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ECB Sovereign Bond Purchases and the Securities Market Programme

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Driven by the markets? ECB sovereign bond purchases and the Securities Markets Programme*

by

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Extended abstract

After the dramatic rescue package for the euro area, the governing council of the European Central Bank decided to purchase European government bonds - to ensure an "orderly monetary policy transmission mechanism". Many observers argued that, by bond purchases, national fiscal policies could from now on dominate the common monetary policy. This note argues that they are quite right. The ECB has indeed become more dependent in political and financial terms.

The ECB has decided to sterilise its bond purchases - compensating those purchases through sales of other bonds or money market instruments to keep the overall money supply unaffected. This is to counter accusations that the ECB is monetizing government debt. This note addresses how effective these sterilisation policies are.

One problem inherent in the sterilization approach is that it reshuffles only the liability side of the ECB's balance sheet. It is not well-suited to either diminish the bloated ECB balance sheet or to remove the potentially toxic covered or sovereign bonds from it. In addition, the intake of potentially toxic assets as collateral and by outright purchases in the central bank balance sheet artificially keeps the asset prices up and does not prevent the (quite intransparent) risk transfer from one group of countries to another to occur. Finally, sterilization takes place in a setting of still ultra-lax monetary policies, i.e. of new liquidity-enhancing operations with unlimited allotment, and, hence, does not appear to be overly irrelevant. A credible strategy to deal with the financial crisis should deal primarily with the asset side of the ECB balance sheet.

This note also addresses negative side effects of the SMP such as, for instance, the fact that the ECB is currently curbing real returns at the bond markets through its bond purchases. Currently, the real return of Spanish, Portuguese and Italian bonds only amounts to 3 to 3.5 percent. This is almost certainly not enough to attract private capital these countries are heavily dependent on.

The most worrisome aspect is that the euro area has stumbled into a perpetuation of unconventional monetary policies by the execution of the SMP. Of course, the

intentions are to bail out banks (but not just banks) and to support governments with issuance. What is difficult to see at the moment is how, once started, it will be able to stop.

Finally, the ECB has been too silent about the following key questions which tends to frighten potential private investors in euro area sovereign bonds: What exactly is the composition of the sovereign bonds the ECB is buying? Which criteria are applied to select bonds to purchase? How is the ECB's bond purchase strategy characterized in cases and periods of primary issuance? How long is the SMP going to last and what amounts may be spent?

JEL codes: G32, E42, E51, E58, E63
Keywords: Accountability, bail-out, bond purchases, central bank independence, insolvency risk, Securities Markets Programme, transparency

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INTRODUCTION

After the dramatic rescue package for the euro area, the governing council of the European Central Bank (ECB) decided on several measures in order to ensure an "orderly monetary policy transmission mechanism". Among them were secondary market purchases of private and European government bonds with the aim of propping up failing bond markets of governments in financial distress and allowing cash-starved commercial banks in those countries to now sell them to the ECB to get funding in return. On the last days before, the ECB council had surprisingly changed its previous traditional course of *drawing a clear line of separation between responsibility for monetary policy and fiscal policy*. Giving in over the weekend before the decision to more than fifty European commercial banks and the European Association of traders, the impression emerged that the ECB was not only driven by the markets, but also by politics.

Since intervention has been (for the time being?[1]) limited to the secondary market, the ECB did not literally violate the Treaty. However, they offended against its spirit as central bank bail-out of government deficits is prohibited. The actors tried to legitimize their move by the extraordinary market tensions, which unfortunately left the bank with no other alternative - accompanied by dramatic statements by A. Merkel and M. Trichet. While the German Chancellor expressed that "the euro is in danger" the ECB President spoke of the "most difficult situation since World War II if not since World War I" and noted that "we live in difficult times". It is true that during the days preceding the largest and most recent rescue package, markets for sovereign bonds of the weakest and most indebted countries of the euro area actually *nearly dried out*. But *markets* in fact *did not appear to be irrational* at all.[2] Their fear not to get their money back was overall realistic. What is more, economic science is not at all clear about whether huge spread increases and drying out markets are really "dysfunctional" or - in view of the fact that Greece's and also Portugal's domestic savings are so small that they are not capable anymore to keep their capital stock constant and to finance their public deficits -

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[1] For the ECB, there is a theoretical way out to arrive at a result similar to a direct purchase of sovereign bonds: if in the financially weak euro area member countries commercial banks would be forced to buy bonds – and the ECB would at the same time abrogate – as already executed in the case of Greece – all her rules for mortgaging collateral, governments could procure money through a small indirect route.

[2] Although all countries have announced broad-based bank rescue packages, investors have differentiated between countries mainly on the basis of other, more country-specific factors (e.g., fiscal outlook). This has also been valid more recently, after February 2010 when markets have increasingly differentiated among the weak members. For a recent study of the factors behind the overall increase in intra-euro area sovereign yield spreads, see Attinasi, Checherita and Nickel (2009).

"functional". While first empirical evidence conveys the impression that, in the past and also during the crisis, sovereign bond spreads reacted in a systematic fashion to the fiscal policy stance (i.e., the government debt levels and forecasts of future fiscal deficits) of individual countries and, hence, indicates that the above mentioned statements were potentially *overridden* (Gerlach, Schulz and Wolff 2010), more results are to be expected from further intensified research in this area.[3]

1. POLITICAL DEPENDENCE OF THE ECB

Many observers argued that, by bond purchases, *national fiscal policies* could from now on *dominate the common monetary policy*. The ECB has obviously become politically more dependent. After all, in the first four weeks after its path-breaking decision, the ECB bought bonds at the amount of slightly more than EUR 40 billion which have to be added (!) to the much larger amounts of Greek bonds already offloaded at the ECB's balance sheet through preceding open market operations applying lower haircuts than usual or no haircuts at all.[4] Starting with EUR 16.3 billion purchases of bonds in the first week of the *Securities Markets Programme* (SMP), the ECB lowered the respective amounts sequentially in the following weeks (EUR 10.4 billion, EUR 8.8 billion and EUR 4.9 billion). But *no official information* has been released about the *composition of these purchases* in relation to whose debt has been purchased or which maturities. Anecdotically, market voices speak of *almost 75% Greek debt purchases*, with Portugal and Ireland being the next biggest beneficiaries, and some smaller Spain and Italy purchases following thereafter. Without any doubt, it can be taken for granted that this portfolio would alternate as the market perception of which country is weak changes. Anyway, the basic principle followed by the ECB seems to be *to get spreads down* and *wipe out any shorting interest* for a rather long time. The ECB makes use of the fact that there is actually *no legal obstacle against targeted bond purchases*. The ECB Council is not at all legally forced to buy bonds, for instance, according to the economic weight of the issuing countries or to the capital shares at the ECB.

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[3] Note that - in support of the above view - the phasing out of the 12-month tender with full allotment on July 1st did not create larger distortions on the money markets. Moreover the demand for new money via the newly created liquidity-enhancing 1-week and 3-month tender was much less than expected.

[4] In terms of the details of the ECB's bond purchases, some information is released every Tuesday in the ECB's Weekly Financial Statement: http://www.ecb.int/press/pr/wfs/2010/html/index.en.html. Quite consistent with Trichet's characterisation of the programme, it is officially known as the *Securities Markets Programme* (SMP). However, there is no mention of what type of securities are being purchased.

In addition, targeted bond purchases issued by highly indebted euro area governments contain an *element of subsidy* which tends to severely weaken their fiscal discipline: the interest rate premium on bonds of fiscally weaker countries declines and that of stronger countries increases. Fiscally *solid* countries are *punished* and *less solid* ones, in turn, are *rewarded* for their lack of fiscal discipline and excess private *and* public consumption. The credit *risk* is thus just *rolled over* from the bonds of the weaker countries to those of the stronger ones and the ECB is made responsible for their liabilities. This transfer does not at all become more favorable by the fact that it recently came to light that the bond purchase programme essentially was an action of redistribution in favor of a Greek oligarch worth several millions.

These facts and circumstances and especially the general perception that the ECB has become more dependent in political terms but enshrouds this in a huge lack of transparency, appear to be rather uncontroversial (in contrast to the assessment whether this is welcome or not) and, thus, do not have to be investigated further in this report.

2. FINANCIAL INDEPENDENCE OF THE ECB AND THE ESCB?

Surprisingly less focus has been put on the at least as equally important aspect of the slowly *vanishing financial independence* of the ECB. Who will actually have to pay the losses of the purchased private and sovereign bonds, if Greece and Portugal will not be able to serve their debt in the end? Ultimately, the owners of the ECB would be asked to pay up, while by far the largest part will be imposed on Germany. It cannot be excluded that the toxic bonds in the balance sheets of the ECB might eat up most of the reserves and its equity capital if they were to fall in value by a sufficiently large amount – in the worst case, the amount could make up for up to three digit billion euros. In this case, less central bank profits are transferred to the account of the euro area governments – with a given public deficit and level of spending - taxes and duties will inevitably go up. In the extreme case, still more realistic for the Fed and the BoE than for the ECB (Belke 2010), losses exceed the whole equity capital of the ESCB. Euro governments will have to prop up the ECB's capital in order to either strengthen the reserves of the ECB or to even prevent a negative equity capital of the ECB.

In order to re-establish the original structure of the central bank balance sheet, governments can recapitalise the central bank by means of newly printed government bonds indefinitely. One problem emerging in this context is that the „deep long pockets" of the governments are rather deep or finally relatively empty in view of the reported public (let alone private) deficit and debt

figures. By the bond purchases, ownership and the risk of the papers is transferred to the national central banks (NCBs) in the euro area. Should a debt restructuring or debt waivers result, the central banks of the euro area would be affected directly now. Admittedly, the financial system would not be significantly shaken, since the commercial banks would not hold too many "Greek" bonds. But the potentially huge losses would finally be *rolled over* to the European tax payer – through *direct* taxation or *indirect* taxation via inflation (if governments are not willing to bear the income losses and a monetary overhang emerges). Does the ECB really want to follow in the steps of the Fed?

Up to now, a mechanism for recapitalizing the Eurosystem as a whole is not available. Instead, each national fiscal authority stands financially behind its own NCB. In view of the current unorthodox monetary policies, this could be interpreted as a *fiscal vacuum* - a lack of a "fiscal backing" of the ECB and the Eurosystem. This is why the ECB did not engage to a very large extent in outright bond purchases before May 2010, except in the framework of the covered bond purchasing programme. Hence, in combination with the specific and carefully defined accounting principles of repo operations in the euro area including a conservative imposition of haircuts and the vast amount of reserve liabilities of the euro area national central banks, *exactly this vacuum until recently prevented the ominous „tango" of euro area governments with the ECB*.

3. STERILISATION OF ECB BOND PURCHASES

The ECB has decided to *sterilise its bond purchases* - compensating those purchases through sales of other bonds or money market instruments to keep the overall money supply unaffected. This is to counter accusations that the ECB is monetizing government debt. M. Trichet has been keen over the last weeks to point out *that this cannot be regarded as quantitative easing* because there are also some new operations to leave the stock of high powered money in the Euro area constant.

Technically, this works for instance through a tender of *interest-bearing time deposits*, through which banks deposit a certain amount of money for a limited time with the ECB. The ECB actually used this instrument already „in order to signal the markets its counter-inflationary stance". Although the bonds received display significantly higher maturities, the ECB has chosen only a one-week tender – more psychology than synchronous sterilisation? Another

possibility explicitly mentioned by the ECB itself would be the *issuance of own debt certificates* by the ECB itself.[5]

But can we really be sure that the *Securities Markets Programme* (SMP) does not contain important elements of quantitative easing? How waterproof is the envisaged sterilization of bond purchases as a protection against inflationary consequences? And does it target the main problem of unlimited bond purchases – the fact that confidence in the political and financial independence of the ECB is on the brink.

Note that the key aspect of quantitative easing in the UK and US over the past year has been targeted interventions in bond markets to get market interest rates down. This is exactly what the ECB is now doing; so the Securities Markets Programme is *a clear variant of quantitative easing* – let us therefore simply call it *quasi-quantitative easing*. Admittedly, the Securities Markets Programme differs from quantitative easing as practised in the UK and US in terms of extra complications to the ECB programme which were not encountered in the UK or the US case, i.e. that the programme *lacks transparency* and is *politically highly controversial*. For instance, we are not informed about the composition of the debt securities the ECB is buying (the suspicion is that the ECB is coy about identifying which debt is being bought because it is mostly Greek!), the criteria being used to select bonds to purchase, the ECB's bond purchase strategy during periods of primary issuance and how long the program is going to last and how much may be spent.[6] The official reason is that otherwise the SMP would not be effective. But one quite obvious reason we do not have an answer to the last item above is that there are *clear internal disagreements* within the ECB Governing Council on this issue. M. Trichet conceded in a recent interview with Le Monde that the ECB decision to run the SMP was not met unanimously.[7] He added that the ECB decision was taken with "an overwhelming majority" – as opposed to the normally "unanimous decision" which taken by itself is an important sign of *internal divisions* and a *re-nationalisation of monetary policy*.

While conducting her new „*minimum price guarantees*" for sovereign bonds, the ECB does not know exactly how many bonds she will have to buy in order to stabilize the prices of the jeopardized bonds sustainably. To be on the safe side, she will *buy more than necessary*, which

[5] The implementation of exactly this instrument has already been proposed by ECB Board member Bini Smaghi in a different context. For a detailed assessment of the pros and cons of this proposal see Belke (2009).

[6] Whelan (2010) introduces an insightful thought experiment and supposes that the Fed set up a program to buy municipal bonds but would not announce how much came from California or Florida or other states or cities. He asks how long would this survive before members of Congress demanded a full explanation of the program? But that is where we are right now in the euro zone.

[7] See http://www.ecb.europa.eu/press/key/date/2010/html/sp100531_1.en.html.

will tend to *blow up the money stock* to an unnecessarily large extent. In addition, the sterilization measures have been merely promised – except the tenders of a time deposit just to put out a few feelers "to see how it will work"; in fact they are not mandatory. *Conflicts of interest* between the national central banks within the ECB are bound to occur. This is especially so since the process of consolidation in countries such as Greece or Portugal - if it will be successful at all – will need more than half a decade. What is more, a central bank in a country plagued by severe fiscal problems will – as a rule supported by European commercial banks and traders – consistently claim that the market for domestic bonds has dried out and is in dire need of support and movements of markets are "dysfunctional".

What is more, the taking in of deposits under any new program appears to be rather *irrelevant* in the grand scheme of the overall ECB monetary policy stance. The ECB is still *offering loans to an unlimited degree* within the framework of its refinancing programs. Hence, the ECB's sterilisation programme does not appear too relevant for assessing the current determinants of the money supply (among them mainly global excess liquidity which is already vagabonding around the globe but did not unravel due to still small money multipliers). Indeed, the one-year-tender through which the ECB has lent the commercial banks huge amounts of money will run out in July. But at the same time the ECB has announced on May 10 new liquidity-enhancing operations with full allotment whose expansionary effect stands in strong contrast to the announced sterilization.

What is more, the announced measures for sterilising this expansionary monetary policy are *not overall credible*. By issuing own ECB debt certificates, Greek and Portuguese bonds would become even less attractive. These countries would have to offer even higher returns in order to be able to place their issues. But this would clearly counteract the spirit of the most recent rescue package for the euro area. Apart from that, even a successful sterilisation will not smooth things over. If actually used for sterilisation purposes, the issuance of ECB debt certificates would contribute to a *huge transfer of sovereign risk* towards the ECB balance sheets. Offering time deposits to banks contributes to this kind of transfer. Already by the mere fact of bond purchases, the ECB acts like a fiscal agent by taxing other euro area creditors through higher bond rates in order to support a government which finds itself in a financial emergency situation. This is valid again when the ECB collects the money which was already spent for bond purchases. Other euro area creditors are put into a disadvantage because the ECB must offer higher interest rates in order to receive the money back which in turn makes credit more expensive.

However, the claim that interventions through targeted bond purchases restore orderly markets does not seem to be compelling, especially *if governments or the ECB decide upon which market movements are justified and which are not and, hence, which bonds to buy and which not*. For instance, a re-nationalization of euro area monetary policy cannot be excluded insofar as the ECB might well feel inclined to buy Greek sovereign bonds in order to make it possible for French banks which are strongly engaged in Greece to sell their holdings down ("French bias") or to protect German banks with their strong stake in Spain from contagion effects ("German bias").[8] While obviously offending against the general principle of a common monetary policy for the whole euro area, this potential outcome is even more critical because *Greece is obviously not in need of additional access to the capital markets* because it has already been bailed out and does not have to place its issues anymore. De facto, Greece does not even have to worry now how and where its secondary market spreads trade. So Greece is lacking that discipline-enhancing bond spread mechanism. Instead, it will have to closely follow the "will of the Troika" as the Greek press calls the group consisting of the IMF, the ECB and the EU Commission. Unfortunately, this pattern looks like throwing even more good money after bad money.[9]

What is more, the again increasing risk premia in Southern European bond markets clearly convey the impression that the assessment *of the euro area by large investors has changed significantly since the adoption of the rescue package* and the announcement of biting austerity programmes in Greece, Spain, Italy and Portugal. The saving requirements appear so drastic that their successful implementation appears to be nearly impossible and politically risky in political terms at least in the cases of Greece, Portugal and Spain. Hence, investors will have to be able to

[8] Der Spiegel (2010) suggests some French conspiracy. However, not least due to the ECB's secrecy this is yet unproven. See http://www.spiegel.de/international/europe/0,1518,697680,00.html. Generally speaking, executing the SMP can be said to boost the solvency of the core banks which are most exposed to the Greek market. The latter in principle consist of some French banks who could (just) withstand the hit to capital and the German Landesbanken who could not. So some say that effectively it is an ECB bail out of the German banks plus Societe Generale & Credit Agricole. But note also that German banks are not potential sellers, because they have actually made a voluntary commitment to Finance Minister Wolfgang Schäuble to hold their Greek bonds up to May 2013.

[9] It is entirely true that secondary market prices do not directly affect the state of the Greek economy and the budgetary situation of the Greek government right now. One easily accessible impact of the secondary market support of Greek bond prices is to help banks which hold these sovereign bonds and have to mark to market. But it is not as straightforward to see how this is related to M. Trichet's alleged contribution to a sound 'transmission of monetary policy'. A slightly different picture and assessment emerges if one considers press headlines such as "Greek debt hits 14%" which are definitely not supporting the ECB and EU in calming the markets. By aggressively purchasing Greek debt, the ECB strives to kill (and probably is successful in doing so) those who are shorting Greek debt. Moreover, it manages to get rid of headlines addressing unusually high yields. From this perspective, the ECB bond purchases of May 2010 have been an *effective*, *though* in view of some credibility and reputation losses *quite expensive* way for the ECB *to get back control of things* and *to buy some time* for the moment.

assess the euro area countries individually according to their country risk and not as a member of a homogenous block. The main problem which is currently increasing in importance is *that the ECB is currently curbing real returns at the bond markets through its bond purchases*. Just for comparison: in an earlier debt crisis the real 10-year return of Spanish bonds rose to nearly 10 percent. Currently, the real return of Spanish, Portuguese and Italian bonds only amounts to 3 to 3.5 percent. *This is almost certainly not enough to attract private capital these countries are heavily dependent on*. In Spain, the next performance test is expected to be at the end of July when the government has to raise more than 16 billion euro at one dash. Moreover, already on June 18 Spain needed around 8 billion euro for repayment of Spanish bonds with shorter maturities. Hence, the ECB is confronted with the delicate issue of fine-tuning bond yields - which in turn raises additional doubts about its political independence.

4. "STERILIZING" MONETARY POLICY SHOULD TARGET THE ASSET SIDE OF THE CENTRAL BANK BALANCE SHEET

The problem inherent in both sterilization approaches is that they reshuffle only *the liability side* of the ECB's balance sheet. Both approaches are arguably not well-suited to either diminish the bloated ECB balance sheet or to remove the (potentially) toxic covered bonds or sovereign bonds. In addition, the intake of potentially toxic assets as collateral and by outright purchases in the central bank balance sheet artificially keeps the asset prices *up*. A *credible* strategy of sterilization to deal with the consequences of the financial crisis should, thus, deal primarily with the *asset* side of the ECB balance sheet.

5. EFFICIENCY OF THE ECB BOND PURCHASES

It did not come as a surprise that the bond purchases by the ECB turned out to be effective on the markets only on the first days. Only a little bit later, around one week after the announcement of the bond purchases, for instance, the euro plummeted to its fours-years low. Also other indicators of the degree of uncertainty traded at the markets convey the impression that investors do not believe in the sustainability of the "newly designed“ euro area any more – the latter being characterized by a daunting institutional failure to make sovereign default in EMU possible. Instead, markets apprehend that "toxic" government bonds would finally be located on the ECB balance sheet, threatening the long-term stability of the euro. As a result, the European currency fell against most other currencies.

Since the beginning, it appeared doubtful that the instantaneously lower bond spreads really signaled a stepwise increase in confidence in bond markets.[10] Much more likely, the activities of the ECB tend to bias bond prices of peripheral euro area countries and fuel skepticism whether at all and for how long the lower risk premia will sustain. If central banks intervene against the market, i.e. in our case against the fundamentally not devious insolvency of Greece and Portugal, this will according to all experience not go well in most of the cases. In this respect, bond purchases are *akin to foreign exchange market interventions*: the central bank intervenes in one asset class because price formation does not correspond to her view of what is justified and because this distortion threatens to spillover to other markets.[11] The idea that spreads on certain financial instruments taking values higher than the central bank would like, should prompt an intervention which has not, at least until recently, been a standard monetary policy tool.

Consider two cases. Either the ECB will hold the bonds to maturity (as indicated at some occasions) or will sell them earlier. In the first case, the ECB will effectively tax the private sector if the ECB will really strive to diminish its balance sheet. It will have to sell non-sovereign bonds which will be lowering their prices and increase the premia corporations will offer to pay for their bonds.

Imagine the intense political pressures on the ECB at any future point in time when the bonds will have to be resold before their maturities to the markets (the second case), at which point it will become clear that adjustment will still take some time or that the core issues will have not been tackled at all and, hence, the country-specific risk premia will skyrocket again quasi-automatically!

In both cases, it appears rather clear that the ECB will have to capitulate again which, in turn, implies that we have definitely seen the persistent *"exit from the exit" from ultra-loose monetary policies* in the euro area. The danger has risen that the ECB will get caught up in the maelstrom of its role of a lender of last resort. The more bonds the ECB will buy, the more difficult it will be to deny further sovereign financing in the future because doubts on the markets will prevail until an institutional solution of debt restructuring will be installed in the shape of a fiscal agent to be financed by the governments themselves and not through the creation of money.

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[10] Of course, the action taken by the ECB has initially stabilized trade of Greek, Portuguese and Irish bonds. But markets have not become as stable and liquid as before. Liquidity and the supply and demand prices offered at the markets decisively depend on the ECB being "at the table" as a buyer.

[11] Accordingly, it does not come as a surprise that former defenders of FOREX market interventions by the ECB now belong to the defenders of ECB bond purchases and vice versa. See ECB Observer (2004).

The ECB should therefore avoid an „anything goes" monetary policy under all circumstances and keep the episode of deliberate bond purchases as exceptional, brief, targeted and limited in volume as possible. Axel Weber and Mario Draghi, heads of the Bundesbank and the Banca d'Italia and potential candidates for the ECB Presidency have already been publicly calling for a quick end to the bond purchase programme under the SMP.[12] Draghi characterizes the moment for withdrawal as when "the markets spontaneously resume trading of the securities of the countries involved." What kind of action Draghi has in mind if the markets are trading these bonds but only with an eye on the ECB staying in the secondary markets is left rather unclear. Even more worrying is that there is no clear indication as to how the SMP is going to develop over the coming months, especially with respect to increasingly suffering Spain. Just to declare that the SMP will be serving as a bridge until new state financing facilities agreed by the European Union can take over will clearly not be sufficient. Instead, keeping the episode of deliberate bond purchases as brief as possible can be reached best by immediately installing some institutionalized default mechanism like, for instance, a European Monetary Fund (Gros and Mayer, 2010). The ECB itself has recently rather quietly proposed to set up a crisis management institution "vested with the power to purchase government debt securities" of countries in fiscal stress. "Authority to purchase debt securities in the open market would be a guarantee that euro area resources made available to Member States in severe financial difficulties would not be used to bail out private creditors but resources would be used to repurchase bonds at their market prices." which rather closely resembles the European Monetary Fund as proposed by Gros and Mayer (2010).[13] By the same mechanism, the damage in terms of credibility and reputation loss could be limited as well.

6. CONCLUSIONS

Though from another angle, the above analysis supports the view taken, for instance, by Gros and Mayer (2010) that without the immediate installation of any sovereign default mechanism such as a European Monetary Fund, the ECB risks to degenerate to the *'Bad Bank' of the euro area* as timid investors are offloading sovereign bonds with uncertain repayment values on the ECB's balance sheet. Although ever larger rescue packages have been prepared, investors clearly understand that some countries supported by the ECB's *Securities Markets Programme*

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[12] See http://www.bloomberg.com/apps/news?pid=20601068&sid=aRlRfmRIPrRw.
[13] Note that a fund which does exactly what the institution proposed by the ECB could be created without any Treaty change.
See http://www.ecb.europa.eu/pub/pdf/other/reinforcingeconomicgovernanceintheeuroareaen.pdf

(SMP) these days will still have the potential to become insolvent. An increasing degree of *political and financial dependence* of the ECB is the dire consequence. Accordingly, we observed the *exchange rate of the euro declining* over the last weeks *proportionally to the deterioration of the ECB's balance sheet*. Since there are strong signs of perpetuation of the exit from the exit from unorthodox monetary policies in the euro area right now, the *internal* value of the euro will follow and shrink very soon which – in turn – will imply higher inflation in the long run (Belke 2009, 2010a and b, Gros and Mayer 2010).

Recent events have vividly demonstrated that in the absence of a mechanism to manage an orderly sovereign default, adjustment programmes lack credibility and the balance sheet of the ECB is put at risk. Only sovereign funds tend to reveal the true opportunity costs to the initiators. However, if one chooses the way through the ECB and the printing press, the opportunity costs of adjustment programmes wrongly appear to be close to zero.[14] This is especially so if (as in the current case of the SMP) these programmes are *not transparent*.

It has been shown above that the ECB will thus automatically transform into a quasi-fiscal agent of euro area governments in times of crises. If this happens in a surrounding of an ultra-lax monetary policy and low transparency this might damage the reputation and the credibility of the institution already in the medium run.

As an (maybe inferior) alternative to an immediate installation of a European Monetary Fund, the ECB could have contributed to sovereign debt consolidation by *solely accepting* (of course, after a transition period) *bonds* issued by those countries which have introduced *upper bounds to debt levels* as collateral.[15] This proposal á la Martin Feldstein would be a welcome departure from the ECB's current practice to support commercial banks by accepting toxic assets as collateral and to purchase Greek and Portuguese bonds. This is especially so because imposing "debt brakes" and the resulting decrease in the interest to be paid should be in the national self-interest of the respective countries.

Seen on the whole, the most worrisome aspect is that the euro area has stumbled into a perpetuation of unconventional monetary policies by the execution of the SMP. Of course, the intentions are to bail out banks (and not just banks) and governments (to support issuance).

[14] This opportunity cost argument is also a counter-argument against those arguing that the ECB does not risk to suffer in financial terms from holding sovereign bonds because the ECB could agree to get repaid far in the future, say in twenty years or so, if the respective country really goes bankrupt.

[15] That the country could effectively be cut off from the euro area's money market when its government debt is no longer eligible as collateral for the ECB's repo operations again demonstrates the strong enforcement mechanisms the EU disposes of (probably in contrast to the IMF). See Gros and Mayer (2010).

What is *difficult* to see at the moment is *how*, once started, *it can stop*. We have already crashed into near-zero interest rates with no likelihood of escape in the near term (at least not without serious consequence). Hopefully, the ECB has not been *checkmated* by (a) the de facto abandoned Maastricht deficit and debt guidelines (for all euro area countries it would appear) and the emerging illiquidity and insolvency risk, (b) giving in to apparently non-revertable government bond purchases under the pressure of powerful interest groups like European commercial banks and traders associations and (c) the huge degree of available global excess liquidity just waiting to enter the euro area through carry trades as soon as the ECB will venture the exit from its unconventional monetary policies. However, it looks a little bit like that.

In the light of my analysis, I would suggest the members of the EP to ask Jean-Claude Trichet the following key questions in order to get an impression of the potentially huge opportunity costs of the SMP: What exactly is the composition of the sovereign bonds the ECB is buying? Which criteria are applied to select bonds to purchase? How can we characterize the ECB's bond purchase strategy in cases and periods of primary issuance? How long is the SMP going to last and what amounts may be spent? The ECB has been quite (too?) silent about this.

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