted. The ECB has shown quite some tolerance to a strong exchange rate, and in my view for good reasons. The time could come, however, when the effects of a strong exchange rate on activity and inflation could add to the reasons to lower the MRO rate, which could help both a weak aggregate situation in the €-area and countering the macroeconomic divide between a South in recession and a North in better conditions.

**Italian elections and OMT**

The OMT´s inherent characteristic is that it is conditional: unlike the commitment of the SNB to keep €/Swiss franc at 1.20, the ECB has clearly stated that a necessary condition to activate the OMT is that the relevant country has agreed a program with the EU. Now, a frequently heard argument says: there is no government that could credibly commit to a program in Italy, given the results of the election, therefore the protection of the OMT has gone. The market does not seem to follow the argument, as the yield on Italian paper has recovered most of the ground lost after the elections. Still the argument deserves attention.

My point here is that the "put option" that Draghi offered to the market has, in my assessment, an implicit strike price which is much lower than the current one. With a 2 year yield just higher than 2.00 for Italy and Spain and a 10 year yield lower than 5.00 per cent, the Draghi put option is far out of the money: neither Italy nor Spain would have an incentive to ask for support under the OMT even for rates which would be 100 basis points higher. Nor, I think, would the ECB be eager to purchase Italian or Spanish paper at prices similar to the current ones. So, in current conditions, there is no issue because the countries have no incentive to ask for help nor the ECB would be willing to provide it. The question is what would happen if indeed there was a new flare up of the yields, bringing them to the 6.00-6.50 % level for 10 years and to 4.00-5.00 for intermediate maturities. My sense is that the urgency that seems to have gone away from political discourse, in particular in Italy, would come back and force any country, including Italy, to a new engagement in taking the appropriate measures (more structural than fiscal in my view). This is indeed what was suggested by recent history, with governments acting under the intense pressure of the market. At the end, my story is that if really the OMT was needed, the political conditions for activating it would be created.

Of course, this is more a political than an economic assessment, and I am no political expert, so you should take my argument with a pinch (or more) of salt. Still this is my assessment. Let me continue on the treacherous political ground to address my last point.

**Rejecting austerity?**

The most obvious reading of the Italian electoral results, with Berlusconi gaining 30% of the vote and Grillo 25%, is that the Italian electorate revolted against fiscal austerity. There is, of course, an element of that but a reading that was limited to that would be simplistic and incomplete. I think that the electorate in Italy revolted against one-sided austerity: ordinary people saw its prospective pension payments significantly affected, while politicians indulged in privilege or sheer corruption. This is, in my view, what Italian rebelled against. Had austerity been fair, it would have been much more acceptable.

This is of course not to deny that, with hindsight, there was too much austerity in too short a time span: in a way the fiscal correction was thoroughly needed but was too intense. This miss-calibration derived from two readings that experience showed were not accurate, the first of economic and the second of political nature.

The imperfect economic reading, which I shared, was to think that a front loaded correction would quickly create confidence effects that would help substituting decreasing public demand with private demand. Without the need to go to the extreme of a Ricardian effect, whereby the substitution is nearly immediate, the view was that, given the crisis and its negative impact on confidence, a front loaded correction would soon re-establish confidence and with it private demand. This was not the case and the argument about the size of the fiscal multipliers is testimony of that. Of course, also the fact that correction programs relied more on taxes rather than expense reductions contributed to magnifying the effect of the fiscal correction on economic activity.

The imperfect political reading consisted in overestimating the ability of societies in stressed jurisdictions to bear such an intense fiscal correction. Even if here my point about the difference between the political sustainability of a fair and an unfair fiscal correction is very important.

What does this reasoning mean, if it is correct, for political prospects in Italy? The logical solution would be to correct the austerity by making it fairer. Economic conditions would be favourable to this solution because Italy does not need to take new corrective measures, as its deficit is under control. An agreement between the PD and the 5 stars movement of Mr. Grillo should, in principle, be able to agree on a limited program to make austerity fairer and then call new elections. Logics does not always win in political matters, and the signs are not at all favourable to this solution. If this does not fly, either immediate new elections (with the necessary institutional lag to elect the new President of the Republic) or a Grosse Koalition between centre left and centre right would be necessary, with clearly less favourable prospects.