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## The ECB's OMTs: A tale of governments, investors, and the central bank <sup>☆</sup>



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### ABSTRACT

This paper analyses official financial assistance via ESM programmes, with and without the ECB's OMTs. As long as macroeconomic imbalances are small, ESM stand-alone programmes galvanize creditors into rolling over their loans, alleviate the liquidity crisis and help the country to implement adjustment policies. Yet the impact of fiscal consolidation and structural reforms is likely to be recessionary in the short run, since these reforms take a long time to pay off. Recessionary effects raise strategic uncertainty in the roll-over decisions of creditors, thus reducing the effectiveness of ESM liquidity assistance. With large imbalances, liquidity problems can only be overcome with credible and sizable official assistance. Adding OMTs to an ESM programme mitigates the policy dilemma, but does not fully restore investor confidence when macroeconomic imbalances are too large.

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## 1. Introduction

In May 2010, Greece became the first euro area country to obtain financial assistance from the International Monetary Fund (IMF) and other European countries. Assistance implied a commitment to implement an economic adjustment programme designed by the Troika of the European Commission, the IMF, and the European Central Bank (ECB). In the following years, Ireland, Portugal, and Cyprus followed a similar path, and Spain obtained European assistance to rescue its banking system. As the crisis of confidence unfolded, Europe created two new mechanisms to face the crisis – the European Stability Mechanism (ESM) and the programme for Outright Monetary Transactions (OMTs). The objective of this paper is to assess the European response to the crisis and analyse official financial assistance via ESM programmes, with and without OMTs.

Compared with previous IMF adjustment programmes, the Troika programmes were special for several reasons. For Greece, Ireland, and Portugal, the sizes of the macroeconomic imbalances at the start of the programmes were much greater than those in the beginning of previous IMF programmes. The debt-to-GDP ratios, the fiscal deficits, the external financial liabilities and current-account deficits were much larger than in the average IMF programme. These findings have been documented by [Barkbu et al. \(2012\)](#), who study the historical record of financial crises, and [Pisani-Ferry et al. \(2013\)](#), who assess the Troika programmes and compare them with previous IMF programmes.

The policy restrictions within the euro area are also extreme. First, it is impossible to devalue a currency inside a monetary union and, unlike previous IMF programmes, the rate of real depreciation has been limited. Second, transfers from a “federal” budget are forbidden as a logical consequence of Article 125 of the Treaty on the Functioning of the European Union (TFEU), the so-called “no bail-out clause.” Third, due to the so-called monetary financing prohibition enshrined in Article 123 of the TFEU, the ECB and the national central banks are prohibited from purchasing government debt securities in the primary market (albeit not in the secondary market).<sup>1</sup>

Such exceptional conditions hindered the Troika programmes and, as the crisis of confidence unfolded, sovereigns seen by investors as more fragile faced increasing difficulties to refinancing their debt. In this setup, two types of official assistance were created for euro area countries. The first option is financial assistance from the ESM, akin to traditional assistance by the IMF.<sup>2</sup> ESM adjustment programmes consist of disbursements at the start of and throughout the adjustment programme, together with a set of measures that are intended to promote the consolidation of public finances and structural changes in the country under intervention. A key feature of the ESM is its limited financial resources. The second option is a novel approach under which the ESM and the ECB may cooperate in insuring investors against the potential illiquidity of a solvent sovereign. This is ensured through the ECB’s programme for OMTs, which involves unlimited purchases of government securities in the secondary debt market, conditional on the beneficiary country adopting an ESM precautionary programme.

The European responses to the crisis had different impacts on the confidence of investors. While the implementation of Troika programmes in countries like Greece, Ireland and Portugal had an ambiguous effect on the (market) financing costs of sovereigns, the mere announcement of the OMTs reduced the cost of (market) finance for the European countries under difficulties. [Fig. 1](#) depicts the daily evolution of ten year bond yields in Greece, Ireland, and Portugal.<sup>3</sup> The three charts in the first column cover the window three months before and three months after the signatures of the

<sup>1</sup> The Troika acknowledged such exceptional conditions, and its official assistance programmes differed from traditional IMF programmes. First, the euro area programmes were significantly larger and longer-lasting than previous IMF programmes. Second, unlike most IMF programmes, official assistance replaced markets in the financing of sovereigns. To contain the conventional “debtor moral hazard” effects, the European Union adopted a philosophy of explicit conditionality in the programmes and through a number of measures which have strengthened the Stability and Growth Pact.

<sup>2</sup> The ESM is an intergovernmental organization whose assistance programmes are designed by the European Commission in liaison with the ECB and, wherever possible, together with the IMF. For simplicity, we call “ESM programme” a programme with financial assistance granted by the ESM and designed by the Troika. [Appendix A.1](#) presents the assistance mechanisms available in the euro area and how they have been used so far.

<sup>3</sup> There is no significant difference between the evolution of the ten-year bond yields and the evolution of the ten-year bond spreads over German bonds, since the behaviour of German yields was fairly stable during the period of analysis.

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