

# Boundaries of the ECB

IMFS Conf., Frankfurt Nov. 26, 2013

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# “Whatever it takes” --- yes or no?

- 2012: Draghi speech , OMT program
- **Pro arguments:**
  - Independence of ECB
  - ECB prevents or solves crisis
  - One thousand arguments: take your pick
  - multiple equilibria resolution
  - **banking crisis, complexity risk, counterparty risk.**
- **BUT:**
  - ECB is instrument-independ., not goal-independ..
  - Maastricht: fiscal bailouts are not allowed.
  - a pan-European, three-steps away-from-democratic-control ECB needs to take extra care of its bounds.
  - Clean framework is crucial.

2013

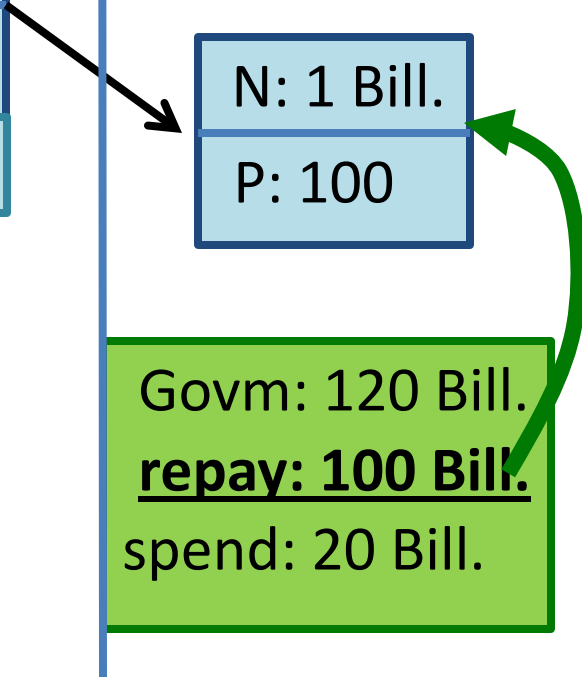
2014

Some country. Outstanding debt in 2013:  
- face value of 100 Billion Euro,  
- issued as N=1 Billion 100-Euro obligations  
Assume: safe rate is 0%. No risk premia.  
P: price/payoff. r: interest rate or yield.

N: 1 Bill.
P: 100
r: 0 %

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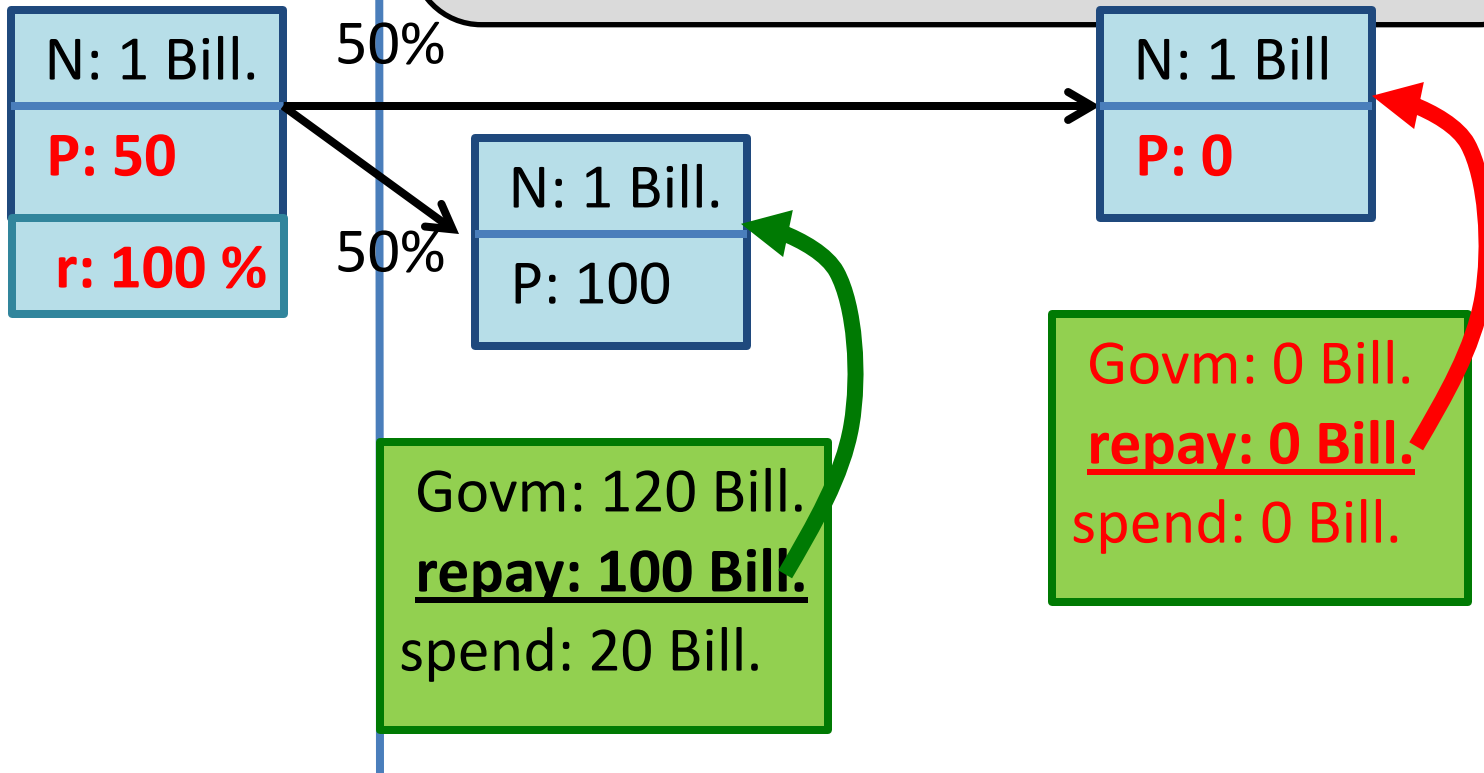
Govm: 120 Bill.
<u>repay: 100 Bill.</u>
spend: 20 Bill.



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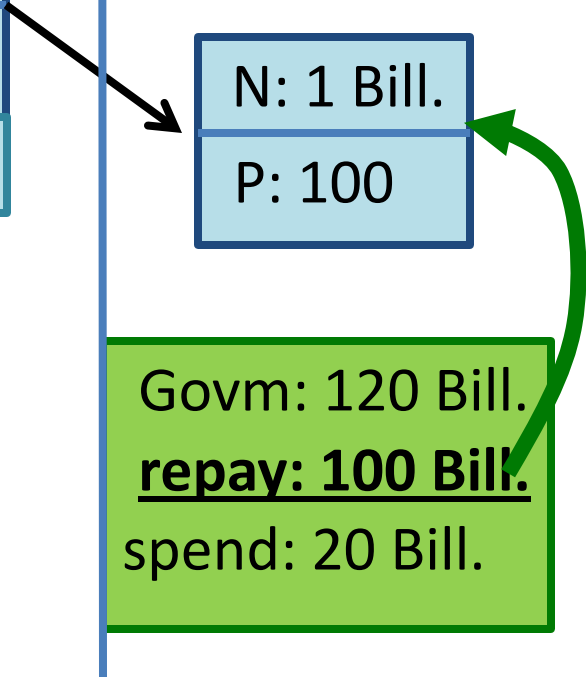
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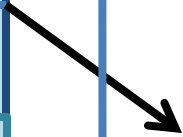
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2013

2014

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P: 100
r: 0 %

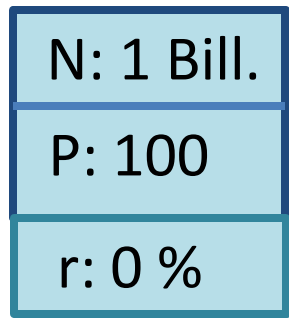


N: 1 Bill.
P: 100

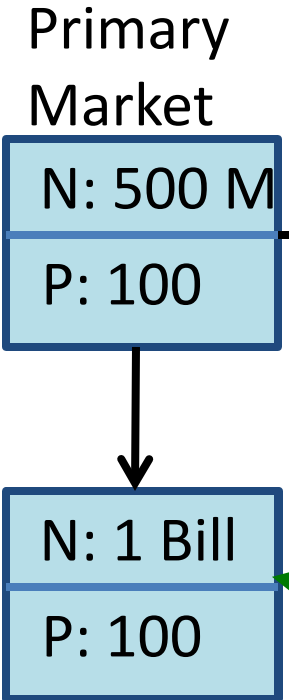


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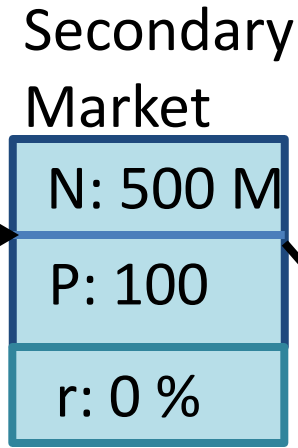
2013



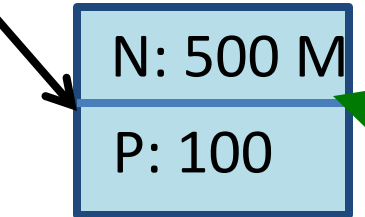
2014



Govm: 70 Bill.  
repay: 50 Bill.  
spend: 20 Bill.

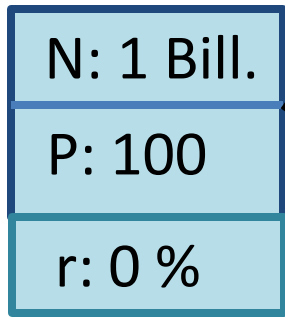


2015



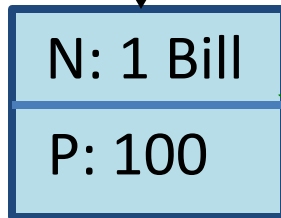
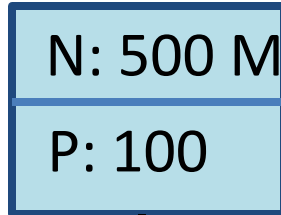
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2013

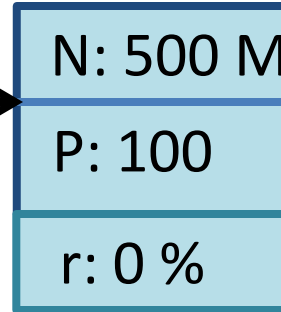


2014

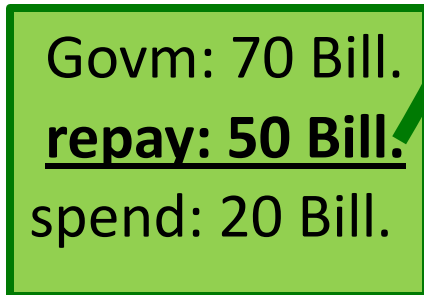
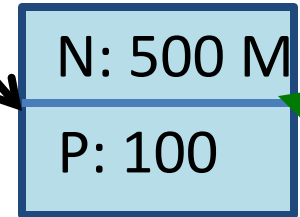
Primary Market



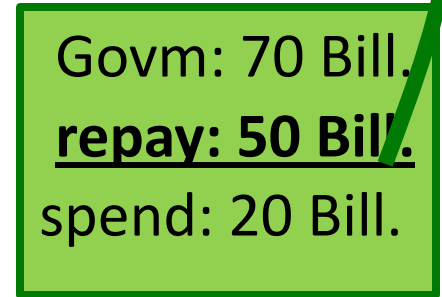
Secondary Market



2015



Regular Scenario

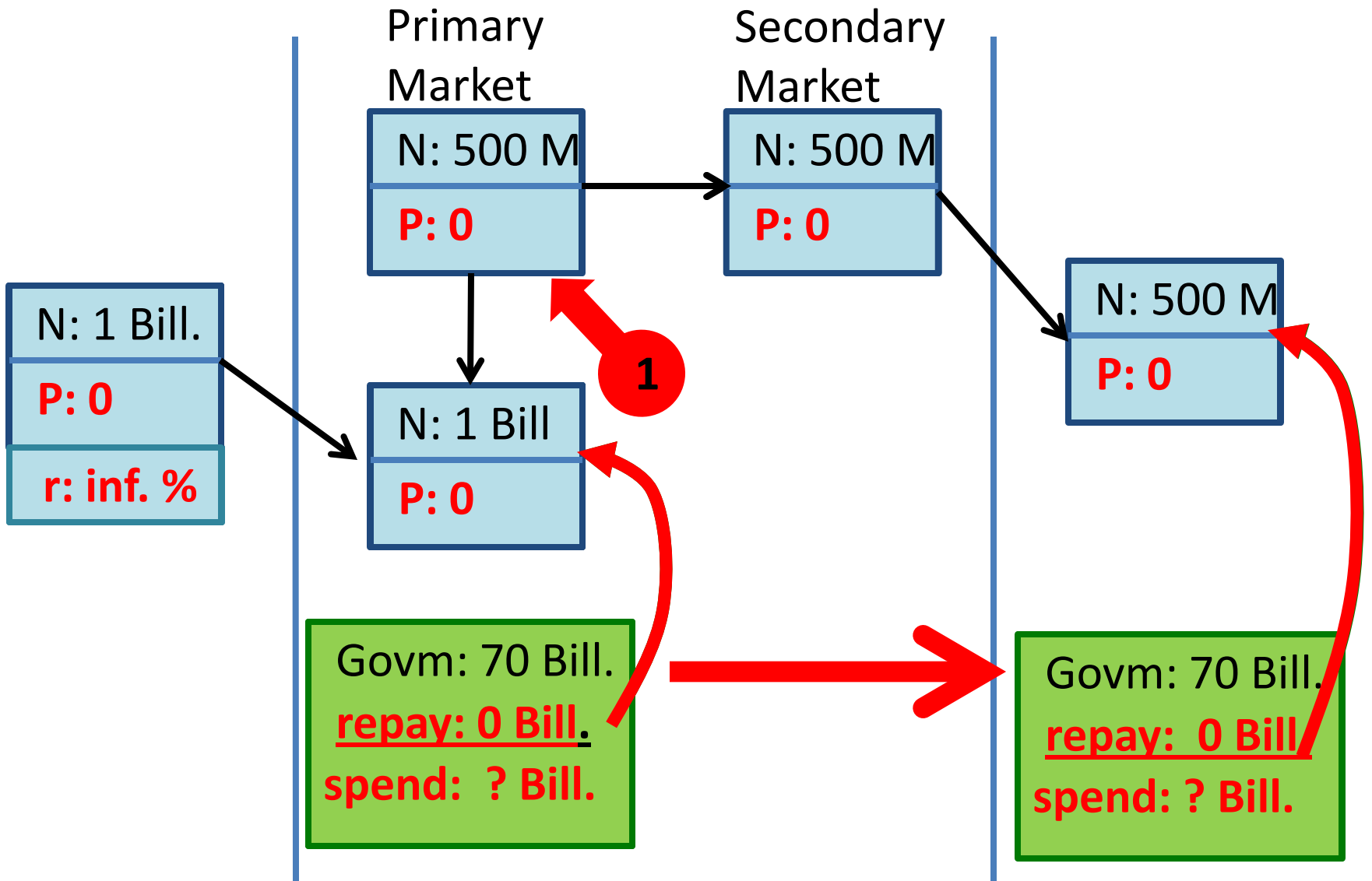




2013

2014

2015





2013

2014

2015

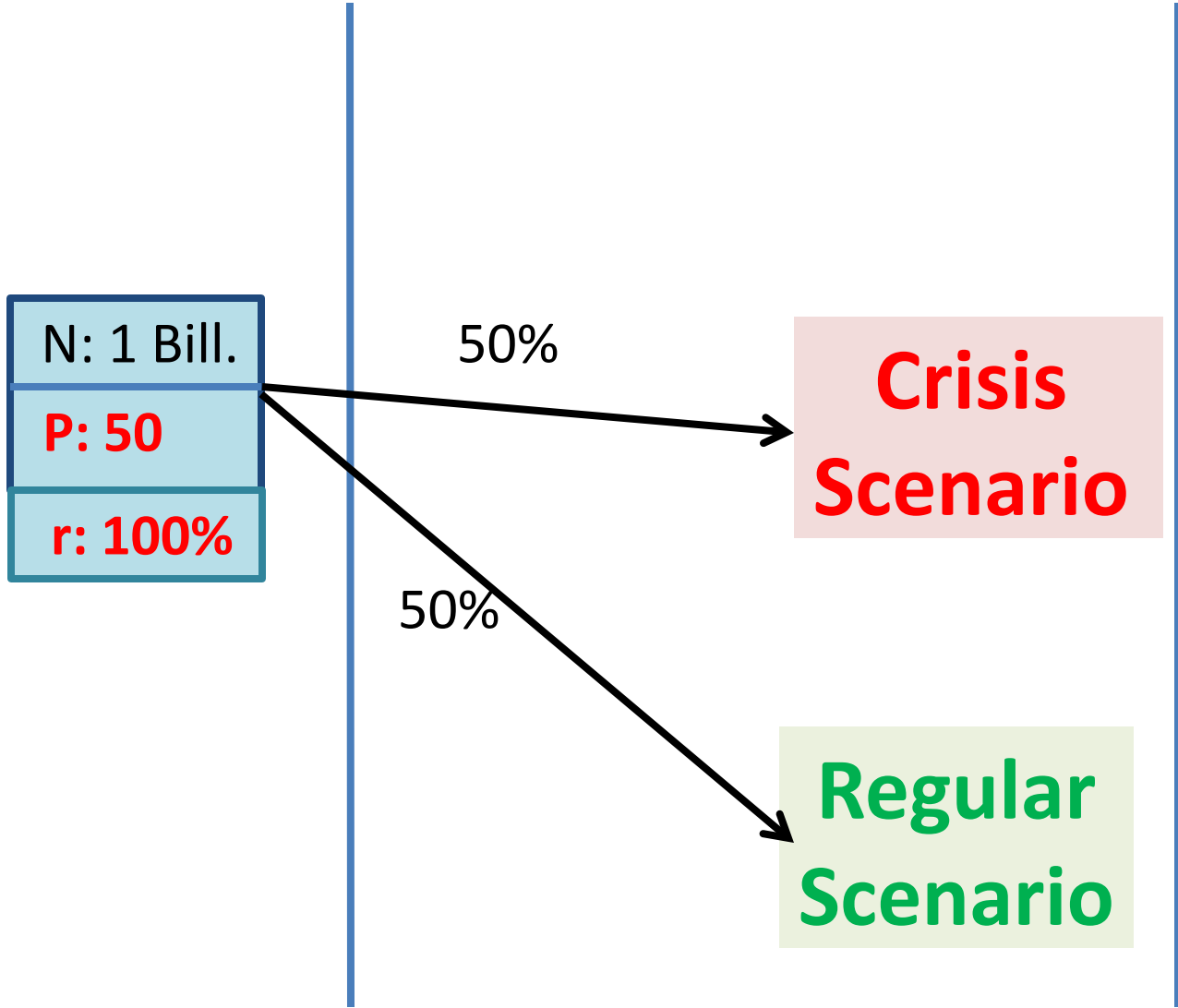
N: 1 Bill.
<b>P: 50</b>
<b>r: 100%</b>

50%

**Crisis Scenario**

50%

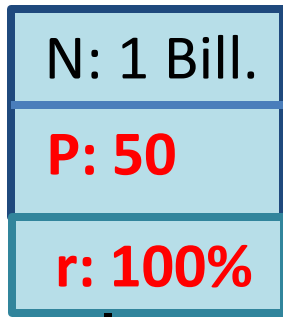
**Regular Scenario**



2013

2014

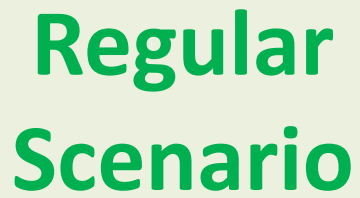
2015



50%



50%





+OMT

2013

2014

2015

ECB: 40 Bill.

N: 1 Bill.  
P: 70  
r: 43 %

50%

Primary Market

N: 500 M  
P: 80

20%

Secondary Market

N: 100 M  
P: 0

80%

Crisis

N: 400 M  
P: 100

N: 500 M  
P: 0

50%

Regular Scenario

Govm: 70 Bill.  
repay: 0 Bill.  
spend: ? Bill.

ECB: 40 Bill.

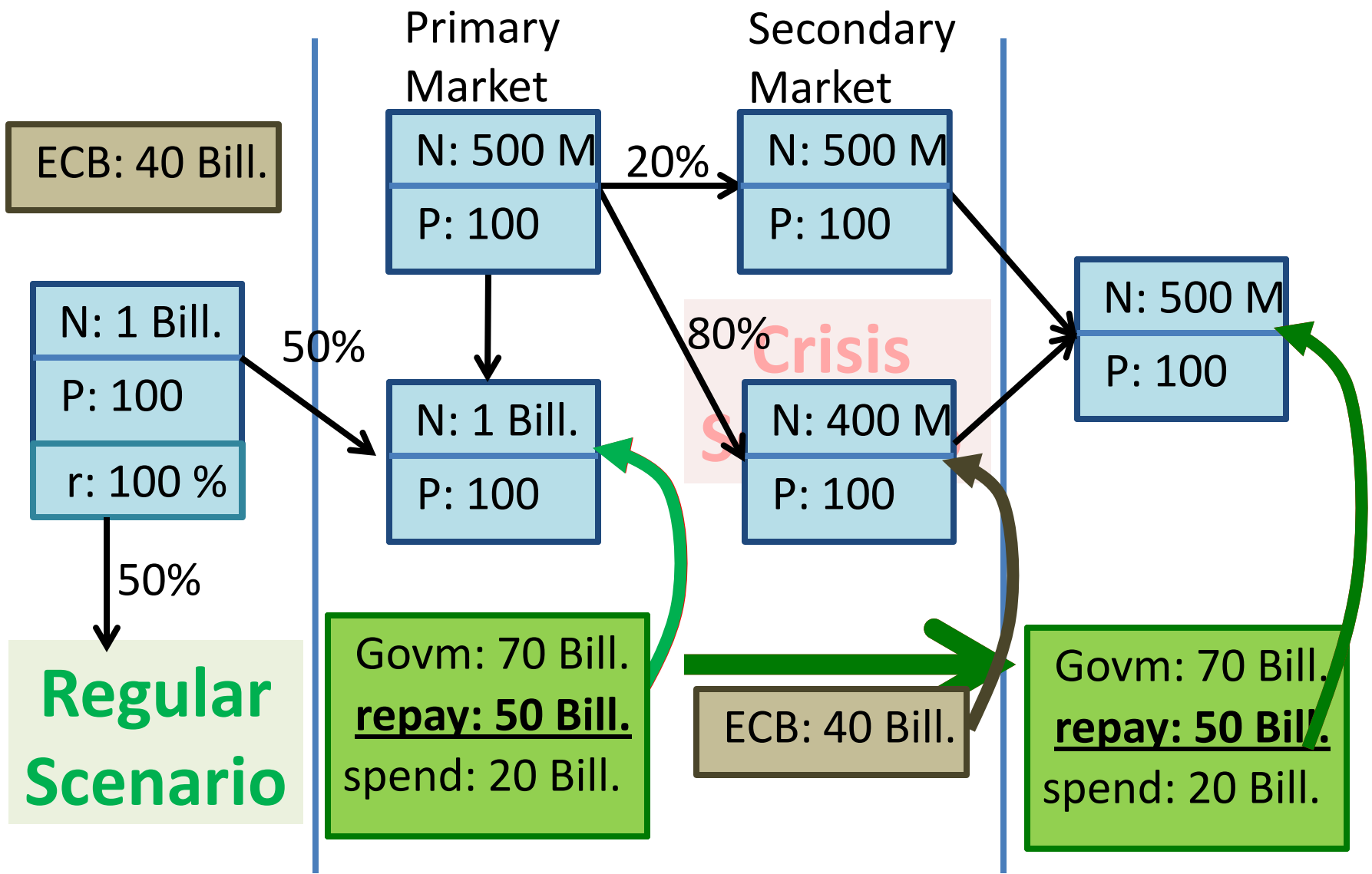
Govm: 70 Bill.  
repay: 0 Bill.  
spend: ? Bill.

**+OMT**

2013

2014

2015



**Regular Scenario**

ECB: 40 Bill.

Govm: 70 Bill.  
repay: 50 Bill.  
spend: 20 Bill.

Govm: 70 Bill.  
repay: 50 Bill.  
spend: 20 Bill.

2013

OMT:  
benign

2014

2015

ECB: 40 Bill.

N: 1 Bill.  
P: 100  
r: 0 %

50%

50%

Regular  
Scenario

Primary  
Market

N: 500 M  
P: 100

N: 1 Bill.  
P: 100

Govm: 70 Bill.  
repay: 50 Bill.  
spend: 20 Bill.

Secondary  
Market

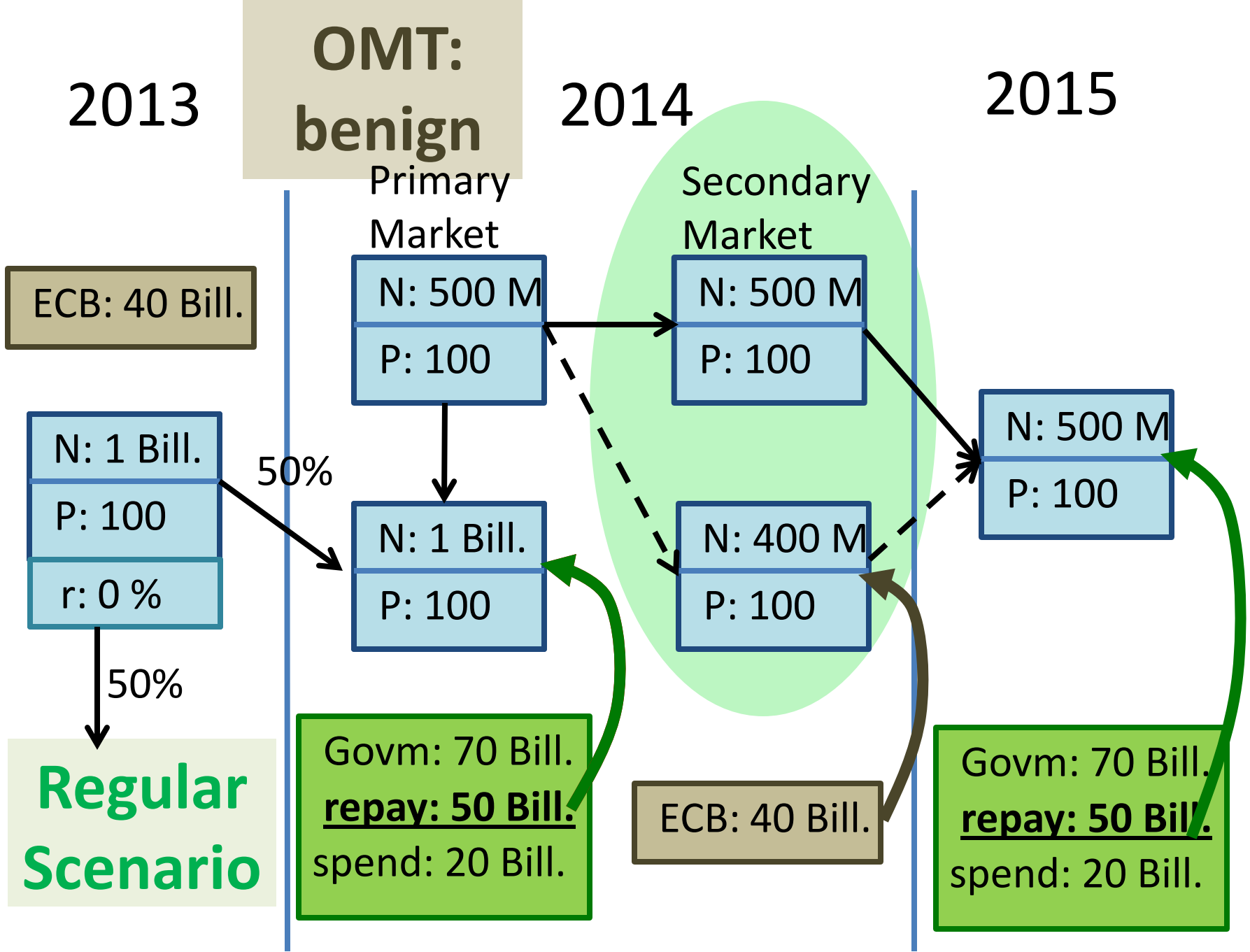
N: 500 M  
P: 100

N: 400 M  
P: 100

ECB: 40 Bill.

N: 500 M  
P: 100

Govm: 70 Bill.  
repay: 50 Bill.  
spend: 20 Bill.





2013

**OMT:  
Bailout**

2014

2015

ECB: 40 Bill.

N: 1 Bill.  
P: 100  
r: 0 %

50%

Primary  
Market

N: 500 M  
P: 80

20%

Secondary  
Market

N: 100 M  
P: 0

80%

N: 1 Bill.  
P: 100

N: 400 M  
P: 100

N: 500 M  
P: 0

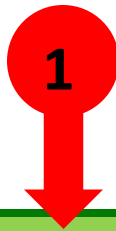
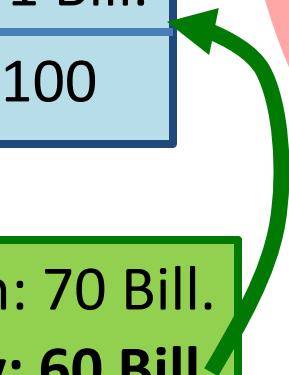
**Regular  
Scenario**

Govm: 70 Bill.  
repay: 60 Bill.  
spend: 10 Bill.

ECB: 40 Bill.

**1**  
Govm: 0 Bill.  
repay: 0 Bill.  
spend: 0 Bill.

50%



2013

**OMT:  
Bailout 2**

2014

2015

ECB: 40 Bill.

N: 1 Bill.  
P: 100  
r: 0 %

50%

Primary  
Market

N: 400 M  
P: 100

N: 1 Bill.  
P: 100

**Regular  
Scenario**

Govm: 70 Bill.  
repay: 60 Bill.  
spend: 10 Bill.

Secondary  
Market

N: 0 M  
P: 0

N: 400 M  
P: 100

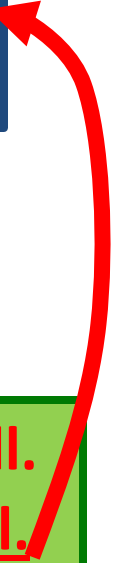
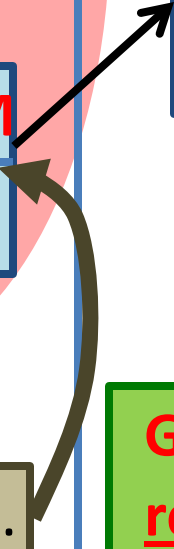
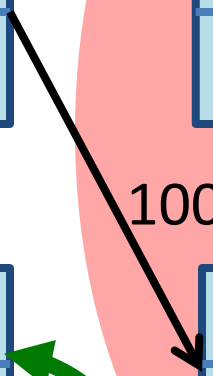
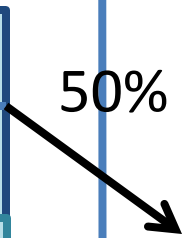
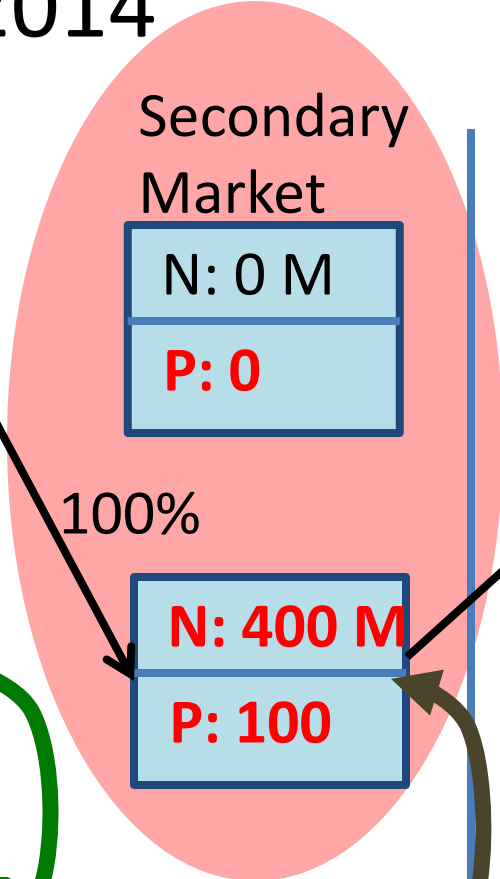
100%

ECB: 40 Bill.

N: 400 M  
P: 0

1

Govm: 0 Bill.  
repay: 0 Bill.  
spend: 0 Bill.



# One thousand arguments

- OMT is great: no purchases, but yields went down!
  - BUT: true in “OMT bailout” in 2013!
- OMT must be about multiple equilibria, since yields went down!
  - BUT: true in “OMT bailout” in 2013!
- ECB only buys short-term bonds!
  - BUT: govt can repay long term bonds with new long-term and short-term bonds, sell short-term bonds to ECB and default on them.
- OMT is good for Europe, good for Germany!
  - BUT: good for all? General economic policy needs democratic control! This is not the task of the ECB.

# Bottom line

- A case can be made pro OMT, in principle ...
  - multiple equilibria resolution
  - European banking crisis, counterparty risk.
- ... but a clean argument is needed.
  - not: one thousand, see which one sticks.
  - need to rule out: fiscal bailouts or “ex-post arguments” to justify arbitrary crisis mode.
- The ECB has so far failed to make a clean case.
- ECB is three steps removed from democracy. Thus, it is crucial that it respects its bounds (“mandate”).
  - “good policy” is not a good defense.