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# The ECB's Magic Wand

We know there is no magic. But after a clever trick by the magician and a wave of the magic wand, the audience still applauds for quite some time. The new magic wand of the European Central Bank (ECB), Outright Monetary Transactions (OMT), has so far resulted in the 2-year Spanish government bond yield falling from a 15-year record high of 6.9% in late July 2012 to below 3% in early September 2012. Longer maturity yields have also fallen somewhat.

Was the OMT move a wise decision? Are the criticisms that are being voiced justified? What is the OMT action good for and what are its limitations? Let us try to imagine where the euro area would be heading without the OMT programme. Up to late July 2012, Spanish and Italian government bond yields were escalating. Speculation was growing that some struggling countries would exit the euro, which led to increased capital outflows from southern eurozone members, fragmentation of credit markets across national borders, and lower consumer and investment demand, thereby negatively impacting output, employment, bank balance sheets and public finances.

Undoubtedly, several southern eurozone members face severe structural weaknesses, banking woes and perilous fiscal situations. But market reactions also depend on psychological factors, because pessimism is self-fulfilling. This vicious circle had to be broken or else the situation would have gotten out of control, with extremely detrimental effects for all euro area members (as well as for outsiders). The announcement by ECB President Mario Draghi on 26 July 2012 that a new instrument was in the making did exactly this: using only the power of words (i.e. without any actual intervention), the escalating trend in government bonds yields was reversed.

The ECB already put a similar programme in place in May 2010, the Securities Markets Programme (SMP), which had exactly the same purpose as the OMT: "to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism". But the SMP has been a major failure, as it had only temporary effects on bond yields, for several reasons. First, the modalities of the SMP were unclear: the ECB started and ended bond purchases without known guidelines. Second, the ECB communicated that the SMP was a limited programme, and a weekly cap was introduced in December 2011. Third, by claiming senior creditor status, ECB purchases increased the eventual losses of other bondholders in the case of a default. Fourth, concerning Greece, the SMP aimed at tempering the government bond market of a country with an unsustainable fiscal situation. Finally, the SMP was subject to moral hazard, exemplified by the Italian government's backtracking on promised reforms in the summer of 2011, after the ECB began purchasing Italian bonds.

The OMT programme, which will also be conducted on secondary sovereign bond markets, differs from the SMP in major respects. The first is conditionality, i.e. compliance with a full or precautionary macroeconomic adjustment programme by either the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM). ECB intervention will not be automatic, but the Governing Council will decide on a case-by-case basis when and to what extent it will intervene. Second, OMT will be unlimited in principle. Third, the ECB will be treated *pari passu* with other creditors, i.e. the ECB will not have any preferential treatment in the case of a credit event. Furthermore, the transparency of OMT purchases will be greater (the breakdown by country and the average duration of holdings will be published). Moreover, there is clarity on the maturity of eligible bonds, i.e. between one and three years, which is the relevant horizon for monetary transmission. These characteristics likely constitute the outer limit of what is feasible within the ECB's mandate.

Several criticisms have been voiced, e.g. that the OMT would finance unsound states and lead to a redistribution of wealth from the healthy to the troubled states, that it is a reflection of the politicisation of central banking, that the distinction between monetary and fiscal policies has now disappeared, that it increases the power of the ECB to decide on the fate of governments, that countries receiving support from the ECB will ease back on painful structural reforms, that the OMT action is tantamount to central bank financing of governments, and that it will create inflation.

However, most of these criticisms have neglected to take notice of the major condition, i.e. the EFSF/ESM programme. Entering a programme and assessing compliance, therefore, will remain the province of the member states, and thus e.g. the German Bundestag will also have to approve all new programmes. The ECB can only decide afterward. This ensures that unsound states will not be able to benefit from the OMT, that the OMT will not be used for wealth redistribution, that monetary and fiscal policies will not be merged, that countries cannot easily backtrack on agreed reforms and that the ECB will not have to decide on the fate of governments.

The criticism of the "central bank financing of government" also rests on weak grounds. The ECB would purchase bonds only on secondary markets, not new bonds issued to finance budget deficits. The goal of the OMT is not to reduce borrowing costs to an artificially low level, but to prohibit interest rate increases which are not justified by economic fundamentals. For example, I would not expect ECB intervention at Spain's current 3% borrowing rate for bonds with 2-year maturities.

The inflation criticism is also unjustified. OMT would be used only in a crisis situation, which is characterised by recession, weak consumer and investment demand, and insufficient bank lending to the economy – circumstances which are not conducive to inflation. Also, the ECB will fully sterilise its OMT purchases, i.e. take back the money created by the OMT through other means.

Nonetheless, the OMT magic wand is not a panacea either.

First, the OMT action cannot solve the euro crisis and cannot fully eliminate the risk of a euro area exit. The OMT can contain a self-fulfilling bubble in bond yields, but the exit risk will remain until robust economic growth and job creation pick up in southern economies, which in turn depends on a number of other factors, and unfortunately, the near-term outlook is not bright in this regard.

Second, the OMT programme cannot address the competitiveness problems of southern European countries. In fact, so far it has worsened the situation by leading to an appreciation of the euro. Yet a weaker euro would help southern economies to improve their trade balances with non-euro countries and would also boost German exports. This in turn would help to address intra-euro imbalances, since increased exports would likely translate into greater wage increases in Germany, due to the country's tight labour market, but not in Spain, due to its high unemployment. Thus, Spain's competitiveness vis-à-vis Germany would also improve. Without a weaker euro, Spain would need to enter a deflationary period, which on the one hand is difficult to achieve and on the other would make debt sustainability even more difficult. The ECB therefore should consider further interest rate cuts and quantitative easing as well, which would be justified by the weak economic outlook and would also weaken the euro.

Third, even if governments seeking assistance wish to comply, they may not be able to due to either inefficiencies in public administration or a deeper than expected recession, which has so far been the rule rather than the exception concerning the macroeconomic forecasts of southern economies. If the OMT programme is started for a country, its abrogation in the event of non-compliance would likely lead to a disorderly default. Yet in such a case, the ESM programme should also be abrogated, which would have similarly disastrous consequences even without OMT; thus, the OMT programme does not add much downside to the adverse outcome.

Notwithstanding these caveats, it was a wise decision to launch the OMT programme, given the alternative of an escalation of the euro crisis. It has worked like a magic wand, as government bond yields have fallen without any actual intervention. Let us hope that the time during which the audience is applauding will be used wisely and that politicians will not impair the magic power of the OMT by mismanaging other aspects of the euro crisis.

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