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Working Paper No. 710

The European Central Bank and Why Things Are the Way They Are: A Historic Monetary Policy Pivot Point and Moment of (Relative) Clarity

by

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Trend Modus Capital Management

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ABSTRACT

Not since the Great Depression have monetary policy matters and institutions weighed so heavily in commercial, financial, and political arenas. Apart from the eurozone crisis and global monetary policy issues, for nearly two years all else has counted for little more than noise on a relative risk basis.

In major developed economies, a hypermature secular decline in interest rates is pancaking against a hard, roughly zero lower-rate bound (i.e., barring imposition of rather extreme policies such as a tax on cash holdings, which could conceivably drive rates deeply negative). Relentlessly mounting aggregate debt loads are rendering monetary- and fiscal policy-impaired governments and segments of society insolvent and struggling to escape liquidity quicksands and stubbornly low or negative growth and employment trends.

At the center of the current crisis is the European Monetary Union (EMU)—a monetary union lacking fiscal and political integration. Such partial integration limits policy alternatives relative to either full federal integration of member-states or no integration at all. As we have witnessed since spring 2008, this operationally constrained middle ground progressively magnifies economic divergence and political and social discord across member-states.

Given the scale and scope of the eurozone crisis, policy and actions taken (or not taken) by the European Central Bank (ECB) meaningfully impact markets large and small, and ripple with force through every major monetary policy domain. History, for the moment, has rendered the ECB the world's most important monetary policy pivot point.

Since November 2011, the ECB has taken on an arguably *activist* liquidity-provider role relative to private banks (and, in some important measure, indirectly to sovereigns) while maintaining its long-held post as *rhetorical* promoter of staunch fiscal discipline relative to sovereignty-encased “peripheral” states lacking full monetary and fiscal integration. In December 2011, the ECB made clear its intention to inject massive liquidity when faced with crises of scale in future. Already demonstratively disposed toward easing due to conditions on their respective domestic fronts, other major central banks have mobilized since the third quarter of 2011. The collective global central banking policy posture has thus become more homogenized, synchronized, and directionally clear than at any time since early 2009.

Keywords: Eurozone; Monetary Policy; Fiscal Policy; European Central Bank; European Monetary Union; Debt Monetization; Euro; Basel; Sovereign Debt; Credit Default Swaps; Liquidity; Solvency; Deleveraging; LTRO

JEL Classifications: E02, E31, E42, E44, E51, E52, E58, E61, E62, E63, F36, H63

PARTIAL INTEGRATION, INSTITUTIONAL INERTIA, AND CRISIS-DRIVEN POLICY MACHINERY

Political and operational confines defining eurozone monetary and fiscal policy settings have taken on increasing importance since spring 2010.

Relative to major policy matters, the pulling of European Union (EU) institutional levers, at least those not pre-authorized by a stretched interpretation of EU treaty manuals, effectively requires *unanimous* pre-consent of eurozone-17 or EU-27 membership. And many of those consents require approvals of member-parliaments, citizenry, and/or courts. Among the seventeen nations sharing the euro currency, a lack of key federal institutions limits actions that can be taken in important areas.¹

Institutional haves and have-nots	Eurozone-17	United States
Common currency	Yes	Yes
Central bank (interest rate, money supply) authority	Yes	Yes
Federal taxing (revenue-raising) authority	No, state-level	Yes
Federal treasury (borrowing) authority	No, state-level	Yes
Functional federal expenditure (spending) processes	No	Yes (legislative, executive branches)
Direct election of federal-level representatives	partial, limited	Yes

Accordingly, the level of institutional inertia that must be overcome to arrive at material EU policy change is some unknowable multiple of that necessary to make a decision in the most politically dysfunctional of member states. It is a hugely energy-intensive process.²

Consequently, not a single material eurozone policy action can be taken except *following* the arrival of a crisis. For initiatives involving treaty consideration, requisite unanimity is attained only with much arm-twisting and only through crisis.

¹ Major initiatives which fall outside the confines of institutions and processes established through EU treaties generally require new treaties or amendments to existing treaties, and also generally require unanimous consent of member governments (i.e., rather than resolution through existing legislative machinery of the EU). Initiation of EU legislation resides within the purview of the European Commission (one representative appointed by each member-government, confirmed by EU Parliament), which serves as a quasi-executive body. Parliament (754 seats) constitutes the only EU body subject to direct election, and one of two (with the Council) legislative bodies. The 27 representatives to the European Council are generally the heads of state of member governments with population-weighted voting in the chamber. Required approval rates (from simple majority to unanimity) vary across the bodies, by type of legislation and by state of treaty implementation (certain changes are scheduled through 2017).

² Imagine if each material piece of US federal legislation, in addition to congressional approval, required *unanimous* approval of the fifty states, with *each* state having its own protocols and processes for approval (and its own, ever-evolving political agendas).

States possessing *fully*-integrated monetary and fiscal operations have four distinct alternatives for dealing with deficit spending, the first three of which may be used in combination: (1) raise revenue (taxes), (2) cut expenditures, (3) “print” money (monetize debt),³ and (4) default.

But the European Monetary Union (EMU) represents a *partial* federal integration of member states, encompassing only monetary policy, operations, and institutions. The management of fiscal matters, including treasury, budget policy, and operations, remains fragmented and disaggregated, residing within the purview of individual member states. Consequently, the EMU landscape features two distinct federal levels: an EMU level comprising monetary policy, and a member-state level comprising fiscal policy. Potentials for fiscal integration (or even coordination) are limited, due to lack of political integration and wide-ranging dissimilarities across member states.

Consequently, heavily-indebted nations such as Greece lack monetary policy alternatives (debt monetization, no. [3], above) while the EMU lacks authority to impose and enforce fiscal policy (revenue, expenditures—nos. [1] and [2], above) relative to Greece and other member states.

Relative to either *full* EMU-level federal integration or *no* such integration at all, the EMU’s immutably bifurcated monetary and fiscal operations (combined with a lack of EU exit provisions for member-states) fuels risk of extreme divergence in economic fates across individual member states.

A 2-SPEED EUROPE AS ECONOMIC FATES DIVERGE

Prior to 2008, the EMU semi-state led to a narrowing of credit spreads for the less creditworthy of member states, enabling borrowings to massively outpace debt-load capacities engendered by underlying economic growth rate potentials. But as debt-to-capacity imbalances in a monetary policy-constrained Greece were laid bare in April 2010, private lending markets quickly lost appetite for the sovereign’s debt and for debt (and equity) of banks laden with Greek sovereign debt. Eyes quickly turned (and wallets closed) to other highly-leveraged eurozone states. These

³ ... via central bank purchases of outstanding treasury debt, covering interest payments, and/or payment of principal at maturity. Fully federally integrated monetary and fiscal policy and operations (and the full range of policy alternatives) are found, for example, in the US, UK, Japan, Canada, and Australia.

collectively earned the derogatory acronym “PIIGS,” representing Portugal, Ireland, Italy, Greece, and Spain.

Since April 2010, a 2-speed Europe has emerged with stark divergence in treasury yields between northern states (running massive current account surpluses) and “peripheral” states (running correspondingly massive current account deficits)—imbalances in large part enabled for the peripherals during the prior decade simply through “*yield-by-association*” as eurozone members.⁴

Given the maturity of the crisis and the degree of monetary and fiscal policy incapacitation within the eurozone an inescapably brutal debt unwind is underway, bringing with it massive change with mind-numbing speed. Six of seventeen eurozone governments have been felled by the crisis. Major Irish and Franco-Belgian banks given clean bills of health by the European Banking Authority (EBA) at annual physicals (a.k.a. “stress tests”) in July of 2010 and 2011 just one quarter hence suffered violent meltdowns, triggering massive capital infusions by the ECB and the International Monetary Fund (IMF) in the first instance, and Belgian and French governments in the second.

With S&P’s February 27 downgrade of Greek sovereign debt to “selective default,” following the Greek government’s retroactive insertion of collective action clauses (CAC) in documentation covering much of its sovereign debt, Greece’s never-ending bankruptcy saga has entered a new phase. With billions of euros of bonds maturing in the coming weeks, the Greek government made the CAC move amid continued uncertainty regarding “voluntary” participation rates in write-downs among private bank and fund holders of roughly 200 billion euros of Greece’s 360 billion euro sovereign debt. Negotiated NPV “haircuts” to the bonds moved from 21 percent in July, to 50 percent in October and, most recently, to 75 percent (with the nonpublic investor group shouldering *100 percent* of contemplated write-downs). Pressure has grown for public holders (i.e., ECB, IMF, pension funds) to also participate in write-downs to enable a further trimming of Greece’s debt load in the face of continued negative growth.⁵

The ECB had gone to great lengths to characterize the negotiated write-downs as voluntary. A non-voluntary write-down (i.e., default) would be expected to (a) trigger

⁴ Basel II also played a meaningful supporting role in eurozone private-bank uptake of sovereign debt by assigning *zero* risk-weighting to eurozone sovereign debt and *fully* counting it as Tier 1 capital (providing considerable incentive relative to other assets).

⁵ The failure of the ECB and other public holders of Greek sovereign debt to participate equally with private holders in a bond exchange with the Greek government risks precipitating (at least) an implied subordination of private holders across other eurozone sovereign issues (with potentially important market consequences).

significant (and potentially destabilizing) payouts on credit default swaps, (b) preclude additional ECB purchases of Greek sovereign debt or accepting it as collateral, (c) cause realization of significant write-downs on ECB, IMF, and other non-private holdings of Greek debt, and (d) potentially serve as a precedent for the handling of other troubled sovereigns.

It remains to be seen (a) whether the inserted CACs will be invoked by the Greek government to force private holders to accept the “haircut” (this will be a function of private-holder participation rates), (b) whether the 3.2 billion euros of credit default swaps will be triggered and (c) how the ECB will treat collateral in the form of Greek sovereign debt already pledged to it (as well as the banks which pledged the bonds). Much may remain uncertain through the critical date of March 20 when 14 billion euros of Greek sovereign debt matures.

Elsewhere on the periphery problems abound. In February, Portugal (with 10-year treasury yields exceeding 15 percent) indicated need of a 30 billion euro infusion. Budgetary and political tensions have been rising in Spain. Creditor nations increasingly are calling for debtor nations to cede sovereignty on fiscal and budgetary matters in exchange for liquidity injections and debt write-downs.

SOLVENCY REALITIES AND RETHINKING TRANSPARENCY

Swaths of the European sovereign and private banking landscapes are insolvent. The Greek government and major Greek private banks certainly are so. The governments of Spain, Portugal, Ireland, Italy, and non-eurozone EU members such as Hungary there also have “arrived” or are at the brink.

Much of the group of 90+ major European private banking ensemble,⁶ grossly over-ballasted with holdings of distressed sovereign debt, is insolvent but for capital ratio-preserving accounting measures. Allowing the marking of holdings by proprietary internal models or at book, cash-flow, or other measures (e.g. as “risk-free” for eurozone sovereign debt) enabled the masking of current market valuations and risk, and overly-generous, quality-indifferent consideration of sovereign and other debt in capital ratios under Basel II.

And, rather ironically in this post-SarboX world, *opacity is in...* and not only allowable, but facilitated and encouraged by accounting, regulatory, and central banking authorities.

⁶ Major European banks subject to the now thoroughly discredited “stress tests” released in July of 2011 and 2010. Dexia, for example, was the most highly ranked bank in the 2011 test, but collapsed within three months, as did Ireland’s two largest banks following clean grades in the 2010 tests.

Except by way of conduits organized by the ECB (e.g. Long-Term Refinancing Operation [LTRO]), European and global *private* funding markets, not surprisingly, are *entirely* closed to distressed elements of the sovereign, private bank funding, and liquidity needs of the world's largest economic block.

LTROs: THE ECB'S "BAZOOKA" ANALOG

On a single day (December 21, 2012), the ECB dispensed 489 billion euros (approximately 635 billion dollars, a sum exceeding the Fed's *six*-month second round of quantitative easing project) to nearly 500 European banks for a three-year term and a 1 percent borrowing rate in exchange for a liberal assortment of collateral, including distressed debt of peripheral sovereigns (the program was first announced on December 8, 2011). In round two of the unprecedented LTRO program on February 29, 2012, 530 billion euros was disbursed to roughly 800 banks. Between the two operations nearly 500 billion euros of new lending was extended by the ECB (almost 300 billion euros and about 230 billion euros of the first and second rounds, respectively, was related to the rolling of existing ECB loans).

For the troubled periphery, the market impact of the LTRO program has been to reduce yields by roughly half on treasuries having maturities three years and in, in both secondary markets and new-issue auctions. Yields beyond 3s, where banks can't match maturities against the ECB three-year term, generally have remained stubbornly high, at levels rendering debt-servicing loads for the euro-tethered peripherals unsustainable.

The LTRO has provided desperately-needed *liquidity* to a private banking sector facing roughly 700 billion euros in debt maturities in 2012. On the sovereign side, Italy, Spain, and Greece collectively face nearly 600 billion euros of maturities in 2012.

Through liquidity to banks (by accepting otherwise unmarketable debt as collateral), and through liquidity to sovereigns (supporting bond prices via backdoor monetization of new sovereign issues maturing three years and in, with private banks serving as yield-arbitrage intermediaries), ECB intervention appears to have at least slowed the downward spiral within the eurozone. Yet conditions on the ground are evolving rapidly. And risks are emerging and morphing as the continent's economic, social, and political fabric wears thin under relentless heaving and pitching.

FROM BILLIONS TO TRILLIONS: AN EXPLOSION OF SCALE

“In economic policy nowadays, the unthinkable suddenly becomes the inevitable, without pausing for long in the realm of the probable. Nowhere has this been more true than in central banking, where the recent huge expansion in the size of balance sheets would have seemed inconceivable as recently as 4 years ago.”

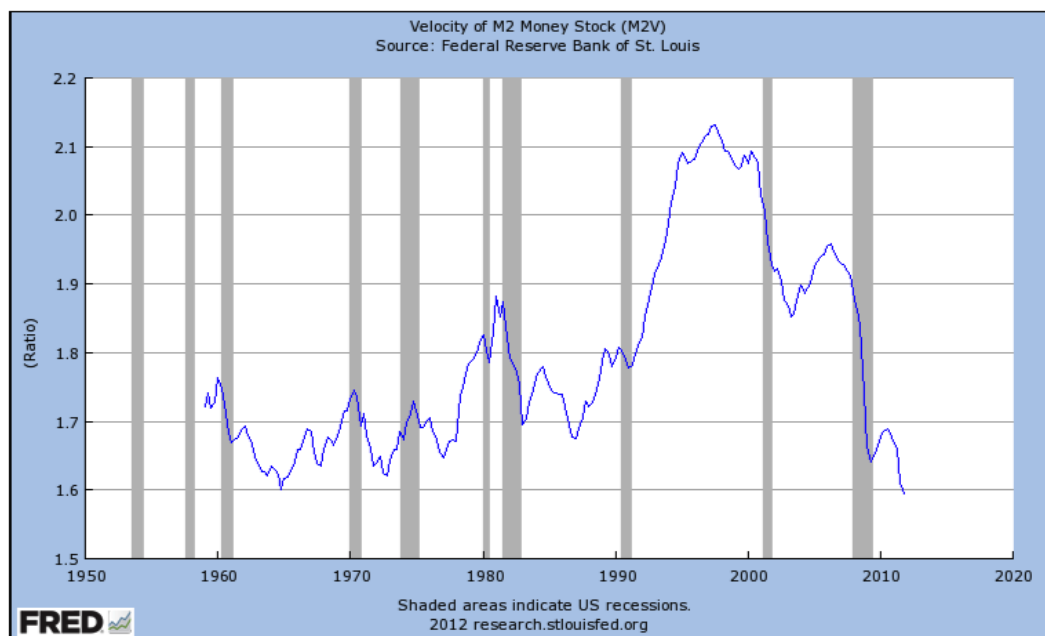
— Gavyn Davies, *Financial Times*⁷

Central bank interventions and treasury operations are taking place globally with breadth and scale not seen since the Great Depression.

Aggregate debt levels in most developed economies have continued to expand throughout the current crisis, even if banking and consumer segments have achieved modest deleveraging through a combination of debt retirement and banking and consumer debt uptake by central banks (via outright debt purchases and expanded secured lending). Given weak GDP, labor market, and tax revenue growth rates in major developed economies, treasury operations generally have expanded to fund increased deficit spending aimed at spurring or sustaining demand and growth.

But following a modest recovery in 2009 and early 2010, money velocity resumed its contractionary course as consumer and commercial lending remained anemic and inter-bank lending, globally, contracted (note that even a flat-lining of aggregate money flows in the face of declining velocity would require an expanding money supply).

⁷ Gavyn Davies, “The Unprecedented Behavior of the Central Banks,” *Financial Times*, January 8, 2012.



With their concerns currently decidedly skewed to deflation risks, central banks have become *primary* (i.e., non-residual) sources of demand for their respective countries' treasury and agency debt, primarily through secondary-market purchases and secured lending. Since February of 2011, the US Federal Reserve Bank, for example, has laid claim to being the largest holder (apart from the Social Security Trust Fund) of US Treasury securities—outpacing China and Japan.

And on November 30, 2011, the Fed reminded the world of its expansionary posture—of its capacity to intervene with massive dollar liquidity and its unflinching willingness to do so through the standing dollar swap facility with other central banks.⁸

Amid new and growing signs of weakness, central banks of the UK, China, Australia, and Brazil all turned 180 degrees in 2011 to monetary easing, especially during the fourth quarter.

⁸ US dollar swaps are dollar-denominated credit lines maintained by the Fed with five central banks (ECB, BoE, BoJ, BoC, SNB) for most of the period since December 2007. Operationally, the Fed lends dollars to other central banks in exchange for the borrower's currency (as collateral) to be repaid in dollars (plus interest). Receiving central banks, in turn, lend dollars to private banks in their jurisdictions. Following revelations last summer (resulting from a Freedom of Information Act petition by Bloomberg) relating to the Fed's hitherto secret 1.2 trillion dollar loan program carried out during the heat of the 2008-2009 crisis, *readers of overt Fed signals have little reason to doubt the Fed's resolve*. On November 30, 2011, the Fed announced a reduction of the borrowing rate for dollar swap lines to 50bps from 100bps, and that the Fed and five other central banks stood ready to assertively utilize the program in a coordinated manner.

Since November of 2011—with a broadening and deepening of the crisis in Europe, and amid signs of waning growth momentum globally—the ECB has dropped any remaining monetary activist hesitations. And now *every* major central bank is mobilized, and globally central banks have now largely shown their hands.

The ECB’s LTRO program represents, in some respects, a massive backdoor form of quantitative easing and a private-banking balance sheet stabilizer. As for the ultimate size of potential interventions on the European continent, 3 trillion euros (3.9 trillion dollars) is now rather a foregone conclusion, and really but a *starting point* for the low end of expectations.

For developed market economies, the method of choice to fiscal expansion flexibility (i.e., public sector liquidity) and private bank liquidity (and operating margins) is through central bank-engineered debt monetization of one form or another. Central banks of developing economies, meanwhile, are relaxing bank reserve requirements and lowering central bank lending rates. Nearly all envision supporting demand through improved export competitiveness via a weaker currency anticipated to result from monetary easing. But mathematically, of course, not all can “win” in the race to the bottom on currency valuation, not all can be lower than the neighbors.

ECB POLICY ORIENTATION: NO LONGER A “RIDDLE WRAPPED IN A MYSTERY INSIDE AN ENIGMA”⁹

Since the first signs of fire on the Greek financial frontier in 2010, eurozone officials have enlisted tortured semantics and disjointed logic in public discourse relating to delicate common currency matters. Certainly much of such dialogue can be attributed to political infighting, shell-shock, crisis fatigue, and confusion. But in calculated and directed discourse, this practice serves two practical purposes: first, the active stretching and contorting of language serves as a means to likewise stretch and contort interpretation of EU treaties and law, thereby facilitating the engagement of a broader range of initiatives by EU institutions; secondly, as does the Fed, ECB and eurozone officials expend a great deal of energy and attention in attempting to shape market perception and market (i.e., asset-pricing) response.

⁹ Partial quote attributed to Winston Churchill, made in reference to the Soviet Union in 1939. The context is, of course, entirely different in its use here, but it does reflect the challenge of distilling a coherent strategy from the wandering rhetoric of EU officials over the past two years.

December 2011 made clear that, concerning liquidity to systemically important banks and banking blocks (and through them, systemically-important sovereigns), the ECB intends to maintain baseline hydration with a level of assertiveness comparable to that which the Fed has demonstrated since late 2008. Prior to December 2011, markets were uncertain on this point. Now they are all but certain on the matter: the liquidity spigot is fully operational, with both the means and will to turn the knob.

But the period since November 2011 has also foreshadowed limits to which the ECB and the supporting global cast will go to maintain the likes of Greece—i.e., those having a relatively (internally) small banking industry and modest GDP footprint and virtually no hope of recovery without a major erasure of debt. *Far more* concerning to the ECB are related banking linkages and risks *ex-Greece*. With Greece now having crossed the default threshold, only the manner of default and knock-on effects remain to be seen.

ADOPTING THE PREVAILING POSTURE AND STEP

The world's four largest sources of debt monetization machinery (the central banks of the US, UK, Japan, and now EU) are now fully operational and fully engaged. Other significant players are similarly disposed. *This wasn't the case six months ago*. The objective held in common is the preservation of global and regional *banking* systems (i.e., *not* securing the fate of any particular troubled sovereign or, GDP-wise, less-than-“significant” group of sovereigns).

With the LTROs, much of the European banking sector, unable to access capital markets otherwise, is in effect becoming a ward (or rather a utility-like functionary) of the ECB. Liquidity is provided by the ECB via 1 percent money, and operating margins, likewise, are provided by the ECB through generous collateral terms enabling banks to arbitrage the lending rate against ownership or purchases of higher-yielding debt.

Without the LTRO and MRO (one-week “Main Refinancing Operations”) programs, much of the banking sector has weakening sources of operating margins and virtually no access to liquidity. Without the LTRO, troubled euro-tethered sovereigns have *zero* prospect of selling debt at sustainable yields. The LTRO more fully equips the ECB to pursue its broader policy

objectives but also to respond, for better or worse, to market dynamics and public sensitivities of the moment (i.e., like the Fed and the market's so-called "Bernanke Put"¹⁰).

A SHARED (IF NOT FULLY-COORDINATED) RESPONSE

Given the reactionary nature and current posture of central banks, and the degree of global banking interdependencies, central bank responses to crises in the near term may be highly contemporaneous and directionally-similar, whether or not they are formally coordinated.

Importantly, though, monetary policy measures are capable of eliciting rather broad, seemingly-indiscriminate and unintended liquidity leakages and responses across assets globally, irrespective of whether they achieve desired price, employment, or other objectives.

Extremes in market volatility and negative performance in capital markets tend to result in heightened attention to monetary policy—and this has certainly been the case since mid-2007. Globally, material downside risk for a range of assets may persist so long as major segments of the banking industry have life-threatening exposure to potentially insolvent sovereigns. It appears, though, that considerable liquidity will likely be brought to bear whenever the edge of a cliff is perceived to draw frightfully near. Major monetary policy makers now have all run through one or more "test" applications of their respective primary policy tools. And most will likely prefer prompt and aggressive application of a liquidity balm to the prospect of gazing (yet again) into the abyss.

But given the scale of current emerging macro dislocations, there is also potential for macro policy of scale to fuel sharp asset rallies and bubbles. Given the precarious positions of numerous sovereigns and significant banking segments, and the highly-reactionary tendencies among major central banks, recurrent and sequential bouts of violent downturns followed by significant liquidity-inspired asset rallies is a distinct possibility in the likely unstable environment of the next 18-36 months. Importantly, in such an environment policy path consistency may prove to be judgmentally, administratively, and politically highly challenging.

With the ECB now fully engaged, and despite a still-plausible and meaningfully "disruptive" Greek default path, near-term concerns regarding risk of imminent calamity propagated from the eurozone may begin to transition to several, no-less-important questions.

¹⁰ ... whereby the Fed, in rather Pavlovian form, is perceived to unleash a wave of liquidity whenever asset prices tumble.

Chief among these will be the implications of *competitive easing* and currency debasement in the global struggle to secure demand, including risks of sharp inflationary pressures on the heels of deflationary struggles associated with the world's largest-ever debt binge and monetary expansion.

In the coming quarters there is likely to be no shortage of political and economic intrigue, market volatility and risk, and price and employment uncertainty. Global monetary policy players have their mitts off and sleeves rolled up on every front, and conditions across sovereigns and banks globally are as strained as they ever have been in the past seventy years.