Box 1

## MONETARY POLICY MEASURES DECIDED BY THE GOVERNING COUNCIL ON 6 SEPTEMBER 2012

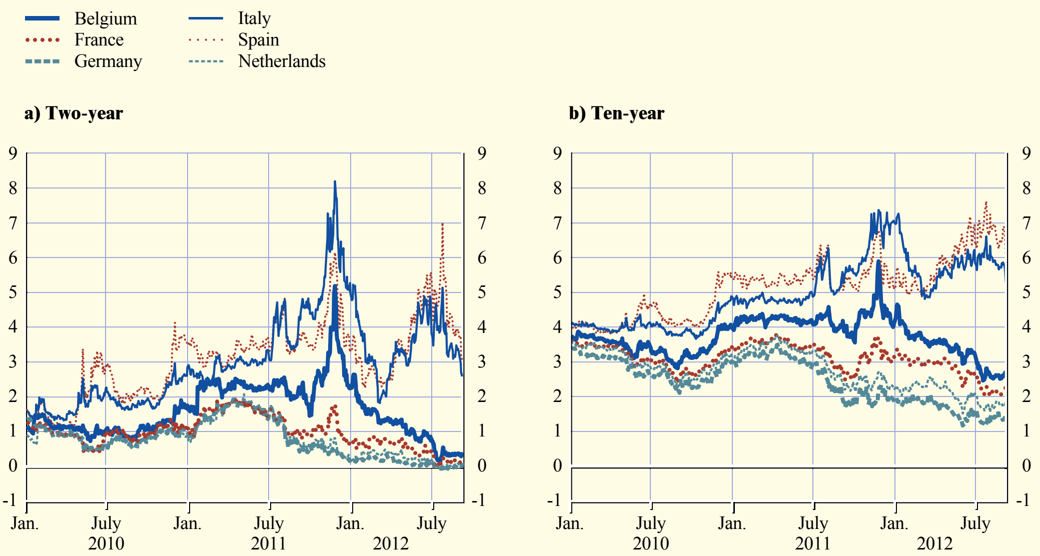
On 6 September 2012, the Governing Council decided on the modalities for undertaking Outright Monetary Transactions (OMTs) in secondary markets for sovereign bonds in the euro area. OMTs aim at safeguarding the transmission mechanism in all euro area countries and the singleness of the monetary policy. OMTs will enable the Eurosystem to address severe distortions in government bond markets which originate, in particular, from unfounded fears on the part of investors of the reversibility of the euro, as reflected, inter alia, in widening differences in the pricing of short-term sovereign debt up to July 2012 (see Chart A). In such an environment, OMTs will provide a fully effective backstop to avoid destructive scenarios with potentially severe challenges for price stability in the euro area.

### The need to safeguard the transmission of monetary policy in the euro area

Government bond markets play a key role at various stages of the transmission mechanism of monetary policy. They are very relevant in determining the financing conditions of banks. First, once fears of adverse developments affecting the sovereign become entrenched, this leads to a spreading of negative expectations with regard to the conditions of banks and

Chart A Two and ten-year government bond yields for selected euro area countries

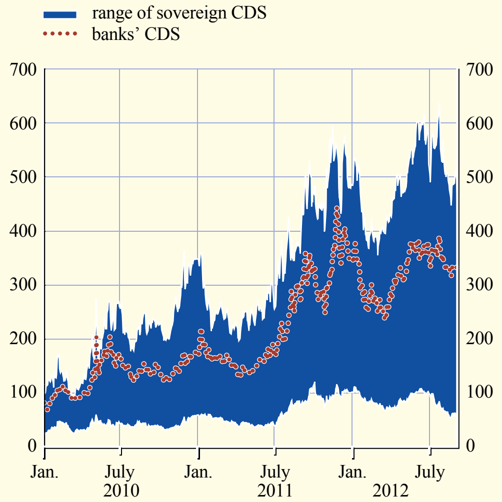
(percentages per annum)




Source: Thomson Reuters.
Note: The latest observation is for 6 September 2012.

**Chart B Range of euro area sovereign CDS and banks' CDS**

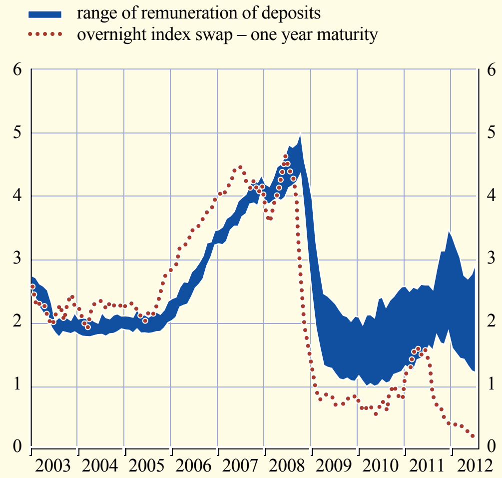
(basis points)




Sources: Thomson Reuters, Bloomberg and ECB calculations.
Notes: Five-year CDS. The range for the euro area displays the minimum and maximum value of sovereign CDS for France, Germany, Italy and Spain. The latest observation is for 4 September 2012.

**Chart C MFI rates on deposits with an agreed maturity of up to one year held by households**

(percentages per annum)




Source: ECB calculations.
Notes: The range is defined by the 20th and 80th percentile of the remuneration of deposits. The range covers three-fifths of the interest rate observations for euro area countries. At the same time, it excludes respectively one-fifth of the observations above and below the lines. The latest observation is for July 2012.

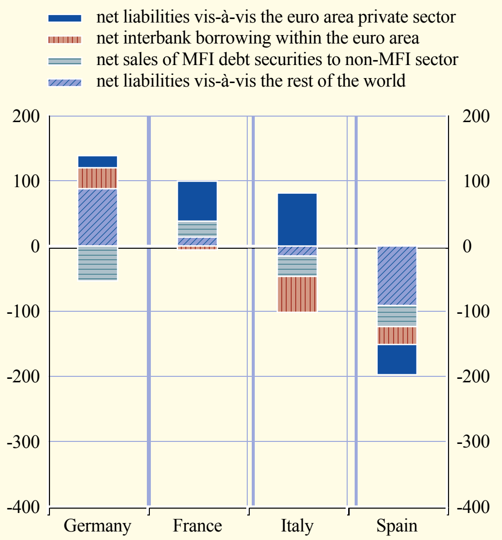
borrowers. Second, in setting the remuneration on their deposits and the return on bonds issued in the market, banks "compete" at the retail level with high yields on bonds and Treasury bills issued by the government. This contributes to increasing banks' funding costs. Third, secured lending among banks in the interbank market is usually conducted using sovereign debt as collateral. Tensions in sovereign debt markets therefore reduce the collateral base of banks and thus their access to liquidity. Fourth, a decline in the valuation of the portfolio of government bonds leads to a deterioration in the balance sheet of banks.

As a result of the tensions in the sovereign bond market, the ability of banks to provide credit is seriously hampered, with adverse consequences for the real economy. Consequently, banks' asset quality is likely to deteriorate further. These tensions are visible in the increase of the CDS of euro area banks, as well as in the ongoing gradual loss of access to funding by banks in some euro area countries. Since spring 2010, developments in the CDS for euro area banks have been closely associated with developments in the upper range of sovereign CDS for the largest euro area countries (see Chart B).

The overall consequences are severe in terms of financing costs and quantities. The cost of banks' funding, for example through deposits, has shown increasingly divergent patterns up to July 2012 (see Chart C). It has increased significantly in countries subject to difficult funding conditions, while it has declined markedly in those countries exhibiting a funding surplus. With regard to access to funding, Chart D shows that MFIs resident in Spain and, to a lesser extent, Italy have exhibited high funding needs from December 2011 to July 2012. These have resulted from a reduction in net funding coming from interbank borrowing within the euro area (excluding the Eurosystem) and non-resident sources, as well as net redemptions of debt securities held

## Chart D MFIs' net liabilities vis-à-vis euro area residents and the rest of the world in selected countries

(cumulated flows between December 2011 and July 2012; in EUR billions)



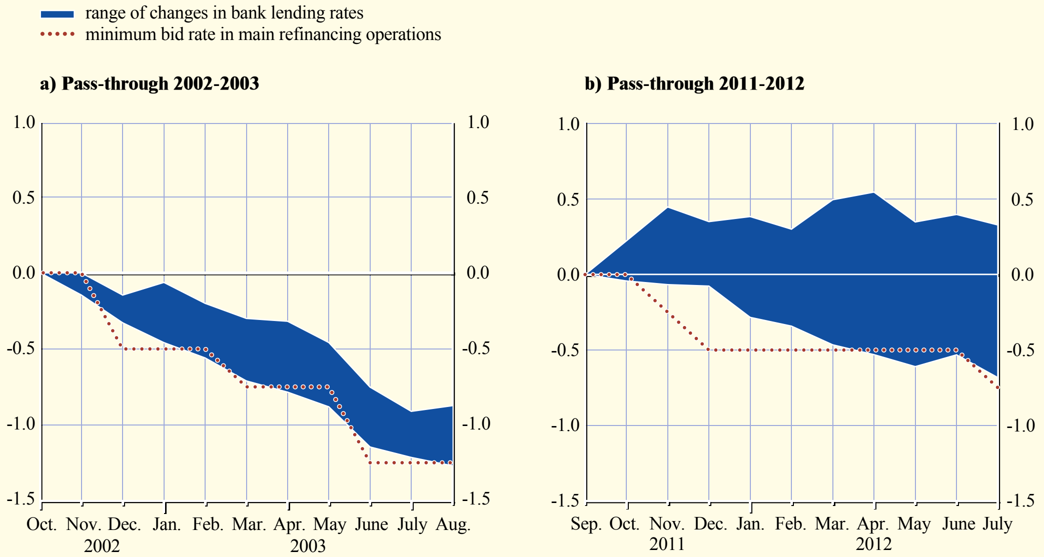

Source: ECB.
Notes: MFI reporting sector excluding the Eurosystem. Net interbank borrowing within the euro area excludes loans and deposits with the Eurosystem.

by the non-MFI sector. By contrast, the funding situation of MFIs in Germany and, to a lesser extent, in France is entirely different. The implications for the conduct of banking business from the reduction in retail and wholesale funding have been partly alleviated by the provision of Eurosystem liquidity, in particular through the two three-year refinancing operations.

The divergence in bank funding conditions is a key factor, in addition to country-specific economic conditions, in explaining the differences in MFI bank lending rates offered to non-financial corporations and households across euro area countries. This leads to a weakening of the pass-through of monetary policy in some euro area countries. Chart E (left-hand panel) shows that the short-term bank lending rates to non-financial corporations across euro area countries responded rapidly and, most importantly, homogeneously to the 125 basis point ECB policy rate cuts

## Chart E Cumulated changes in an ECB policy rate and bank lending rates for short-term MFI loans to non-financial corporations across euro area countries

(changes in percentage points)




Source: ECB estimations.
Notes: The range defined by the 20th to 80th percentile lines identifies the development of short-term bank lending rates covering three-fifths of the interest rate observations of euro area countries. At the same time, this excludes respectively one-fifth of the observations above and below the lines. The latest observation is for July 2012.

implemented between November 2002 and August 2003. By contrast, following the 75 basis point cuts implemented between October 2011 and July 2012, bank lending rates across euro area countries have not responded in a systematic fashion. In fact, as shown in Chart E (right-hand panel), the lower bound of the range of changes in bank lending rates for short-term MFI loans to non-financial corporations declined, as would be expected, while the upper bound increased, despite lower ECB policy rates. This suggests that the stance of monetary policy is not being transmitted appropriately. The key element underpinning OMTs is the better alignment of funding conditions of the real economy with the key ECB interest rates.

### Modalities of OMTs

A number of key operational modalities and conditions have been decided in order to ensure the effectiveness of OMTs.[1]

A necessary condition for OMTs is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. Such programmes can take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases. The involvement of the IMF shall also be sought for the design of the country-specific conditionality and the monitoring of such a programme.

The Governing Council will consider OMTs to the extent that they are warranted from a monetary policy perspective, as long as programme conditionality is fully respected, and will terminate them once their objectives are achieved or when there is non-compliance with the macroeconomic adjustment or precautionary programme. Following a thorough assessment, the Governing Council will decide on the start, continuation and suspension of OMTs in full discretion and acting in accordance with its monetary policy mandate.

OMTs will be considered for future cases of EFSF/ESM macroeconomic adjustment programmes or precautionary programmes as specified above. They may also be considered for Member States currently under a macroeconomic adjustment programme when they will be regaining bond market access.

OMTs will be focused on the shorter part of the yield curve, with maturities of between one and three years. Importantly, as indicated by Chart A, short-term government bond yields appear to be more severely affected once tensions escalate. Moreover, movements in the short end of the yield curve are expected to spillover to longer maturities. The shorter maturities are also close to the current focus of monetary policy and are more closely related to the reference rate for short-term bank lending rates.

The short-term nature of securities purchased should help to ease the enforcement of conditionality and limit the persistent expansion of the Eurosystem balance sheet. This is an important aspect in maintaining fiscal discipline and addressing moral hazard.

1 For the technical features of OMTs, see http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html

To comply with the monetary financing prohibition (Article 123 of the Treaty on the Functioning of the European Union), purchases will be conducted in the secondary market only. The application of strict conditionality will ensure fiscal discipline in countries eligible for OMTs. In deciding on these transactions, the ECB acts with the aim of countering risks to price stability over the medium term emerging from destructive tail scenarios with potentially severe challenges for price stability in the euro area. Therefore, OMTs are fully in line with the primary mandate of the ECB. In addition, all decisions on OMTs are taken by the Governing Council in full independence.

To further support the effectiveness of OMTs, the Eurosystem will clarify in the relevant legal act that it accepts the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through OMTs, in accordance with the terms of such bonds. Furthermore, the liquidity created through OMTs will be fully sterilised.

### Additional non-standard measures adopted to preserve the availability of adequate collateral

With the view to preserving the availability of adequate collateral in Eurosystem refinancing operations, the Governing Council also decided to suspend the application of the minimum credit rating threshold in the collateral eligibility requirements for the purposes of the Eurosystem's credit operations for the following assets: marketable debt instruments issued or guaranteed by the central government, and credit claims granted to or guaranteed by the central government, of countries that are eligible for OMTs or are under an EU-IMF programme and comply with the attached conditionality as assessed by the Governing Council.[2] In addition, marketable debt instruments denominated in the US dollar, the pound sterling and the Japanese yen, and issued and held in the euro area, will be accepted as eligible collateral in Eurosystem credit operations until further notice. This measure reintroduces a similar decision that was applicable between October 2008 and December 2010.

2 For further details on these measures, see http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_2.en.html