What is unorthodox monetary policy?

by

Georg Erber

August 2012

Abstract:

After the near collapse of the global financial system after the default of Lehmann Brothers money markets froze and caused the problem of the massive contagion process of a global liquidity crisis. To counter this process the Fed, the ECB and the Bank of England in particular started monetary activities summarized under the label of unorthodox monetary policies (see Muellbauer 2008). Until that time orthodox monetary policies, i.e. interest rate policies, were the key instrument to guide the liquidity provision of money markets. After already lowering key interest rates of the central banks rapidly close to zero and money market still not recover from the shock, monetary policy was considered to become stuck in the liquidity trap. However, Demand for liquidity still stayed at extraordinary high levels even if the price of money has decreased to near zero. Uncertainty about future developments of the still unfolding crisis triggered a money hoarding unseen before after WWII. The key question therefore was: How to pump prime money markets to make them operate again normally? The remedy put into practice was unorthodox monetary policy. But what does this mean? Has the Fed and the ECB violated the legal framework? What are the short-term and long-term impacts of unorthodox monetary policies of the Fed and the ECB? Do unorthodox monetary policies create long-term new endogenous risks of further financial market instability? What kind of new moral hazard related to unorthodox monetary policies emerges? Is the Fed and the ECB lacking a credible exit strategy?

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After the near collapse of the global financial system after the default of Lehmann Brothers money markets froze and caused the problem of the massive contagion process of a global liquidity crisis. To counter this process the Fed, the ECB and the Bank of England in particular started monetary activities summarized under the label of unorthodox monetary policies (see Muellbauer 2008). Until that time orthodox monetary policies, i.e. interest rate policies, were the key instrument to guide the liquidity provision of money markets. After the central banks already lowered key interest rates rapidly close to zero and money markets still not recovered from the shock monetary policy was considered to have become stuck in the liquidity trap.

**Figure 1 - Main refinancing operations interest rate, 1999-2012.**

1. From 28th June 2000 until 9th October 2008 variable tenders, before and after fixed rate tenders.

Source: ECB. DIW 2012
Besides lowering the interest rate the ECB switched its money supply policy to provide again liquidity at fixed interest rate tenders instead of variable interest rate tenders after the crisis broke out after the 15th of September 2008. So any commercial bank could obtain any amount of liquidity needed at the fixed rate. By these measures a global liquidity crisis could be avoided. However, demand for liquidity still stayed at extraordinary high levels even if the interest rates of the major central banks globally has decreased to near zero (see figure 1).

“Since the onset of the Great Recession in 2008, commercial banks in the United States began accumulating huge cash reserves in their accounts at the Federal Reserve. Thus, in 2007, just before the onset of the Wall Street crash and ensuing recession, commercial bank reserves at the Fed totaled $20.8 billion. By the end of 2008, that figure had ballooned to $860 billion. By the middle of 2011, it had reached $1.6 trillion, where it remains as of this writing (June, 2012). This is more than 10 percent of U.S. GDP, an order of magnitude for commercial bank cash holdings that is without precedent since the Federal Reserve began reporting such statistics systematically.” (Pollin 2012, p.2)

At the beginning of this monetary policy switch the ECB did not signal to the market that this liquidity provision would be long lasting. The perception at this time was most likely that it was a very short-run phenomenon of a market panic which the central banks could overcome by offering sufficient liquidity. When the panic would end monetary policy could return to their ordinary orthodox policy model. After the recovery of the money market did not take place as rapidly as initially expected, the Fed and ECB later changed their positions to commit themselves to maintain this extremely easy money policy for a preannounced time frame.¹ But this did not help either.

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¹ Ben Bernanke announced to keep the Federal Funds Rate at near-zero at least through 2014. Similarly Mario Draghi committed to keep interest rates at low levels at least until 2014 and lowered the interest rate to 0.75 per cent.
In a similar fashion the Fed and the Bank of England reacted at the beginning of the crisis. However, uncertainty about future developments of the still unfolding financial and economic crisis triggered a continued money hoarding unseen before after WWII. Therefore the traditional approach to overcome a panic in the money market did not have the desired effect.

Currently the overnight deposits at the ECB in the second quarter of 2012 are close to 4 trill. Euro. The key question therefore is: How to pump prime money markets to make them operate again normally? Why there is a persistent lack in credibility of market participants that there will be a new liquidity squeeze against the commercial banks are hedging by trying to keep huge overnight deposit at the ECB. Looking at the development of overnight deposits at the ECB there is evidence of a persistent money hoarding as in the US.

Whenever a major liquidity squeeze emerged in 2008 and 2010 in Europe the ECB as well accomplished through its monetary policy up to now a turnaround in this development. However, there is a growing concern that the current liquidity stored in the overnight deposit accounts sooner or later could ignite a rapid acceleration of inflation in the Euro area (García, Werner 2010). Similar worries are present in the US as well (Laperriere 2012). It would be very difficult to sterilize excess liquidity just in time, if the market sentiment changes that liquidity at the ECB or the Fed is a safe haven against major money market disruptions in the Euro area or the US or even globally.

The possibility of a falling apart of the Euro area could be such a trigger currently in particular under the current debate on Greece. The so called Grexit, i.e. the Greek exit from the Euro area, could become a trigger for further countries to leave the common currency area. So the growing uncertainty about the political persistence of the Euro area might be mirrored in the hoarding of liquidity. However, the same liquidity freeze prevails in the US as well, so the cause for the behavioral motives might be more general than purely due to the specific European difficulties.

Figure 3 – HICP, annualized Inflation rate of the Euro area, 1991-2012.

Furthermore after a peak in high inflation, measured by the harmonized consumer price inflation index
HICP) triggered by an oil price shock in 2008, inflation rates came down rapidly during the short recession in the overall Euro area. However, worries of a major deflationary development which occurred in 2009 did not materialize until now (Lange 2011). Inflation accelerated afterwards peaked at the end of 2011 and is approaching the 2 percent target range of the ECB again. So why the ECB did not turn back to normal and cares about price stability as its major aim and purpose?

Looking at the GDP growth rates for the Euro area, we notice that since the beginning of the year the whole overall growth which was decelerating in the year before is leading currently to a mild recession. However, the situation now is not comparable with the sharp recession which occurred in 2009. Under a homogenous economic framework condition the ECB could just follow a Taylor-Rule-approach to monetary policy (Taylor 1993).  

Since inflation is decelerating in the whole Euro area and the economy is falling into recession a more expansionary monetary policy would suffice. What makes the situation more complicated are the internal imbalances of the Euro area countries. Furthermore monetary policy has exhausted its possibilities to drive down the nominal interest rate. It needs to provide more stimuli beyond the liquidity trap boundary. Similar challenges prevailed for the US Fed and the Bank of England (Pollin 2012).

That the current development emerged is not surprising since a number of member countries face major fiscal consolidation processes after running extremely high deficits before to steer the global economy out of a looming global recession or even depression. Overall the Euro area showed a fairly good performance with regard to the public deficits before the Great Recession in 2008. Only in 2003 its overall deficit to GDP ratio exceeded the 3 percent deficit ceiling.

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2 According to Taylor’s original version of the rule, the nominal interest rate should respond to divergences of actual inflation rates from target inflation rates and of actual Gross Domestic Product (GDP) from potential GDP.
Even now after the big fiscal stimulus programs running from 2009 until 2011 the deficit reduction has begun and is approaching the 3 percent ceiling this or next year (see figure 5). The primary deficit of the Euro area has already shrunk to 1.1 percent of GDP. So overall the Euro area seems to be back on a sustainable fiscal position. So the problem of the Euro area and the ECB as well as the governments of the member states is more to organize a rebalancing between the uneven developments between the single member states (figure 6). Compared to other countries like the US and Great Britain the fiscal consolidation process, however, has made much better progress (figure 7)

Figure 5 - Deficit/Surplus of all governments in the Euro Area (17), 1995-2011.

Figure 6 - Deficit to GDP ratios of the GIIPS-Countries, 1995-2011.
The ECB as well as the Fed need new instruments and approaches to overcome the current situation to make monetary policy more accommodating toward higher growth and employment.

The situation in the Euro area is furthermore complicated because of the heterogeneity of the states of the different member countries. That created the particular aim of the ECB to tackle this situation on their own when fiscal policies in particular in the crisis countries have become ineffective due to high indebtedness and a debt trap in the GIIPS-countries makes the situation so delicate. At the core lies the problem that at its current state the Euro area is anything but an optimum currency area (Mundell 1961). It was established by politicians as a political project of building a common institutional framework for a United Europe but they have failed to deliver before starting the monetary union.\(^3\) The current worry is that under the present policy framework the monetary union will be at risk. However, it is a risky approach to take monetary policy of the ECB as a substitute to policy failures of the governments of the Euro area.

The current solution of the European Fiscal Compact and the ESM\(^4\) to overcome these short-comings may be still insufficient to overcome the internal political disagreement between the different countries. In particular the GIIPS-countries on the one hand show strong resistance to implement a severe austerity policy to bring their public deficits under control, on the other hand countries that have to bail-in significantly into financing the GIIPS-countries which tend otherwise to go insolvent under market conditions have little intention to enter into a transfer union with the GIIPS-countries without a credible fiscal discipline implemented there. Anti-austerity movements have become highly popular in GIIPS-countries because the burden is put on ordinary people there who feel innocent of the mismanagement of the past decade. So the ability of politicians to keep the Euro area intact is doubtful. Simple reelections could bring Anti-Euro parties to power. Greece is a good example for this tendency, but Euro-skepticism is gaining ground over the past years everywhere. Since the political structural reform process is dragging along, the inability to act immediately if another critical outbreak of the crisis reemerges keeps global

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\(^3\) “The sovereign debt crisis in the Euro area is a symptom of policy failures and deficiencies in – among other things – fiscal policy coordination.” (Schuhknecht, Mourot, Rother, Stark 2011)

\(^4\) ESM - European Stability Mechanism.
investors cautious to commit to long-term investments.

The ECB is therefore tempted to close this gap by monetary policy measures. By this however the ECB would begin a self-empowerment\(^5\) to engage in activities not defined in her legal framework. In particular the temptation to give easy credit via the ECB to those countries and governments who have lost access to private money on capital markets seems to be a first choice for salvation of the Euro area. By this the ECB gets into direct competition with the other rescue mechanism of the EFSF\(^6\)/ESM which were just establish to accomplish the same task.

While the countries with a better reputation at financial markets like Germany want to have control over the refinancing of public debt in crisis countries through the EFSF/ESM the GIIPS-countries try to avoid such conditionalities common from the rescue operations of the IMF. Refinancing their public debt via the ECB without such supervision and conditionalities is their first choice. This, however, brings the ECB in conflict with the struggling parties. Instead of being an impartial institution which is bound to the overall well-being of the Euro area, she might easily become bending towards one group of member states, and by this challenges the opposing countries.

Monetary policy which should have been exempt from political pressures from governments gets into these disputes by becoming a stakeholder to save the countries in distress but by a strategy the opposing countries with Germany as their leader want to avoid. The legitimacy of the ECB for acting in the particular interest of the GIIPS-countries is according to Mario Draghi the necessity to be the only institution which could save the Euro area. That this is the case is put into doubt by those who prefer to use the EFSF/ESM instead of the ECB as lender of last resort (LOLR) to the countries in distress.

But the situation in the US even having a centralized federal government is not much better either. There the economy has not returned to the normal growth trend of 3 percent annually and is keeping unemployment extraordinarily high in particular by US standards. Furthermore the unemployment benefits paid to those unemployed are at risk, since the legal framework in the US has no procedures to handle long-term unemployment. There seems to be a common factor beyond the specifics of the Euro area, the US and the UK.

The remedy put into practice was unorthodox monetary policy. But what does this mean?

**Unorthodox monetary policy options**

The Financial Times Lexicon offers the following definition:

> “Any policy undertaken, usually by central banks, that operates outside the usual parameters for influencing either the price or the quantity of money in an economy. In 2009, the Federal Reserve, European Central Bank and Bank of England among others implemented forms of unorthodox monetary policy. The Bank of England's policy of quantitative easing, for example, created large amounts of new money and used this to purchase government bonds, thereby pumping funds into the economy.”\(^7\)

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\(^5\) The self-empowerment already has led to a lawsuit from a German Member of Parliament, Peter Gauweiler, against the ECB at the European Court of Justice (ECJ) for violating the statutes of the Maastricht Treaty. Recently a Minister for European Affair from Hessen in Germany considered a similar step for the German government in case that the ECB should begin to buy government debt in large volume from crisis countries without an adequate legal foundation.

\(^6\) EFSF - European Financial Stability Facility.

Lender of Last Resort Option

Willem Buiter first defines unorthodox monetary policies differently according to their additional aims:

“With official policy rates near or at the effective lower bound, the size of the central bank’s balance sheet and the composition of its assets and liabilities have become the new, ‘poor man’s’, monetary policy instruments. The LLR and MMLR roles have expanded to include solvency support for SIFIs and, in the euro area, the provision of liquidity support and solvency support for sovereigns also.” (Buiter 2012)

Often another abbreviation LOLR is used. Lender of Last Resort is defined as the emergency provision of sufficient liquidity by the central bank in case of a financial market panic to stop further financial market turmoil. Normally this objective and authorization to do such operations is legally enshrined in the laws of the respective central bank laws, e.g. NBG, Art. 5 Sec. 2 of the Swiss National Bank Law.

This kind of monetary intervention goes back to a policy adopted in the 19th century by the Bank of England (Bagehot 1873). It was later named after Bagehot the Bagehot rule (Wood 2003). It is summarized as, “lend without limit, to solvent firms, against good collateral, at ‘high rates’.”

It is noteworthy that it restricted central bank lending even in times of financial panic to good collateral and high rates, i.e. imposing a financial haircut as a penalty for those who mismanaged their liquidity requirements. This should guarantee that the central bank does not incur the risk of losses from such operations or even face insolvency himself and the haircut by higher lending rates should work as a deterrent for moral hazard for borrowers to mismanage their liquidity risks due to the reliance that in times of a financial market crisis the central bank will bail-out distressed banks without penalizing them. A free rider attitude of commercial banks should be subdued. Therefore good collateral and punishment by a haircut are essential elements of a LOLR-operation of the central bank in the traditional sense of Bagehot.

“The effective fulfillment of the lender-of-last-resort function of the central bank requires that during a liquidity crisis the central bank lend freely to an institution that is illiquid but not insolvent (if assets can be held to maturity), against collateral that would be good during normal times but that may have become illiquid during disorderly market conditions, and at a penalty rate. The requirement that lender-of-last-resort facilities are only offered on punitive terms is key to the minimization of moral hazard and thus to discouraging future imprudent, reckless lending and borrowing.” (Buiter 2008)

The before mentioned definitions are both fairly broad definitions of the LOLR. The first focus on new instruments, the second on additional aims of monetary policies. The latter have their focus in systemic stability issues. Both do not cut a clear narrow line in the same manner as the Bagehot rule does. But they do not explicitly challenge the Bagehot rule in principle.

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8 LLR – Lender of Last Resort
9 MMLR - Market Maker of Last Resort. “The same principle (Bagehot rule – G.E.) of providing assistance to illiquid but solvent institutions only on punitive terms applies when market illiquidity rather than funding illiquidity is the problem facing the troubled private financial institution and the central bank intervenes as market maker of last resort. (Buiter 2008)
10 SIFI – Systemically Important Financial Institution. “SIFIs are financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.” Definition of the FSB (2011).
Unorthodox monetary policy, however, should not be considered arbitrary action of a central bank without any legal foundation and claiming that this transgression has been necessary to save the system. This would destroy the legal foundations of our monetary system. It has become confused by the public opinion that anything which seemingly helps to stop the crisis like a financial system crisis is already justified.

LOLR is historically directed primarily towards private sector financing, not government debt financing. It should stabilize financial institutions like commercial banks which still are solvent, i.e. have sufficient valuable assets to cover their liabilities. Commercial banks which are obviously insolvent should not be saved through LOLR-Loans. Therefore during the financial crisis in the US hundreds of commercial banks in the retail banking business were closed down.11 The same did not happen in Europe.

In Europe the approach to stabilize the financial systems of the different countries was different. Large commercial banks which got into trouble were nationalized or obtained massive state subsidies. Similar steps were taken by the US government through the Troubled Asset Relief Program (TARP) program.12 But the Instead of closing down the commercial banks which mismanaged their risk-portfolio like the FDIC in the US did, governments took over these banks (see e.g. in Germany the HRE, in the UK Northern Rock, in France and Belgium gave massive state subsidies to Dexia, in Spain Bankia, in Ireland the Anglo Irish Bank). One exception has been the closing of the WestLB after massive pressure through the European Commission. This, however, was already a public commercial bank. As a consequence of such state intervention in the financial industry Euro area, countries like Ireland faced extraordinary increases in their public deficits (figure 6). Taking over the heavy burden of troubled commercial banks Ireland immediately faced a sovereign debt crisis.

Therefore the bail-in of the different governments to save their national commercial banks transformed a banking crisis into a couple of sovereign debt crisis, which now haunts the governments there. The idea that the risk transfer from single commercial banks considered to be too-big-to-fail (TBTF) through state guarantees or nationalizations rapidly undermined the financial credibility of the respective governments themselves. Instead of stabilizing the system the countries now faced double-trouble.

Socializing losses of insolvent private banks destabilized the credibility of the public finances. Ireland in particular was forced to be saved by financial support through the EFSF in 2010 himself. Taking over too much risk from failed commercial or public banks led to a contagion effect putting the financial stability of who states at risk. This increasing doubt into the solvency of member states of the Euro area started another contagion process. Countries like Greece and Portugal became victims due to their already high public debt and current account deficits. So again the same strategy was applied to establish the EFSF to act as LOLR to these three troubled countries after their private market refinancing costs had before skyrocketed.

As Buiter has stressed in the quote before, LOLR experienced a massive extension to insolvent SIFIs

11 FDIC – Federal Deposit Insurance Corporation, Failed Bank List
12 The Dodd–Frank Wall Street Reform and Consumer Protection Act reduced the initial amount authorized of $700 billion to $475 billion. By March 28, 2012, the Congressional Budget Office (CBO) stated that total disbursements would be $431 billion and estimated the total cost, including grants for mortgage programs that have not yet been made, would be $32 billion. These are much less costs to cover by the US government and the US tax payers than that which the governments in Europe will have to face.
and sovereign states. That unsurprisingly led to a major inflation of risk piling up inside the national financial system and in public finances in particular. Instead of gaining control over the financial crisis governments in Europe by this policy contributed significantly to the contagion of the crisis to public finances through bail-ins into insolvent commercial banks. The mantra for this kind of self-defeating policy was: There is no alternative.

From the position of financial markets this established a huge moral hazard problem for the future. In particular with officially giving major banks the TBTF-status through the SIFI list (FSB 2011), they are now officially granted in advance a bail-out by national governments if in case of another financial crisis their existence will be at risk. This guarantee was even given without any clear definition of the kind of extra obligations they have to fulfill to rule out or significantly reduce their risk of default.

From the bailout of SIFIs by national governments the next step of contagion of the whole Euro area was not too far. Putting their public finances via bail-ins in insolvent banks at risk in different member states, the previous generally accepted principle of sovereign debt as safe assets lost its credibility. The rapidly increasing interest rates between different member countries of the Euro area and respective interest rate spreads between Germany at the bottom and Greece at the top just was the market reaction that governments in an increasing number of the Euro area had failed to accept the limits of their own debt burden capacity. Seemingly the governments lacked any understand that there is possibly a public debt ceiling. Even having signed the Maastricht treaty to keep their public debt burden permanently below the 60 percent of their GDP ratio, this legal binding contract were never taken seriously in the past. In particular countries like Italy or Belgium were exempted from this debt ceiling rule. However, ignoring the legal framework signed by the heads of states before, could not avoid that in a global financial system market participants had their own opinion about this situation and acted accordingly.

This led to a sovereign debt trap, i.e. rapidly increasing interest rates for government bonds plus rising public debt pushed public finances on an unsustainable trajectory. Countries with huge current account deficits became in particular vulnerable because foreign creditors showed reluctance to refinance debt in such countries facing a significant possibility of a sovereign default. For them an early exit strategy was feasible putting additional strains on those who could not follow. This led and still leads to massive capital flight from these countries.

After Greece followed Portugal, after Portugal came Ireland, after Ireland comes Cyprus, and after Cyprus Spain and Italy are on the verge to become unable to refinance on private capital markets.\(^\text{13}\) Obviously there is seemingly no clear boundary when countries become financially fragile in the global financial markets. Contagion risk is under such circumstances increasing continuously step by step when another country shows financial weaknesses. Even Germany\(^\text{14}\) as possibly the last man

\(^\text{13}\) Deutsche Bank Research publishes regularly the Sovereign Default Probabilities Online.

\(^\text{14}\) “The rising uncertainty regarding the outcome of the euro area debt crisis given the current policy framework, and the increased susceptibility to event risk stemming from the increased likelihood of Greece’s exit from the euro area, including the broader impact that such an event would have on euro area members, particularly Spain and Italy. Even if such an event is avoided, there is an increasing likelihood that greater collective support for other euro area sovereigns, most notably Spain and Italy, will be required. Given the greater ability to absorb the costs associated with this support, this burden will likely fall most heavily on more highly rated member states if the euro area is to be preserved in its current form. These increased risks, in combination with the country-specific considerations discussed below, have prompted the changes in the rating outlooks of Germany, the Netherlands and Luxembourg. In contrast, Finland’s unique credit profile, as discussed below, remains consistent with a stable
standing in the Euro area could become vulnerable as this process of contagion carries on. The problem governments are facing today is that in a system of globalized financial markets sovereigns are not sovereigns any more. They become highly dependent on the willingness-to-lend from abroad to finance current account deficits and refinance public debt.

**The ECB and Ultra Vires**

For the Euro area the ECB has not even such a legal foundation to act as a LOLR. It was considered that the National Central Banks (NCB) of each country would act with regard to their respective National banking system should take on this position. This has been practically done by NCBs to a large extent via the Target2-System in a stealth fashion which offered the opportunity to obtain unlimited liquidity from the ECB. However, the Target2-System (Sinn, Wollmershaeuser 2011) was not considered to be used for this purpose. Many consider this lack of LOLR-entitlement of the ECB to be a major flaw in its legal framework of the ECB.

“According to the treaties, the ECB cannot monetize debt. If it were to take on the role of LOLR, someone would take the ECB to court (there is already a court case in the European Court of Justice (ECJ) against the ECB for its securities markets programme (SMP). Of course, legislation can be changed, but that would require a treaty change.” (Greene 2011)

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15 Ultra vires is a Latin phrase meaning literally “beyond the powers”. 

rating outlook.” Moody’s (2012)
As a particular option the European system of national central banks has the possibility to declare through the Emergency Loan Authority (ELA) a temporary issuing of liquidity to national commercial banks according to the principles of the Bagehot rule. ELA was used by Greece and Ireland already. However, this monetary policy support not based on the principles of the Bagehot-rules. As Orwell in his book Animal Farm ironically stated: “Some are more equal than others.”

“Barclays Capital analysts Laurent Fransolet and Giuseppe Maraffino recently looked at ELA, pointing to some interesting details from the 2009 experts report about the collapse of Belgian-Dutch lender Fortis Bank, back in October 2008. It’s a rare window into ELA loans. According to the report, Fortis was given €61bn of emergency loans from the Belgian and Dutch central banks — but at a rate up to Libor plus 500bps for funding needs in dollars. (Needless to say, Libor was hardly a cheap base rate itself in late 2008.)” Cotterill (2011)

Therefore it is not surprising when Willen Buiter comes to the conclusion that:

“There is a growing suspicion in the markets that the ECB is subsidizing some euro area banks that are eligible counterparties at its discount window (the Marginal lending facility) or in repos, by overvaluing or overpricing illiquid collateral offered to the Eurosystem by these euro area banks.” (Buiter 2008)

It is a severe short coming of accountability and oversight of the ECB, by the member states, the European Commission, and the European Parliament not to investigate such activities and make the result public. It seems that the ECB is misinterpreting the principle of independence from political influence if it does secretly get involved in activities not covered by her mandate. What is actually happening in the case of Greece to avoid the default by giving loans through the ELA would be as well a case needing further investigation (Cotterill 2012, Dalton, Paris 2012). The current practice put the credibility of the ECB as an impartial institution with regard to member countries and commercial banks at jeopardy. It would also have major difficulties to explain why such discriminatory practices contribute to the common good. Such attitude to unorthodox monetary policy has no foundations in economic theory but is just plain clientelism. It undermines the ECBs reputation which might have long lasting impacts.

**ECBs valuation problems by accepting assets in repo operations**

Furthermore the ECB can use the Repo activities to take in inadequate risks by making intentionally or unintentionally major errors in the valuation of the assets assigned for the Repo.

The challenge a central bank faces is:

“Any illiquid assets the central bank accepts as collateral in repos, at the discount window or at any of the more recently created special liquidity facilities, such as the Term Securities Lending Facility and the Primary Dealer Credit Facility in the USA or the Special Liquidity Scheme in the UK, must be valued or priced in a way that ensures that the transaction does not involve a subsidy from the central bank to the borrowing institution. The repo, collateralised loan or swap should earn the central bank an appropriate risk-adjusted rate of return. The same would apply if the central bank purchased illiquid

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16 “Irish banks are paying an interest rate of less than 3pc on the €51bn of ‘emergency liquidity assistance’ (ELA) that has been sanctioned for them by the Central Bank of Ireland…..The interest rate paid by Irish banks on ELA is in the “ball park” of 2pc-3pc, informed sources said. The rate is based on the ECB’s marginal lending facility of 1.75pc, plus a “penalty” reflecting the emergency nature of the aid.” Cotterill (2008)
private securities outright from a financially challenged private financial institution. There is nothing wrong in principle with the central bank taking credit risk onto its balance sheet, as long as it earns a rate of return that adequately compensates it for that risk.” (Buiter 2008)

After the Great Financial Crisis broke out, the Repo activities of ECB with MFIs increased significantly (figure 9). This led as well to an increase in the problems related to the valuation of assets accepted in a Repo activity.

“According to the ECB’s handbook, The implementation of monetary policy in the euro area, September 2006, when a market reference price is available for a security offered as collateral to the ECB or one of the National Central Banks of the euro area, that market price is used to value/price the security. ‘in the absence of a representative price for a particular asset on the business day preceding the valuation date, the last trading price is used. If the reference price obtained is older than five days, or has not moved for at least five days, the Eurosystem defines a theoretical price.’ The valuation/price assigned to the collateral – either a market reference price or a theoretical price – is subject to a further liquidity haircut (or discount). The key problem is that while the haircuts (as a Percentage of the valuation) are known, because they are published by the ECB, the valuations are not. This does not matter when there is a market reference price. When there is no market reference price but instead a theoretical price is used, the absence of information on the actual valuation represents a serious deficiency in the Euro system’s accountability for the use of public resources.” (Buiter 2008)

“The issue is of more than theoretical interest. The past year (2007) saw the collapse of an out-of-control property price boom/bubble and a construction boom in Spain which at its peak accounted for about 18 percent of Spanish GDP. This year, Spanish commercial banks, heavily exposed to the
Spanish construction and housing sector, are reported to have repoed at least € 46 bn worth of their (often illiquid) assets in exchange for ECB liquidity. The Spanish construction sector is dead in the water and house prices in Spain are falling, exposing banks to the risk of negative equity for their mortgage holders. As a result, some of the collateral offered by Spanish banks to the Eurosystem has been illiquid and has had to be valued at a theoretical price. Some assets offered as collateral may have been non-marketable assets like mortgages. According to the ECB’s handbook again, ‘Non-marketable assets are assigned a value corresponding either to the theoretical price or to the outstanding amount. If the national central bank opts for the valuation corresponding to the outstanding amount, the non-marketable assets may be subject to higher haircuts’. For instance, non-marketable retail mortgage-backed debt instruments are subject to a valuation haircut of 20%.”

The key problem is that, even if we know the haircuts, we cannot tell whether the ECB or the National Central Banks of the euro area are subsidising their counterparties when these offer illiquid or non-marketable collateral for which a theoretical price has to be established. There are stories doing the rounds in the markets that suggest that the illiquid or non-marketable collateral offered by the Spanish banks has been priced not more than 5 percent below its notional or face value. If true, this is likely to represent a wild overvaluation of the collateral offered by the Spanish banks, and an illegitimate subsidy of the Eurosystem to these Spanish banks.” (Buiter 2008)

This causes the suspicion that the ECB has acted as lender of first resort (LOFR), i.e. accepting collateral of dubious value and without any appropriate haircut.

Buiter suggested as a necessary remedy to the current situation of mistrust in the LOLR-operations of the ECB: “First, the immediate publication of the model or models used to compute theoretical prices for illiquid or non-marketable financial instruments. Second, the publication (with an appropriate lag to respect commercial confidentiality) of the actual prices/valuations to each specific item of illiquid collateral offered to the Eurosystem. That information is still not in the public domain.” (Buiter 2008)

Buiter continues his statement on LOLR-operations of the ECB: “There is no justification for this. Neither the citizens of the EU, nor the European Parliament’s Committee on Economic and Monetary Affairs (and in particular its Sub-Committee on Monetary Affairs (one of the bodies to which the ECB/Eurosystem is formally accountable) can hold the ECB to account if they cannot verify whether the Eurosystem’s repos earn a proper risk-adjusted rate of return. The ECB and the National Central Banks of the euro area play with public money – tax payers’ money. The European Parliament’s Committee on Economic and Monetary Affairs should request (polite for demand) this pricing information from the ECB. It’s time the ECB faced some substantive accountability for the first time in its existence.” (Buiter 2008)

This view is in line with the personal opinion of the author of this paper. In the public debate the principles of LOLR and LOFR have become blurred. Without establishing an appropriate supervision that the Bagehot rule is applied the credibility of the ECB or any other central bank would be permanently damaged. It is no surprise that the German chancellor Angela Merkel rejected any attempt of covering debts occurred from LOLR-operations by the ECB which cannot make credible that the principles of LOLR-operations were applied appropriately.17 Cohen and Portes have made

17 „Zwischen dem Internationalen Währungsfonds und der Europäisches Zentralbank hat hinter den Kulissen ein heftiger Schlagabtausch begonnen. Die IWF will, dass die EZB einen Teil ihrer 40 Milliarden Euro an
some propositions how a LOFR-option could be defined (Cohen, Portes 2006). Even if these would be considered desirable they have never been implemented at any national central bank to my knowledge as a legal authorization. In the current financial market crisis there has seemingly emerged a fuzziness of the LOLR-operations which should be contained through effective supervision including the necessary transparency of such operations.

The Draghi-Plan – Caveat Emptor

Very recently Mario Draghi announced that the ECB will use all its powers to protect the Euro monetary system (at all cost?). That might get into conflict with the non-inflationary loss-absorption capacity (NILAC) of the ECB at some point. The idea behind this proposal is that the ECB might have sufficient NILAC to counter any possible speculative attack against the ECB. The proposal of Draghi started a public debate if the ECB will finally begin to finance or refinance public debt of countries which face high interest rates in the private capital market by buying up such papers at a reasonable interest rate determined by the ECB. This will currently address primarily the refinancing problems of Spain and Italy which currently have insufficient access to funds offered by the EFSF.

“The non-inflationary loss-absorption capacity (NILAC) of the leading central banks is vast. For the ECB/Eurosystem we estimate it at no less than EUR3.2 trillion, for the Fed at over $7 trillion. This is tax payers' money that is not under the effective control of the fiscal authorities. The central banks have used their balance sheets and their NILACs to engage in quasi-fiscal actions that have been essential to prevent even greater financial turmoil and possible disaster, but that also have important distributional impacts between sectors, financial institutions, individuals and nations. The ECB was forced into this illegitimate role by the fiscal vacuum at the heart of the euro area; the Fed by the fiscal paralysis of the US Federal government institutions.” (Buitet 2012)

Figure 10 – ECB purchases of government bonds from Greece, Portugal and Ireland, 2010-2011.

Since the ESM has not begun to become operational at the 1st of July this year, the two countries are running out of options to refinance their debt. This new unorthodox way of providing liquidity to Griechenland-Papieren abschreibt. Die EZB hat mit Krisen-Beratungen begonnen. Für die Deutsche Bundesbank könnte dies einen Verlust von etwa 5 Milliarden Euro bedeuten.”

18 Caveat emptor is Latin for "Let the buyer beware."
distressed governments and/or private banks has raised a much more intense debate if the ECB is not finally breaking the last legal barrier to more or less directly monetize government debt and accepting on the other hand the risk of higher inflation because these operation could not be sterilized by the ECB (Stark 2012). Furthermore by accepting subprime government bonds as collateral the ECB runs the risk of accumulating huge losses, if the countries finally fail to meet their financial obligations in the future. Previously the ECB already bought temporarily government bonds form the three countries, Greece, Portugal and Ireland to bring down the high interest rates. This activity was run under the title of SMP Securities Markets Programme (SMP). All together the ECB bought for about 221 bill. Euros government bonds in 2010 and 2011 from these countries. Currently (latest date: 24. August 2012 the outstanding amount at the ECB is 208,830 bill. Euros. According to press reports the ECB and the Greek National Bank hold together 38 percent of the total outstanding Greek government debt.

This led to severe disagreements between the German representatives Axel Weber and Jürgen Stark with the other members of the ECB Executive Board and the Governing Council. Finally both German representatives stepped down from their positions of the ECB. Jens Weidmann, following Axel Weber as President of the German Bundesbank has been opposing as well any kind of monetary intervention like the SMP in the future. Therefore the current debate initiated by Mario Draghi to rescue the Euro monetary system led to further conflicts between the representatives of the German Bundesbank and the other members of the Executive Board and the Governing Council. Again Weidmann considered stepping down (Blome 2012) because of this breach of the legal framework by the ECB not to directly or indirectly monetize government debt of any of the member countries.

A consequence of such direct or indirect financing of government debt is that in the conceptual design of the refinancing operation the ESM would obtain a banking license, i.e. the possibility to issue unlimited amounts of credit papers which could be monetized by the ECB. The ESM as an intermediary would buy the government bonds from the respective governments at a fixed “appropriate” interest rate. These would be used as collateral to issue ESM bonds on the secondary market and/or transfer them in Repos on to the ECB which monetize the ESM again. Private investors or the ECB could buy these bonds to stabilize the interest rate of the ESM bonds in the secondary market.

Under particular circumstances the ECB might intervene to keep the interest rates of government bonds of both countries under control that the do not reach a level where the countries would face a future unsustainable fiscal burden. By this the ECB explicitly takes on the responsibility to guarantee the solvency and liquidity of the member states of the Euro area. Whenever a debt trap is looming over one member country the ECB would intervene to drive down interest rates to a level which the ECB considers appropriate to avoid a sovereign default. It is a totally open question how far this kind of guarantee given by the ECB to all member countries public finances would not lead to adverse selection and moral hazard problems at least in the long-run if not immediately.

Therefore the Draghi plan is considered as a significant violation of the Articel 123 of the EU-Maastricht Treaty.  

http://www.ecb.int/mopo/liquidity/html/index_en.html#portfolios  
20 Article 123 « 1. Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as ‘national central banks’) in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase
The debate on the Draghi-plan has not come to a final conclusion. Details how this kind of government financing via the ECB would be implemented are still unsettled at the time this paper has been completed. One particular issue noteworthy is that the ECB would use a kind of interest rate upper barrier which the ECB would guarantee to keep interest rates below this upper barrier. As an alternative a double barrier, i.e. an interest rate band, is as well considered. It is also unclear if these threshold barriers would be publicly announced or kept secret to make it more difficult for speculators to attack the interest rate targets of the ECB. However, it is unconvincing that this would make much a difference. There are numerous barrier and double barrier option pricing models out there, which could be easily adapted to the particular circumstances by market participants who aim to speculate against the interest rate guarantee of the ECB (Cheng 2003, Faulhaber 2002).

Conclusions

After the outbreak of the Great Financial crisis central banks around the world had to face major challenges to supply sufficient liquidity towards money markets and in particular commercial banks, but as well private equity and hedge funds which otherwise have run into trouble. The traditional guiding principle has been the Bagehot-rule. Central banks should act as LOLR to stabilize the financial sector by providing sufficient liquidity to the market.

However, gradually a transgression of this LOLR-rule has occurred in the monetary policy design of the central banks in particular of the ECB and the Fed. The both got more and more involved to become LOFR for distressed governments which could not refinance their huge deficits on private capital directly from them by the European Central Bank or national central banks of debt instruments.

2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions.”
markets. This led to a growing dependency of central banks towards the political system and by this as a means for easy credit to finance unsustainable public deficits.

Furthermore the ECB to help distressed countries of the Euro area lowered its standards for Repo-operations significantly so that she is running a risk of losses from toxic assets accepted as collateral. Instead of accepting only assets of highest degree of creditworthiness she accepted even subprime assets from distressed countries and their banks in the Euro area. After getting involved into the stabilization efforts of the EU-Commission, the IMF in the Troika missions they also took over responsibilities to determine the progress made by the previously negotiated consolidation programs of the three EFSF-supported countries. This poses for her a dilemma. If one has already bought assets from these countries of currently 208 bill. Euro. They face the risk of a revaluation leading to huge losses for the ECB. When the first haircut on Greek public debt was negotiated the ECB faced the request to contribute to it, by writing-off the Greek government bonds and the other national central banks of the Euro area held in the portfolio. At the current state where uncertainty about a possible Greek exit, i.e. Grexit, still prevails, the situation of the ECB becomes even more delicate. If she supports in the next Troika-report on Greece that Greece has met the necessary steps agreed upon before to obtain additional financial support from the rescue program of the EFSF, it might do so because the ECB has become a stakeholder in a possible Greek default, when the payments from the rescue program is stopped. To avoid this loss the ECB might be willing to compromise that Greece has made sufficient progress even if it had not. The ECB is risking her credibility to protect their balance sheet prom major losses from the SMP.

This dilemma might repeat even at a much higher scale when the ECB starts to buy government bonds in large volume from the two big crisis countries Italy and Spain. Italy has regularly to refinance 1.9 trillion Euros of public debts and Spain 735 bill. Euros. Both countries still struggle to bring even their deficits under control. If financial markets keep being skeptical about the stabilization process making sufficient progress the ECB would become easily the LOFR for these countries. Since the ECB is refinancing to an ever growing degree these countries they will lose their ability to keep inflation in the Eurozone under control. Furthermore if the whole stabilization process cannot be maintained than the risk of major losses from the government bonds bought by the ECB looms at the horizon. That could be the final blow to lead to a collapse of the Euro area in the end. Draghi is taking a high risk strategy by implementing his plan. He cannot guarantee its success since this depends on the willingness and commitment of the crisis countries to get their economies back on track. Furthermore he might face legal challenges in particular because there is strong resistance in Germany to accept the new unorthodox policy approach Draghi is just trying to implement. In any case the ECB has lost already now its independence from the policies of different member states. Furthermore if the fiscal union would be established the ECB would even more so become a subsidiary of the governing council of the fiscal union. It would then be in the same league as the Bank of England and the Fed. Both already have become institutions to finance the public deficits on demand.

If one looks at the results of the past activities of unorthodox monetary policies one gets a mixed impression. Of cause the global economy has not fallen into a deep depression at happen after 1929. However, there was no steep recovery either like a phoenix from the ashes, some of the proponents of unorthodox monetary policy were expecting. Meanwhile huge liabilities for the future have built up (White 2012). Therefore at some time in the future observers will come to a major revaluation of what unorthodox monetary really contributed to the crisis management. The enormous debt burden accumulated in the public sector as well as in the central banks is one of them. However, there are additional numerous distortions when monetary policy is used to drive down sort-term interest rates for such a long time. Easy money now piling-up at the central banks have the potential to trigger a much more lasting inflationary process the proponents of unorthodox monetary policy are willing to take into consideration. Furthermore the LOFR makes it difficult to find an exit strategy without causing at this time another recession. Market participants have become used to this system and adjust to it. Readjustment to the orthodox monetary policy model could therefore be painful in particular if another financial market bubble bursts. Or as Misnky said: “It could happen again.”
References


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