Jörg Asmussen: Introductory statement by the ECB in the proceedings before the Federal Constitutional Court

Introductory statement by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, in the proceedings before the Federal Constitutional Court, Karlsruhe, 11 June 2013.

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Mr President,

Members of the Federal Constitutional Court,

Introduction

The Federal Constitutional Court has invited the European Central Bank to comment on its monetary policy mandate, and particularly the decision taken by the Governing Council of the ECB in respect of the bond-buying programme, Outright Monetary Transactions (OMTs).

My aim is to demonstrate that our measures were necessary, that they are effective, and that they fall within the mandate of the ECB.

I will confine myself to the most important aspects of our written statement, looking in particular at two aspects – the "scope of monetary policy" and the "possible consequences of the ECB's measures for national budgets" – as specifically requested by the rapporteur for today's oral proceedings.

The necessity and effectiveness of the ECB's actions

Let me first briefly explain why the European Central Bank opted for the OMT programme.

The need for monetary policy operations

In order to understand the need for our monetary policy measures, it is important to be aware of the economic environment that we faced last summer.

Fears of an involuntary break-up of the single currency led to severe tensions in the capital markets. At the heart of those distortions lay turmoil in the government bond market – the largest capital market in the euro area. The government bond market is extremely important for price formation in other capital market sectors – for bank and corporate bonds, for example. Spreads between the yields on the government bonds of euro area countries increased to levels that, in a number of cases, significantly exceeded those justified by fundamentals.

Yields on Spanish and Italian ten-year government bonds incorporated premia of more than 6 and 5 percentage points respectively relative to German government bonds. Even at the short end of the yield curve, distortions could be observed: in July 2012 the yields on Spanish and Italian two-year government bonds peaked at 6.6% and 5.1% respectively, while the ECB's main refinancing rate was 0.75% at that time.

Those spreads could, in part, be attributed to concerns by market participants regarding the sustainability of public finances. Fiscal reasons alone did not provide a full explanation, however, because the rapid rise in spreads in the first half of 2012 was not accompanied by an equivalent deterioration in those countries' fundamentals. At the same time, there was an acute risk that contagion would affect other euro area countries, pointing to systemic risks that were not limited to specific countries.

A key factor driving those developments was fears in the markets regarding an involuntary break-up of the euro area – i.e. fears concerning the "reversibility of the euro" and the associated implicit exchange rate risk. This view was supported by model calculations which showed that, in July 2012, the spread that could not be attributed to fundamentals stood at up to 2 percentage points for Italian and Spanish two-year government bonds.

There were also signs that international firms were hedging against the risk of individual Member States leaving the euro area. Britain's financial supervision authorities were advising financial institutions to be prepared in the event of the euro area collapsing.

Moreover, Spanish and Italian banks lost their access to market-based financing instruments. Between April and July 2012 Spanish bank bonds to the value of €36 billion matured, but no more than €0.5 billion of Spanish bank bonds could be newly issued during that period.

Against that background, we had to conclude that, in individual parts of the euro area, the steering of monetary policy was not functioning fully, or was in part not functioning at all. The key interest rate had lost its key function, with considerable disruption of the transmission of monetary policy on account of the implicit exchange rate risk.

This economic environment clearly pointed to a significant credit crunch and a severe decline in economic activity. There was a risk of an incipient deflationary spiral – a process involving continual declines in prices. Price stability would then no longer have been ensured across the euro area. We in the Governing Council of the ECB discussed and debated at length the issue of what the European Central Bank should and had to do in such a situation in order to fulfil its tasks and responsibilities.

Effective action

The instrument being considered had to be effective, in order to eliminate the unfounded fears regarding the reversibility of Monetary Union and the resulting interference with our monetary policy mandate. In setting up the OMT programme, we learnt from our experience with the first bond buying programme from 2010 – the Securities Markets Programme (SMP) – and made the OMTs even more targeted. The OMT programme differs from the SMP in the following ways.

First, there is strict conditionality because the OMTs are attached to a European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme, thereby ensuring that the Member States concerned remain under considerable pressure to implement reforms and maintain fiscal discipline. The OMT programme seeks only to reduce unwarranted interest rate spikes. I would like to make it very clear at this point that the OMT programme was not aimed at harmonising the financing conditions of the Member States. The market mechanism will continue to operate.

Another important point in this regard is that an EFSF/ESM programme is a necessary – but not a sufficient – condition for OMTs. There is no automatic follow-on. The Governing Council of the ECB will decide independently in each individual case, looking exclusively at the necessity of OMTs from a monetary policy perspective.

Second, our OMT programme is limited to the short end of the yield curve – i.e. to maturities of between one and three years – as the Eurosystem's other monetary policy instruments have also traditionally been aimed at this period.

The third distinction between the OMTs and the SMP is the transparency of our actions, through the publication of relevant information on OMT interventions.

A fourth way in which the programmes differ from one another is that, under the OMT programme, we are not only able to buy government bonds, but also to sell them again, and their valuation is based on market prices rather than on final maturity.

Fifth, we announced that our OMT interventions would be ex ante "unlimited". We have no doubt that this strong signal was required in order to convince market participants of our seriousness and decisiveness in pursuing the objective of price stability. At the same time, however, the design of OMTs makes it clear to everyone that the programme is effectively limited, for one by the restriction to the shorter part of the yield curve and the resulting limited pool of bonds which may actually be purchased.

OMTs – in the event that they are conducted – will not give rise to any inflationary risks. For every euro that the Eurosystem spends on government bonds, one euro will be withdrawn from the money supply in the euro area. We already did the same successfully under the SMP, which has now come to an end.

Barely a year after the announcement of OMTs, the positive effects are obvious, and this development has certainly also been enabled by the reform efforts as a whole.

First, banks and firms regained access to the capital market.

Second, the spread between the yields on Spanish and German ten-year government bonds fell from more than 6 percentage points in July 2012 to just under 3 percentage points in May 2013. At the same time, the premium on Italian bond yields was halved, down from more than 5 percentage points. One further sign of the normalisation of developments – one that is important for German savers – is the fact that yields on German government bonds increased by around one-quarter of a percentage point over the same period.

Third, TARGET balances – which are an important indicator of fragmentation within the euro area – have declined noticeably. They are down by €285 billion – around 25% – compared with their peak in 2012, so they are now back at the level observed at the end of 2011.

In conclusion, we can see that the announcement of OMTs significantly contributed to the stabilisation of the situation. Firms, banks and households throughout the euro area benefited from this measure. Destructive extreme scenarios were ruled out and the damaged transmission mechanism was, to a certain extent, repaired.

Scope of monetary policy and acting within the ECB's mandate

I will now come to the first of two points to which the rapporteur has requested we pay particular attention: the "scope of monetary policy". This includes the question of whether we are acting within our mandate.

Our mandate is clearly formulated in Article 127 of the Treaty on the Functioning of the European Union: to maintain price stability.

According to primary EU law, the ECB and the national central banks of the Eurosystem are already permitted to purchase government bonds in the financial markets in the context of their monetary policy tasks (Article 18.1 of the Statute of the European System of Central Banks and of the European Central Bank).

While the Treaty clearly states the objective the ECB has to pursue, it describes just as clearly what the ECB is not allowed to do.

Article 123 of the Treaty prohibits monetary financing. In particular, we are not allowed to buy any government bonds directly, i.e. on the primary market. Government bonds can only be purchased if they are already on the market and traded freely. The market mechanism – the basic principle Member States have to follow to finance themselves independently – should apply.

We therefore also interpret the prohibition of monetary financing as being comprehensive insofar as ways to circumvent it are addressed. It is not possible to purchase newly issued government bonds at certain times. Furthermore, the central banks of the Eurosystem observe the issuing behaviour of Member States, banks and market players for signs of collusion. If, for example, a country were to convert all its bond issues to a short maturity (of up to three years), we would react.

Possible consequences of the ECB's measures for national budgets

The rapporteur has also asked us to address the possible consequences of our measures for national budgets.

Of course, conducting monetary policy will always be associated with risks. For this reason, central banks hold capital and set aside funds for provisions and reserves as a pre-caution. This adds to their financial independence.

In view of the expansion in balance sheets in previous years and the added risks associated with this, the central banks of the Eurosystem have further strengthened their financial buffers. By the end of 2012, funds for provisions had increased to €56.5 billion and those for reserves to €76.6 billion.

The Eurosystem is obliged to keep financial risks under control as best it can. The institutional framework for OMTs is therefore designed in such a way that risks for the Eurosystem are manageable and controllable, for example through the aforementioned orientation of the programme towards short-term maturities.

The risks associated with OMTs would materialise only if a Member State operated un-sound policies and failed to service its debt.

Put simply, the mechanism according to which losses go into the profit and loss account applies to both the ECB and the national central banks. If a net loss remains even after taking into account all provisions and reserves, it could be recorded on the balance sheet as losses carried forward and be offset by any net income in the following years.

It is important that it is understood from the principle of financial independence that a central bank needs to be adequately capitalised in the long term. But in no way does it follow from this that all losses carried forward would have to be offset immediately and in full by the capital holders or Member States.

Conclusion

To conclude, I would like to summarise my arguments.

The announcement of OMTs was and is the necessary and appropriate step to eliminate the disruption in the transmission of monetary policy caused by concerns that there would be an unwanted break-up of the euro. The risks of not acting would have been greater.

The ECB and its decision-makers are aware of the limits of its monetary policy mandate. Our measures are aimed at maintaining monetary policy transmission and preventing an unwanted break-up of the euro. It is not allowed to, is not able to and does not want to replace the actions of democratically elected governments. Quite the opposite. The OMT programme is therefore aimed at protecting the market mechanism so as to urge the Member States to make the necessary reforms.

The ECB will decide completely independently – on the basis of its own assessment of the situation – when and whether to intervene on the secondary market for government bonds for monetary policy reasons.

Not only do the framework conditions set by the Governing Council of the ECB for OMTs ensure that the ECB acts within its monetary policy mandate, they also ensure compliance with EU law, particularly the prohibition of monetary financing.

I am firmly convinced that introducing the OMT programme was the right thing to do to ensure price stability in the euro area. After all, a currency can only be stable if its continued existence is not in doubt.

I am now at your disposal for questions.