The ECB’s new doctrine: Sailing into unchartered waters

In this note I’ll argue that yesterday the ECB de facto introduced a new doctrine in central banking; namely that of explicit policy conditionality for its actions. To my knowledge, that’s never been attempted before. We are familiar with policy conditionality from IMF programs, and more recently the Troika in the eurozone, and I have no doubt about their generally positive contribution in those settings. However, introducing explicit policy conditionality by central banks raises some complicated – and uncomfortable – questions, which I’ll highlight below.

If it leads to better policies by governments, if the EFSF/ESM appreciates those efforts and if this comforts the general public (and the media) in core Europe and therefore frees the hands of the ECB to do what they have to do to restore a proper transmission mechanism, then I can see not only the light of the end of the tunnel of this crisis, but the opening itself.

But it seems to me that the ECB has seriously raised the stakes for the eurozone and might one day face a serious dilemma: In a future scenario where a government cannot reach agreement with the EFSF/ESM, do they stick with their new doctrine and refrain from intervening and accept what could well be sovereign default, or do they risk their credibility and reverse to their previous doctrine of intervention if the dispute is small enough (or the country big enough), thereby seriously challenging their own future?

Only time will tell. I hope for the former but fear for the latter. Regardless, it feels as if we are moving into some extremely volatile times with further curve steepening as a general theme.

1. How I think we got here, and some general concerns about the outcome:

At yesterday's press conference, Draghi responded to a suggestion that he had been back-pedaling compared with his speech in London last week, by saying that if anything, yesterday's statement about the ECB’s willingness to intervene in debt markets was now even stronger than he had indicated because the GC has endorsed it. I am not sure I see this; rather I'll suggest that yesterday's statement might have been the product of some hard-core political bargaining which indeed implied some back-pedaling.

There is one significant difference between Draghi’s London speech and GC’s statement at the press conference. In London last week, Draghi said that “Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.” This seemed to be a very clear statement if one has read the treaty and is familiar with their previous interpretation of their mandate.

Erik F. Nielsen, Global Chief Economist  
(UniCredit Bank London)  
+44 207 826-1765  
erik.nielsen@unicredit.eu
I, for one, thought that "our mandate" referred to a need to repair the transmission mechanism when it is out of kilter and threatens the effectiveness of monetary policy (in my view today is such a case). After all, this was the narrative used by the ECB when they introduced the SMP in 2010 and when they expanded its use to Italy and Spain in 2011. Yes, in retrospect, the SMP was not overly successful at that time, but there can be no doubt that the ECB saw it as being within in their mandate – otherwise they would certainly not have done it, for sure. (I think its lack of effectiveness was caused by primarily two factors: Vocal opposition from the Bundesbank, which – curiously – was never taken on in public by those with different interpretations of the treaty, and its timid use.)

Yesterday, however, Draghi implied that the ECB’s mandate to use the SMP is conditional upon countries having done enough on the fiscal and structural reform side to make the SMP effective in restoring an acceptable degree of transmission mechanism. This is news to me – and I suspect to the ECB itself. Certainly, Draghi was not yet in a position to spell out what those conditions would be (apart from the need for a Memorandum of Understanding (MoU) with the EFSF/ESM; described as “necessary but not sufficient). Committees inside the ECB will decide in the coming weeks on the modalities that will apply.

Intellectually, I can easily understand that a central bank cannot step in and fill the vacuum left by other policymakers, but attempting to spell out exactly what conditions will apply for using the SMP to restore the transmission mechanism, and delegating part of this assessment to another agency, leaves me puzzled on several accounts.

First, I think the ECB may be trotting into dangerous territory when they now insist on specific policy conditions before undertaking market operations. (Yes, I remember the famous letter to the Italian government from Trichet and Draghi, but I always preferred to think of it as an exception rather than the beginning of a rule.) Certainly, the treaty does not give the ECB an exception from its mandate if certain fiscal or structural policies are not to their (or the EFSF/ESM’s) liking. And while a central bank with an inflation target would always have to take into account what governments do in other policy areas when they try to fulfill their mandate, I cannot recall another example of a central bank telling its democratically elected officials that there will be a threshold in terms of their policy stance below which the central bank will simply throw in the towel and accept that markets (dysfunctional or not) have made it impotent with respect to its ability to steer policies to fulfill its mandate.

I find this to be uncomfortable territory, and – if I had to make a guess – I think it must be the result of a compromise dictated by “realpolitik” in Germany. This outcome may please the general public because it seems at times to have greater trust in central banks than in the elected officials. As an economist (and ex central banker myself), I don’t have any big problems with that, but if the central banks then start to conduct policies on the back of guidance from the general public (presumably conveyed via mass media), I get nervous.

It is well known that the Bundesbank is against the use of the SMP, and I suspect that Draghi has been spending the better part of this past week trying to negotiate conditions for getting Weidmann and the Buba on board. That did not happen. So, without the Bundesbank on board, Draghi needed to put so many conditions in front of the potential use of the SMP that the German general public, political leaders and media would broadly accept it, if it were to be used – and that included the requirement of an EFSF/ESM program. Not surprisingly, with such stringent conditions now attached, all other members of the GC, including the Dutch, the Finns and the German Executive Board member, agreed to the possible use of the SMP.
2. How it all may play out – and the risks.

I suspect that both Italy and Spain will be on their way to Luxembourg very soon to get their MoU signed; the only reason to wait would be to see what other conditions the ECB will decide on in the coming weeks. In my view, agreement on a MoU should be relatively straightforward for Italy, while potentially time-consuming for Spain. I worry about their regions and generally evaporating trust after the massive fumble around the bank recap.

With the MoU signed, the EFSF/ESM may begin purchases of sovereign debt in Italy and Spain (but they will remain opaque with respect to volumes, price objectives and length of engagement), and which will likely open the door for ECB purchases as well. But remember that the EFSF/ESM program is a necessary but not sufficient condition for ECB purchases. What makes it “sufficient” we still don’t know. If interventions by the ECB take place, it’ll be in the short end, and its seniority (in case of a future debt restructuring) will be “addressed”, presumably meaning that the ECB will not be senior creditors. This ought to lead to a steeper curve, but maybe the EFSF/ERSM will buy the longer end?

This is great news for those feeling that the periphery needs more fiscal and/or structural reforms in the short term, and that this is why markets don’t invest in the peripheral sovereigns. So, what, for Italy and Spain, used to be peer pressure or informal conditionality, will now become formal conditionality, and that may work better.

Personally, I have two problems with this reasoning. First, I think the market stays away from the periphery not (primarily) because of insufficient reforms, but because it itself has become dysfunctional. Second, I think Spain and Italy have already implemented just about as many fiscal cuts and structural reforms as their economies – and social fabric – can handle in the short term. And the positive effects are very visible already, as we have documented in several recent papers. (Hence, my preferred route would have been to 1) continue the national reform processes; 2) accelerate the pan-European reforms, particularly with respect to banking union, while telling bank supervisors to stop their use of capital controls; and 3) fix the dysfunctional markets by hitting the markets to punish the shorts – which should happen mostly like lightning from a blue sky, and not after long negotiations – and by reforming the system of equally dysfunctional reliance on credit rating agencies.)

I see two possible outcomes from here (assuming that the crisis does not resolve itself): The best case scenario is that Spain and Italy approach the EFSF and a MoU is signed on the back of existing policies with only marginal refinements and – importantly – continued monitoring of implementation and fulfillsments of promises. I could imagine this happening before the end of summer. This triggers EFSF/ESM as well as ECB purchases and it’ll be “enough”, as Draghi promised. The Buba may register its unhappiness, but the German political leaders and most of the media will broadly agree that Italy and Spain are making good progress and that the ECB has to do what it has to do.

But there are risks, and potentially serious ones for the medium term. What if Spain (or Italy or another country sometime in the future) cannot reach agreement on a MoU? Maybe because the EFSF/ESM – knowing what is at stake with the German public – try to read the public mood and therefore plays hardball beyond what the national government is willing to impose in terms of hardship at this stage? While negotiations move slowly, markets sell off and deposits leave the country. Maybe sovereign yields go to 10% or 12% or 15%.

Obviously, the transmission mechanism for the Spanish private sector will break down completely and while households and businesses see their costs of credit sky rocket as well, they have no way of persuading their government – even if they wanted to – that they should accept whatever the collective European authorities, represented via the EFSF/ESM, want. In this scenario, the risk of a sovereign default would increase significantly.
If the country is big enough, this would no doubt cause serious economic (and potentially political) problems throughout Europe (and maybe the world). As Europe licks the wounds of this outcome, the ECB will then presumably explain that the government’s delay in liberalizing this or that product market or dealing effectively with this or that regional issue meant that its mandate did not make intervention possible to restore the transmission mechanism.

Or – in this scenario, if the country is big enough – does the ECB change its mind and intervene to save us from potential disaster – in the process risking its own reputation by doing a massive U-turn? I don’t know. My intuition would say no, but then again, Draghi said that the euro project is irreversible! Moving from the concrete example to the abstract: Is conditionality imposed by a central bank really realistic? If a government cannot agree with the EFSF/ESM on this or that policy measure, then who blinks first? Can the EFSF/ESM and hence the ECB really walk away? I hope we’ll never have to find out.

Our baseline is the optimistic scenario but the stakes have increased with the ECB’s new identification of the EFSF/ESM (and, presumably, the input from other governing bodies) as the gatekeeper for deciding when its mandate allows them to intervene to restore their transmission mechanism.

Best
Erik
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