Monetary Policy Responses to the Eurozone Crisis

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Abstract
This article examines the European monetary policy responses to the Eurozone Crisis and the extent of their impact in their general and country-specific context.

Keywords: Eurozone crisis, monetary responses

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1. Introduction

The Eurozone crisis is an on-going financial crisis manifesting itself in the inability of many states to repay their government debt without requiring third parties’ assistance. Some of its multiple factors are the 2007 global financial crisis and its subsequent recession coupled with
sovereign managerial imprudence, and the real estate bubbles combined with high-risk lending and borrowing practices that were present prior to 2008. The effects of these factors were emphasized by the imbalances of international trade and the approaches used by some states to bail out defaulting private agents. Furthermore, the downgrading of many governments' debt in some countries was one of the indicators of the crisis and allegedly one of the fuelling elements. By 2009, the deficit to GDP and the debt to GDP ratios across Europe were at best critical and at worst unsustainable, as described in Figure 1.

Figure 1: Budget Deficit and Public Debt to GDP

![Figure 1: Budget Deficit and Public Debt to GDP](source: Eurostat (2011))

2. Monetary Responses in General

The impact of fiscal measures was dampened by the absence of a European fiscal union or even the harmonisations in fiscal policies within the Eurozone, and while austerity measures raised efficiency concerns among economists on one hand and public dissatisfaction and protests on the other, central banks were nonetheless accommodating fiscal responses with monetary policy measures. These measures were carried out by the European central bank while supposedly respecting the inflation objective, the independency criteria, and remaining outside the scope of
quasi-fiscal operations in order to avoid blurring the boundaries between monetary and fiscal policies.

2.1. Interest Rate
The price development objective of the European Central Bank (ECB) was monitored through interest rates, wage and price settings, and supply and demand in goods and labour markets. Long term interest rates and asset prices were set despite the interest rate channel witnessing impairment when it reached the zero lower bound level, which in turn made the process of refinancing less easy. The evolution of long-term interest rates from October 2009 to December 2012 can be viewed in Figure 2 below, and with the exceptions of Greece, Portugal, and Ireland, interest rates remained between 1% and 6% during this period. Ultimately, with marginal lending and deposit rates falling to around 2% and 0% respectively, and the European Central Bank resorted mostly to credit supply.

![Figure 2: Long Term Interest Rates](Source: European Central Bank (2011))

2.2. Liquidity
The European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM) were established as support measures, and were announced in September 6th, 2012 to provide “free unlimited support” for all Eurozone countries included into one of the sovereign state...
bailout or precautionary programs. In its inaugural benchmark issue in January 25th, 2011, the EFSF issued five billion euros of five-year bonds, attracting an order book of 44.5 billion euros, which is 24.5 billion euros more than the EFSM and a record for any sovereign bond in Europe. The role of the liquidity channel lied in the credit supply operations, e.g. accommodating the liquidity at a fixed rate, extending the range of maturities for open market operations up to one year, the provision of liquidity denominated in foreign currencies, and outright purchases of covered bonds. In this respect, the ECB provided more than one trillion euros to sustain money flows between European banks. Another notable measure was the introduction of three-year maturity Long Term Refinancing Operations (LTROs).

 Particularly, the covered bond market represented a primary source of funding for banks in large parts of the euro area and constituted the largest and most active segment of the fixed income market alongside the public sector bond market, where the long-term debt securities, such as the ‘Pfandbriefe’ in Germany and ‘Obligations Foncières’ in France, are issued by banks to refinance loans to the public and private sectors. Hence, sector-specific measures included the covered bond purchase program consisting in the Eurosystem gradually purchasing covered bonds, denominated in euro and issued in the euro area, for a total of 60 billion euros between June 2009 and June 2010. The objective was to influence the prices of financial assets provided that they are imperfect substitutes both for other financial assets and for central bank reserves. The size of the program embodied only around 2.5% of the total amount of covered bonds, but in the given context was an effective catalyst to restart the market.

 Moreover, the ECB pursued a so-called qualitative easing monetary policy that extended its list of assets accepted as collateral to a wider range of securities of which the total value was worth 12.2 trillion euros in 2009. This amounted to 86% of all debt securities issued in euros and to 130% of the euro area GDP. Among the overall amount of securities accepted as collateral by the ECB, government securities accounted for 44% of their nominal value and private securities accounted to
66%. This vast eligibility of collateral had a strong effect in easing the banks’ liquidity constraints during the crisis.

To evaluate the differences between the European Central Bank, the Bank of England and the Federal Reserve, an indicator that could be used is the purchases of securities relative to GDP. And as Figure 3 shows, the European share was more or less one fifth of the Federal Reserve’s purchases, with a peak of 3% of the GDP compared to almost 18% in the United States.

Additionally, the ECB’s approach with the Eurozone crisis was slightly different than the Federal Reserve’s approach in dealing with the United States 2007 crisis. While the latter engaged in directly buying debts issued by the nonbanking sector such as government bonds, government mortgage agencies, and occasionally portfolios of long-term bonds or loans including toxic assets, thus in effect bypassing the banking system, the ECB has taken the opposite path, privileging the funding reinforcement of financial intermediates, thus reflecting the tendency to have a more intermediated banking sector in Europe compared to the United States. On a side note, even though the ECB has conducted quantitative easing operations to increase its monetary base when deemed necessary,
the references to quantitative easing mechanisms being similar to those conducted by the Federal Reserve may not be entirely accurate, mainly because the Federal Reserve’s purchases of government bonds on secondary market remained within the quantitative limits set by monetary policy goals. In other words, the purchases were neither “unlimited” nor “unconditional”.

Overall, the measures implemented by the Eurosystem in response to the financial crisis helped to sustain financial intermediation in the euro area and in turn credit availability for private agents. Nevertheless, some of these measures could undermine the ECB’s reputation as “the truly independent central bank” which, in turn, could negatively influence the stability of the Euro. Furthermore, potential inflationary and fiscal consequences may occur, undermining cross-country political consensus around the common currency. This was already witnessed during what is referred to as the “Grexit” and through other electoral programs for multiple parties throughout Europe. Some of these measures could also create wrong incentives for private investors, in the sense that those who did not hesitate to accept higher risk in exchange for higher yields ended up receiving free risk insurance. It should be also noted that the increasing involvement of the ECB in various segments of financial markets could crowd out the involvement of the private sector, making interbank lending decrease in favour of ECB-related refinancing. And last but not least there is a risk that large-scale market interventions of the ECB, especially the LTROs, could lead to reducing cross-country lending exposures in favour of in-country lending.

3. Country-specific Monetary Responses
Aside from responses targeting European financial markets in general, the European Central Bank and Other Organisations adopted country-specific measures in an attempt to diminish the impacts of the downturn and to steer the economic activity to its trend.

3.1. Greece
Greece had the highest government debt among its European neighbours and the European Commission (EC), the International Monetary Fund (IMF), and the European Central Bank (ECB),
provided a series of loans in return for austerity packages. Additionally, the Troika pursued debt restructuring measures through agreements with private holders of Greek debt, making them accept a bond swap with a 53.5% nominal write-off, partly with fresh Greek bonds with lower interest rate and an 11 to 30 years maturity and partly in short-term EFSF notes. This represented the most substantial debt restructuring operation ever done so far, hence allowing the Greek debt to diminish by around 110 billion euros.

3.2. Ireland
The sovereign debt crisis was mostly due to the state guaranteeing the six main Irish-based banks which had financed a property bubble. With the banks defaulting, the economy collapsed causing a rise in unemployment to around 14% in 2010 and in the national budget deficit to 32% of the GDP, despite various austerity measures.

The Eurogroup reduced the interest rates paid by Ireland by almost half of their value and doubled the loan deadline to 15 years, furthermore the EC cut the interest rates coming from the EFSM down to 2.59%, virtually making Ireland pay back 0% in nominal as this rate is the same the European Union (EU) itself borrows at from financial markets.

3.3. Portugal
The Portuguese case was the manifestation of the Public Choice Theory as the overspending of past government was burdened to the subsequent ones, eventually resulting in a crisis. The IMF and the EU contributed with a 78 Billion Euros bailout package in 2011, and Portugal is expected to benefit from other interventions by the ECB in the form of yield-lowering bond purchases as soon as it regains complete access to financial markets, forecasted in September 2013.

3.4. Spain
Despite the relatively low Debt to GDP rations, bank bailouts and economic downturn led to a downgrade in the Spanish credit rating. This resulted in Spain’s 10-year bonds to face market difficulties, as they were being required to yield high interest rates for investors. Spain later received a financial support package of 100 billion euros through the then-created fund responsible for
recapitalization, which will however make the package appear as an additional sovereign debt in Spain’s national account. Additionally the ECB announced an “unlimited bond-buying plan” to be initiated if Spain signs a new sovereign bailout package with the EFSF and the EFSM.

4. Conclusion

Even though sovereign debt was very high only in a few countries accounting for less than 10% of the Eurozone’s GDP it has led to risks of contagion and even speculations about a possible breakup of the Euro zone. The country-specific shocks, such as the Greek current account and fiscal imbalances, and the credit booms and banking crises in Ireland and Spain, have deepened asymmetries between the different countries of the Eurozone. These asymmetries were furthered by disproportionate fiscal policy responses and a highly fragmented labour-market, mostly due to divergent labour-related institutional frameworks. All these factors and others made the outside lags take much time, eventually intensifying the GDP variations across Europe as depicted in Figure 4. And as it can be noticed, while the dispersion among the states composing the United States of America actually declined in 2008 and with a lesser rate in 2009, then started rising in 2010 to regain its 2007 level, the intra-European dispersion has been rising with more or less the same upward slope. In 2011, while the US dispersion was plummeting by around 0.7%, the Eurozone’s dispersion rose by more than 2%.

Figure 4: Coefficient of Variation of GDP across US States and Eurozone Countries
The monetary policy was relatively fruitful mostly due to the implementation of unconventional measures sustaining the credit flow and the proper financing of the economy; however more fiscal integration is vital if not compulsory for the future of the Eurozone. In a final, slightly less economic, off-topic side note, the Friedman’s aversion to macroeconomic stabilisation policies could be a valid approach when it comes to some countries, probably less for risks of overshooting and altering the market nature but for a somewhat Darwinist purpose: Some stars in the European flag may bring inefficient drawbacks to the whole Eurozone. For the euro to survive and challenge the dollar as the first reserve currency, more intra-European prioritisation could only be beneficial.

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