

The Changing Growth Pattern in the Spanish Economy Driven by the Eurosystem: from Poor Supervision to Conditionality on the Provision of Central Bank Reserves

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Abstract: The Spanish economy has experienced a deep change in its growth pattern over the last 20 years, shifting from a debt-led model driven by the real estate sector, from the introduction of the euro to 2007, to a “seemingly” export-led model, from 2014 to 2019. Although this shift was partly due to the unsustainability of the former growth pattern in the long run, it was strongly affected firstly by the poor supervision of banks by the Banco de España, allowing for a huge private indebtedness and real estate bubble, and later by the conditionality imposed by the ECB on governments in troubled economies in exchange for granting access to reserves to banks in their respective jurisdictions. This paper contains three conclusions. Firstly, the Banco de España should explain the degree of complacency with which it viewed the situation until the real estate bubble burst. Secondly, the ECB went beyond its mandate with its conditionality. And thirdly, despite its strong pressure for the adoption of fiscal consolidation and wage devaluation, Spain has not become a true export-led economy.

Keywords: ECB, Bank supervision, export-led growth pattern, unconventional monetary policy

JEL classification: E12, E42, E58

INTRODUCTION

The Spanish economy has changed significantly in the last 20 years, since the launch of the euro. One of the most noteworthy changes was a shift in its growth pattern: during the decade that stretched from 1997 -a couple of years before the introduction of the single currency- to 2007, it was a private debt-led economy, with the construction sector working as the driving force

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behind the whole economy, fuelled by a huge flow of bank lending to private agents; by contrast, from 2014 to early 2020, it displayed certain features that were closer to an export-led economy. In between, from 2008 to 2013, there was a deep recession.

There are several factors behind such change, one of them being that the former growth pattern was unsustainable as it required growing doses of debt to keep the pace of growth of GDP stable at a high level. However, the shift did not happen only as a result of “re-equilibrating market forces”: quite to the contrary, it was strongly affected by policy variables.

Among them, and this is the central focus of this paper, we have the role played by the Eurosystem (the Euro System of Central Banks, or ESCB for short, a system that comprises the ECB and national central banks of all countries that use the euro as a currency), in this process. The ESCB affected the working of the Spanish economy not through the management of interest rates¹ but by means of two unconventional channels: (i) in the debt-led period, the Bank of Spain did not supervise banks correctly and did not put in motion the required macroprudential measures to avoid a real estate bubble, and (ii) in the “seemingly” export-led period, through the conditionality required for governments, in order to accept their public debt as eligible collateral in refinancing operations, in the provision of emergency liquidity assistance and its eligibility in outright purchase programs.

In a nutshell, our argument is that, from 1997 to 2007, Spain experienced very cheap and generous access to bank funding, coinciding with the introduction of the euro and the deregulation and liberalization of capital markets in Europe. Private indebtedness rocketed in that decade, to fund a huge demand for housing, allowing the construction sector to keep the Spanish economy growing for ten years at almost 4% annually. The responsibility of the Bank of Spain was to supervise and regulate banks in order to temper the boom in bank credit to firms and households, although it did not fulfil this role adequately. As a matter of fact, in 2006, officials at the Bank of Spain still considered that there was not a real estate bubble.

This debt-led pattern came to an end by late 2007, because of its unsustainability, but the consequences of outstanding debt in Spain became apparent in 2010, coinciding with the first Greek sovereign debt crisis. From that time to the present, the ECB has assumed the role of watchdog of fiscal rectitude (and competitiveness) with the ultimate end of avoiding a euro breakup, using its collateral framework to press on debtor countries to force them to adopt some rebalancing measures (in general, fiscal consolidation, structural reforms mainly in the labour market, and

recapitalization and restructuring of the banking industries). Beyond conducting monetary policy through changes in the interest rate, the ECB threatened governments with ceasing the provision of reserves to banks in their respective jurisdictions. The ECB exerted its power through three channels: refinancing operations, emergency liquidity assistance (ELA) and outright purchase programs. Greece illustrates the first channel well: on several occasions from 2010 to 2015, the ECB conditioned the acceptance of Greek bonds as eligible collateral in refinancing operations upon its compliance with the conditionality attached to external financial aid provided either by the Troika or the European Stability Mechanism. As for ELA funds, the pressure was directly exerted on governments, as shown for instance in some disclosed letters from Trichet to the Irish Minister of Finance in November 2010 (Whelan, 2014), where the then President of the ECB urged the Irish government to request financial aid from the Eurogroup and adopt the corresponding painful measures as a condition to keep the ELA going.

Trichet also sent letters to the Prime Ministers of Italy and Spain in mid-2011, two days before both countries were also included in the SMP, an outright public debt purchase program (Viterbo, 2016; Tooze, 2018), urging those governments to adopt measures that were similar to those requested in the Troika's programs. And with the so-called Outright Monetary Transactions, OMT, the program of unlimited purchases of public debt that replaced the SMP in September 2012, the ECB shifted to an explicit conditionality, requiring governments whose debt would be purchased to first ask for financial assistance from the European Financial Stability Fund (EFSF) / European Stability Mechanism (ESM) and sign a memorandum of understanding where the required conditionality was clearly described.

With that conditionality, the ECB became an enforcer of the Troika's conditions for financial aid, obliging governments in troubled countries to adopt fiscal consolidation policies and structural reforms, mostly with a view to liberalizing labour markets. We find Viterbo's claim (Viterbo, 2016: p. 502) to be quite correct, that while the ECB's ultimate motivation for requiring conditionality was the survival of the euro, it is clear that it undertook political decisions that were beyond its mandate. These decisions were based on a supply-side conception of how the Eurozone should work, in which a balanced budget is a necessary condition for restoring investors' confidence (e.g. Draghi, 2011; see also Fazi, 2019). And with that behaviour, the ECB benefitted creditor countries in the core of the Eurozone, allowing their banks to replace troubled assets issued by EZ debtor countries with

ECB reserves (Thompson, 2015).

The structure of this paper is as follows. In the next section, I give an account of the boom in the Spanish economy from 1997 to 2007 and the role played by the Bank of Spain during that period. I then focus on the recession from 2008 to 2013. The change in the growth pattern is described in the subsequent section. The role of the ECB in the process of structural change is dealt with in the section entitled “the ECB as an enforcer of changes in the growth pattern.” Conclusions and remarks are given in the final section.

THE BOOM (1997-2007).

The Spanish economy experienced a long decade of prosperity between 1997 and 2007, driven by the construction sector. From the first quarter of 1997 to mid-2007, the average annual growth rate of GDP was 3.85% while construction sector growth was 7.53%. Employment in construction was 9.93% of total employment in 1997, and in 2007 it rose to 13.25%, while in the EU, it was 7.8% and 8.2%, respectively.² Property prices almost tripled in that decade, and the number of newly constructed dwellings in Spain amounted to more than 6 million units (see for instance Febrero and Bermejo, 2013).

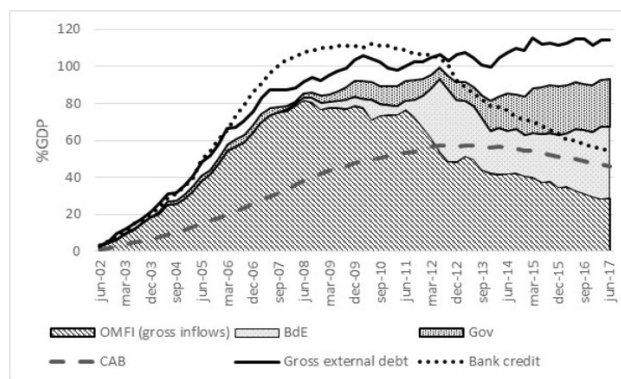
Among the factors that explain this strong growth in the real estate sector are demographics, rising employment and a strong culture of ownership (baby boomers reached their thirties -the age at which people generally buy a house in Spain- in the mid-1990s; immigration, which was almost nil in the early 1990s, increased markedly to reach nearly 10% of the total population at the end of that decade; aged foreigners made large investments in dwellings along the coast and on the islands; and roughly 80% of households owned the houses where they lived).

Notwithstanding, the list is incomplete if we do not include financial conditions. For one thing, interest rates declined markedly starting in 1997, once exchange rate risk had disappeared and there was a strongly credible commitment to comply with the conditions in the Maastricht Treaty. Meanwhile, Spanish banks eased their requirements to borrowers, lending roughly 100% of the value of houses³ and extending the maturity of mortgage loans by several years.⁴ Bank credit to private agents (households and non-financial corporations) shifted from 68% of GDP in 1997 to 167% ten years later, and bank credit to fund transactions related to real estate activities (purchase or repair of houses, building, real estate services, *et cetera*) exceeded 100% of GDP in 2007 (Febrero and Bermejo, 2018: p. 280, Table

12.6).

The conditions that banks required of borrowers in Spain mirrored the conditions under which they could refinance their liabilities in international markets, as the following figure shows (reprinted from Febrero *et al.*, 2019).

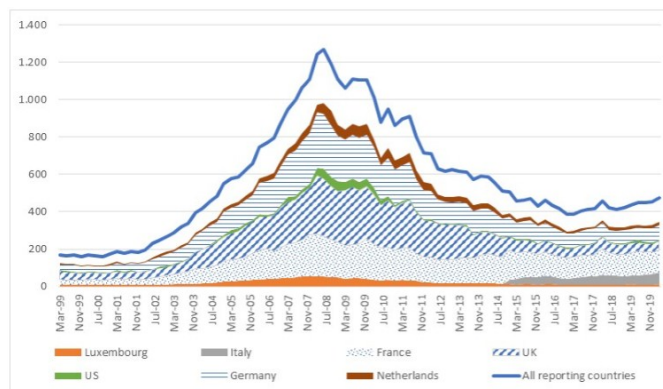
Figure 1: Accumulated gross capital inflows, current account deficit and bank credit. Spain: 2002-2017. % GDP.



Source: Banco de España, INE, and author's calculations; reprinted from Febrero *et al.* 2019, p. 1136, Figure 4. N.B. OMFI stands for Spanish banks' gross external debt, BdE is Banco de España's TARGET2 liabilities, Gov is the Spanish Government's external debt, and CAB is current account deficit. This figure shows the accumulated inflows of debt by institutions, bank credit or CA imbalances, since 2002, divided by the GDP of the four quarters preceding each period of time on the horizontal axis.

In Figure 1 we can see that the increase of outstanding bank credit to private agents in Spain between 2002 and 2008 reached 110% of GDP in 2008 (dotted line), the volume of accumulated gross external debt in that period of time was 92% of GDP and accumulated bank external debt was 82% of GDP. This means that banks were responsible for almost 90% of accumulated Spanish gross external debt and that they refinanced in international markets nearly 75% of the credits that they were granting to resident agents during the boom (unfortunately, we have official statistics on these issues only from 2002).⁵

Figure 2 shows that in 2008, according to BIS locational statistics, two thirds of Spanish foreign claims held by banks were located in Germany, France and the UK (see for instance O'Connell 2015, who states that the UK as a financial hub was often locating German and French investments abroad). The fall of the exposure of core EZ banks to Spain was possible through a massive injection of reserves by the ESCB that next flowed to Germany through the Target2 system.⁶

Figure 2: Spanish external debt held by BIS's reporting Banks. Billion USD.

Source: BIS (locational banks statistics, table A3-S) and author's elaboration.

What was the role of the Bank of Spain?

The Bank of Spain has a great deal of responsibility for the crisis as it allowed a very large volume of credit to be granted by Spanish banks to households and non-financial corporations between 1997 and 2007, resulting in a deep banking crisis. It is clear that the Bank of Spain did not have any control over the official interest rate, which is managed by the ECB; and it did not have control over capital inflows either, which were highly deregulated before the introduction of the euro. But it should have used its power to limit the volume of credits that banks made to resident agents, especially with regard to real estate activities, through macroprudential regulation, i.e. the management of asset-side tools, like debt-to-income (or debt servicing-to-income) or loan-to-value ratios (see for instance Yellen, 2014).

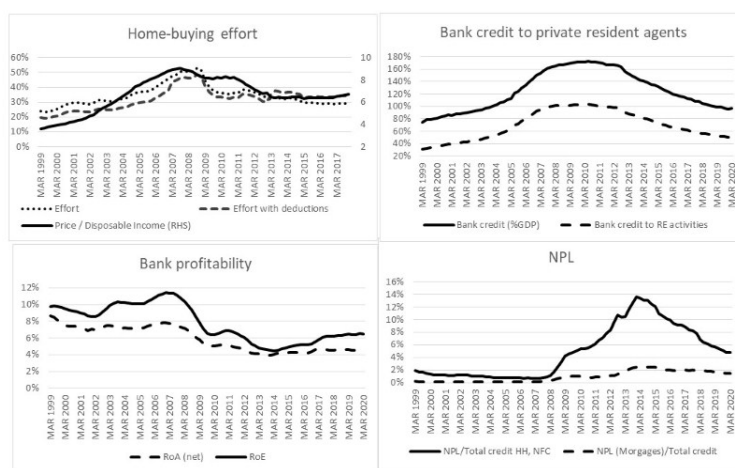
It is surprising that in 2006, just a few quarters before the outbreak of the Great Financial Crisis, the Bank of Spain had not yet found property prices to be excessively overvalued (perhaps 20% above the equilibrium values) and officials took for granted that the convergence towards their corresponding equilibrium levels would happen gradually (they explicitly excluded the existence of a speculative bubble: Banco de España, 2006: p. 65; Caruana, 2006).⁷ Household indebtedness, which had grown from 52% of disposable income in 1997 to 105% in 2005, was seen as unproblematic, responding to the evolution of interest rates, wealth, employment and household income (Malo de Molina, 2005: p. 30).

In defence of the Bank of Spain, we must concede that it had implemented a system of dynamic provisioning against risk in 1999, that it

is difficult to identify the existence of bubbles “in real time”, and that financial bubbles associated with the real estate market occurred simultaneously in different countries and no central bank was able to stop them.

Nevertheless, despite these facts and in hindsight, it is difficult to understand the complacency with which the monetary authorities viewed the situation in Spain:

Figure 3: Bank credit, profitability, non-performing loans and some real estate market indicators. Spain.



Source: Banco de España. N.B. The price to disposable income ratio (upper left-hand side) accounts for the quotient between the price of an average house of 93 square meters over the disposable income of a median household. The home-buying effort is measured by the quotient of debt servicing needed to repay a loan that covers 80% of the price of an average house over a median household’s disposable income. Bank credit (upper right-hand side) is the outcome of dividing the volume of outstanding credit to households and non-financial corporations over GDP. RE stands for real estate. RoA (in lower left-hand graph) is return on assets, and RoE is return on equity, both for Spanish banks. NPL is non-performing loans, and is measured as the percentage of total loans whose scheduled repayments have not been settled after 90 days.

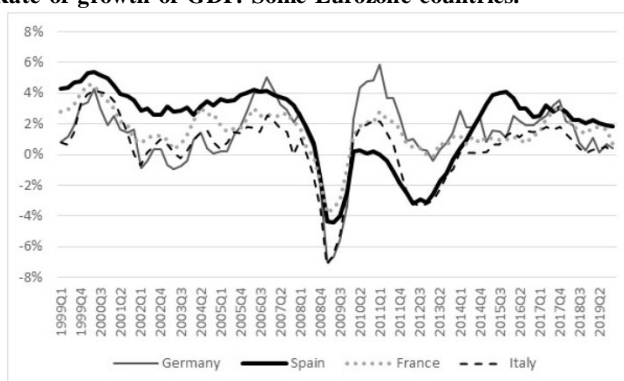
The ratio of the price of an average house (measuring 93 square meters) over the disposable income of a median household shifted from 3.6 times in 1999 to 8 times at the end of 2005 (9 times in 2007), the volume of outstanding bank credit to Spanish private agents shifted from 75% of GDP in 1999 to 130% of GDP in 2005 (165% in 2007), and credit related to real estate activities reached 100% of GDP in 2007. The profitability of banks (measured by the return on equity) grew from 8.1% in 2001 to 11% in 2005 and the rate of non-performing loans was below 0.2% (of total outstanding credit) in that year.

Was this due to inappropriate economic theory, bankers' greed or market failures? Surely, it is a mix of all these ingredients. However, one essential element is undoubtedly bad regulation, which is one of the roles that the monetary authority must play, and which is part of its policy.

THE CRISIS (2008-13) AND THE SUBSEQUENT RECOVERY (2014-19).

From 2008 to 2013, we can distinguish two crisis waves: one over 2008-2010 and another over 2011-2013. During the first shock, the fall in the Spanish GDP was similar to France, and less marked than Germany and Italy, while the following rebound was shorter in Spain than in all of the aforementioned countries. In the second crisis wave, the recession in Spain was as large as Italy's, but the recovery that began in 2014 (until 2019) was stronger.

Figure 4: Rate of growth of GDP. Some Eurozone countries.



Source: Eurostat.

The first fall in GDP was mostly due to the bursting of the real estate bubble and a decline in exports because of the international dimension of the crisis. The banking sector did not suffer extensively at that time because of the retail nature of its type of business, the existence of dynamic provisioning reserves, and the fact that a large fraction of its liabilities had long term maturity (Vázquez Suarez, 2017a). Additionally, the Spanish government implemented a program to provide collateral to help banks refinance their debt, and another which aided in the purchase of bank assets (as at that time, it was assumed that banks merely had liquidity problems). And most notably, it adopted a rather expansive fiscal policy to offset the shrinking private demand over 2008-09, within the framework of the so-called European Plan for Economic Recovery, following the recommendations of the G-20

and the IMF (Febrero and Bermejo, 2013). However, in 2010, the Spanish government, like other peripheral EZ countries, had to make an economic policy U-turn because of rising tensions in financial markets due to a crisis whose epicentre was located in Greece (for details, see Geithner, 2014, chapter 11; Blyth, 2014, chapter 3; Tooze, 2018, chapters 14-18 or Vázquez Suárez, 2017b). Although some rebalancing measures (i.e. fiscal consolidation, wage devaluation, reforms in the pension system and restructuring of the banking sector) had been adopted in early 2010, the Greek crisis accelerated their implementation; in mid-2011, as the Greek situation was deteriorating, and with debt restructuring involving capital losses to private bond holders as a condition for further rescues, funding conditions worsened in Spain (and Italy); the ECB responded by reactivating the SMP including Italian and Spanish public debt as well to fight fears of spreading contagion, requiring further fiscal consolidation and wage devaluation in exchange.¹ Later, with GDP falling and unemployment rising dramatically, and after having borrowed large amounts of reserves from the ECB in two LTROs in late 2011 and early 2012, which then flowed through the TARGET2 system chiefly to Germany, serious problems in the Spanish banking industry resulted in an additional push for austerity measures in 2012. With Bankia, a large bank that was the result of merging 7 *cajas* (saving and loans), requesting financial aid from the Spanish Government less than one year after being nationalized, the latter had to ask for a rescue loan for the recapitalization of the banking industry from the EFSF (amounting to roughly 10% of GDP), which in turn imposed additional conditionality. Such conditionality was then reinforced with Draghi's announcement of the OMT in the summer of 2012. Austerity measures adopted over 2010-12 were behind the second crisis wave over 2010-13. Ultimately, the Spanish economy experienced a 5-year recovery over 2014-19, with a current account balance in a surplus position (and some tail winds making a positive contribution to growth: IMF, 2016, p. 26, Cárdenas *et al.*, 2018).

THE CHANGING GROWTH PATTERN AFTER THE CRISIS.

Fiscal consolidation weakened domestic demand in a period of private deleveraging (see Figure 3, upper right graphic). And labour market reforms led to falls in nominal wages that caused a distributional shift in favour of profits as commodity prices did not fall in proportion to decreasing wages, thus reinforcing the weakening of domestic demand. A weaker domestic demand led to fewer imports. The following table shows a comparison

between Spain and Germany before and after the crisis, providing an account of the structural change that took place in Spain.

Table 1: From debt-led to export-led growth. Spain and Germany: 1997 – 2007 vs. 2014 – 2018.

		97-07	14-18
GDP growth	Germany	1.64%	2.04%
	Spain	3.81%	2.70%
Contribution domestic demand to GDP growth	Germany	0.95%	2.02%
	Spain	4.65%	2.69%
Contribution exports	Germany	2.56%	1.81%
	Spain	1.58%	1.48%
Contribution net exports	Germany	0.69%	0.01%
	Spain	-0.84%	0.01%
Average trade balance	Germany	3.20%	6.96%
	Spain	-2.87%	3.28%
Nominal unit labor costs (rate of change)	Germany	-0.23%	1.81%
	Spain	2.53%	0.17%
Increase of private debt (percentage points of GDP)	Germany	-7.36 ⁽¹⁾	1.41
	Spain	105.59 ⁽¹⁾	-44.53
Construction (%GDP) ⁽²⁾	Spain	10.67%	5.86%

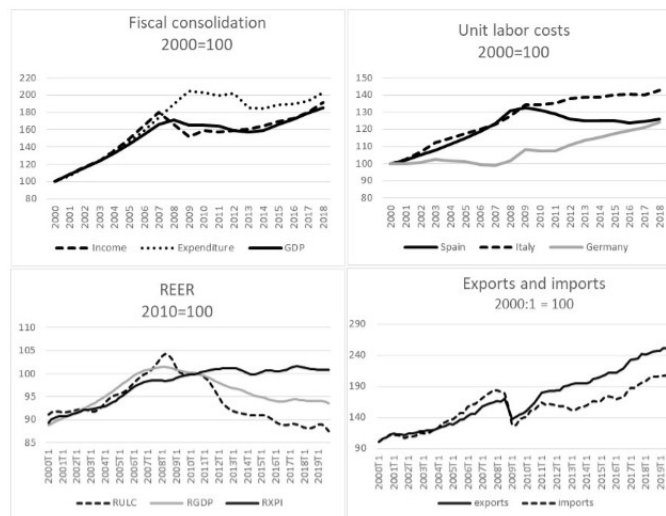
Source: AMECO, INE, ECB and author's calculations. N.B. The yearly rate of change of nominal unit labor costs in Spain over 2010-16 was -0.96%. (1) The increase of private debt accounts for the change in the rate of private debt for households and non-financial corporations, including loans and values other than shares, over GDP, between early 2000 and late 2007, and between 2014 and 2018. (2) The figures for construction stand for its sectoral value added over Spanish total value added.

The average annual rate of growth in Spain declined in 2014-18 with respect to 1997-2007 by more than one percentage point. The contribution of domestic demand to GDP growth was lower in 2014-18 by roughly two percentage points, with construction playing a less relevant role, and the contribution of net exports was higher (almost one percentage point); unit labor costs rose more slowly (actually falling over 2010-16: see the upper right-hand side graph in Figure 5 below). Private indebtedness increased in Spain, from 2000 to 2007 by an amount larger than the 2007 GDP. By contrast, private debt in Germany declined 7 percentage points of GDP in that same period of time. During the second period, the Spanish economy experienced major deleveraging while German indebtedness remained rather stable.

Although Spain got closer to an export-led model in 2014-18, the reader should realize that the contribution of exports of goods and services to GDP growth was higher in 1997-2007, with unit labor costs rising much faster in that period of time. A weak domestic demand and gains on competitiveness

nevertheless contributed to higher exports and lower imports (see García and Prades, 2015). Our position here is that it is not competitiveness but rather a weaker domestic demand that causes this shift.⁹

Figure 5. Spanish economy: 2000-2018



Source: AMECO, Eurostat, INE and author's calculations. N.B. REER stands for real effective exchange rate.

The two graphs in the lower row of the figure above are especially enlightening: on the lower left-hand side, we can see that the real effective exchange rate, deflated with unit labour cost (RULC) declines starting in 2009; it declines using the GDP deflator as well (RGDP), although the fall is weaker; however, it does not fall at all when deflating the exchange rate with an index of export prices (RXPI), so we can conclude that falling unit labour costs are not shifted to export prices and, therefore, competitiveness is not behind the rise of exports. The graph on the lower right-hand side shows that imports grew faster than exports over 2000-2008, during the boom. However, exports grew faster than imports (and a bit slower than over 2000-08), from mid-2009 to 2019 because of a weaker domestic demand after fiscal consolidation and wage devaluation. In the upper row, the reader may see that fiscal consolidation begins in 2010 mostly through cuts in public spending, while public revenues begin to grow a little faster than GDP (right-hand side figure), and unit labour costs begin to decline in 2010 as well, due to a combination of employment falling at a faster rate than output (thus, increasing labour productivity) and also declining wages due to labour market reforms.

Hence, the improvement of the trade balance is not due to competitiveness but mainly to weaker domestic demand, which slowed down imports, caused by changes in distribution -as wages fall more than prices-, fiscal consolidation -public expenditures fall and revenues rise, as shown in the upper left-hand graph- and because private agents are engaged in a strong deleveraging process (see upper right-hand graph in Figure 3).¹⁰

THE ECB AS AN ENFORCER OF CHANGES IN THE GROWTH PATTERN.

Before dealing with the ECB's level of responsibility over the change that occurred in Spain, a clarification must be made. A debt-led growth pattern that results in a bubble, like the one that occurred in Spain over 1997-2007, is not sustainable in the long term (e.g. Minsky, 1975, chapter 6). Consequently, such an indebtedness process should stop once indebtedness reaches a certain level. And if banks have borrowed too heavily in international markets, after having lent to private resident agents, they should stop borrowing as well.

Usually, a slump takes place once new borrowing falls below debt servicing, causing a problem of effective demand. Quite often, a banking crisis occurs at the same time, because the increase of non-performing loans leads to solvency problems for banks. By and large, stand-alone countries suffering a banking and balance-of-payments crisis at the same time, are forced to devalue their currency and adopt painful rebalancing measures in exchange for external aid, often provided by international agencies like the IMF. However, when these developments take place in a country that belongs to a monetary union and its debt is held by agents that reside within the borders of the union, these measures can take place simultaneously with some expansive aggregate demand decisions, in order to avoid a deflationary situation, as some post-Keynesian authors have suggested (e.g. Hein and Detzer, 2015). Unfortunately, and this is widely recognized, the reaction to the Great Recession that followed the financial crisis of 2007-08 consisted merely of rebalancing measures adopted by national governments following pressures, on the one hand, from Germany (which strongly rejected any possibility of mutualizing debt and whose public opinion was in favour of debt restructuring) and, on the other hand, the ECB (which agreed on the necessity of reaching fiscal balance at the national level as a precondition for financial stability, but was against restructuring debt because of its consequences in financial markets) and France (whose banks had been widely exposed to debt-led EZ countries, like Ireland, Greece

and Spain), with no expansive demand policies that would have prevented a slump while the deflationary decisions took effect. Therefore, the change that took place in Spain (and other troubled EZ countries) should not be viewed only as the consequence of the single push made by the ECB. Our aim in what follows is simply to show that its role was quite relevant.¹¹

With this caveat in mind, we hold that the ECB contributed to the cause of a deep shift in the composition of aggregate demand in the EZ impaired economies starting with the Great Recession, through an unconventional monetary policy channel: the conditions under which banks could borrow reserves from the Eurosystem. Three broad mechanisms can be distinguished: the eligibility of collateral in refinancing operations, the constraints under which national central banks can provide central bank reserves through so-called Emergency Liquidity Assistance (ELA) and the conditionality to be complied with in order to become a beneficiary of massive asset purchase programs by the ECB (see Viterbo, 2016). In some cases, the ECB's conditionality was explicit and public (requesting financial assistance from the Troika and therefore signing a memorandum of understanding); in others it was explicit but exerted through private channels (letters to Prime Ministers) and on other occasions it was implicit (using a country as a scapegoat -very often Greece- to show what might happen to other countries if they would not accept particular conditions).

The context in which the ECB required such conditionality can be described as follows. In October 2008, the ECB had adopted a number of measures to fight the Great Financial Crisis, gathered under the heading "enhancing credit support" (see for instance Eser *et al.*, 2012). In mid-2009, liquidity problems appeared to recede so the ECB decided to phase out some of the crisis measures, allowing refinancing loans to mature. In 2010, with the Greek sovereign crisis looming, the ECB faced a dilemma (see Gabor, 2012): it had to stabilize funding markets, where banks were looking for reserves to repay their debts to the ECB, but it did not wish to intervene in sovereign debt markets, where banks obtained collateral to be used in private repo markets. In hindsight, we know that the ECB's preferred stance was that the stability of public debt was the responsibility of governments, and that the ECB would lend to banks once securities were stabilized through fiscal consolidation. That is why it only agreed to implement the SMP after Greece had requested external aid, and it stopped that program promptly (June 2010) once the European Financial Stability Fund was established. This dilemma returned in mid-2011, when Italian and Spanish public debt became a serious cause of concern. On that occasion, the ECB

reactivated the SMP, but it then had to provide significant amounts of reserves through two very large LTROs in December 2011 and February 2012 (the preferred option), and finally Draghi pronounced his famous “whatever it takes” in mid-2012, before announcing the OMT.

Upon requiring conditionality on its provision of reserves to Greece in May 2010, the ECB was sending clear signals to other troubled economies that it wished to bear the burden of stabilizing public debt markets, and that its preferred option was to merely lend reserves to solvent but illiquid banks to avoid problems of financial instability.

The ECB collateral framework

It is well known that the ECB provides reserves through credit to counterparties against adequate collateral valued at market prices and subjected to a haircut (according to the Statute of the European System of Central Banks, Protocol no. 4, art. 18, para. 1). Under *normal* conditions, refinancing operations are the most important tool in the conduct of the ECB’s monetary policy, and are implemented as repurchase agreements (repos), involving the lending of reserves against the provision of eligible collateral (ECB, 2020); government securities are roughly 50% of total eligible collateral (see for instance Wolff, 2014, figure 4). Such collateral is relevant for the protection of the lender (the ECB) and also for the transmission of monetary policy (Bindseil *et al.*, 2017). If the quality of collateral falls, mark-to-market leads central banks to make margin calls (and may impose higher haircuts on public debt), requiring additional collateral, when its market value declines. These measures make borrowing more expensive and worsen the situation on borrowers’ balance sheets if they bear large amounts of collateral. Additionally, they have negative consequences on the issuers of the securities used as collateral, because they reduce the willingness to hold onto them if they do not translate into larger amounts of central bank funding (Whelan, 2014).

As Orphanides (2018) states, the origin of the management of conditionality in refinancing operations can be traced back to November 2005, when the ECB decided that all eligible collateral had to be subjected to a minimum credit rating of A-, which had to be set by private agencies. The measure was, to some extent, a response to criticism that giving equal treatment to all public debt (as collateral in refinancing operations) could ease fiscal discipline (see for instance Buiter and Sibert, 2005), in the context of several violations of the Stability and Growth Pact. The requirement of a minimum credit rating threshold, which aimed to shift the responsibility of

fiscal discipline to markets, was adopted with the awareness of officials at the ECB, of the problem of the cliff effect (or the eligibility cliff) that this measure might generate (see references to Issing and Papademos in Orphanides, 2018): in the context of multiple equilibria, if investors consider a sovereign to be insolvent after a shock, they will get rid of their bonds, and as the price plummets, agencies will downgrade it making its price fall even further as its rating gets closer to the minimum threshold, leading to funding problems for banks that are reliant on these securities (Gabor and Ban, 2016, section III). An overreaction of the market may lead to a self-fulfilling prophecy of sovereign default (see for instance De Grauwe and Ji, 2011).

One clear consequence of such a change in the requirements for accepting collateral in refinancing operations is that the ECB became an enforcer of fiscal discipline among EZ member states, something that goes beyond its mandate to keep inflation close to -but below- 2% (for details, see Tooze, 2018, part III). A clear example of this argument occurred in May 2010, during the first Greek sovereign debt crisis when the ECB accepted Greek public debt as collateral in refinancing operations, despite its having been downgraded to junk bond levels, after the Greek government had approved a tough adjustment program, as a condition for obtaining financial aid from the Troika (as Viterbo, 2016, p. 508 states, “the ECB almost acted as an enforcer of the Troika’s conditionality”; Viterbo, 2016, and Gabor and Ban, 2016, provide additional examples of the pressure made by the ECB on Greece to adopt further rebalancing measures through haircuts and margin calls, and Bindseil *et al.* 2017, minimize the impact of such measures).¹² The question of what might have happened if Greece had rejected the ECB’s threats could be found in the ECB’s decision in early 2015, when Tsipras tried to renegotiate the conditions previously agreed upon with the Troika. The ECB responded by suspending the waiver on Greek bonds, so that Greek banks could only obtain central bank liquidity through the so-called ELA¹³; as a result, bond spreads with the German *bund* soared and customers made a run on Greek banks to withdraw their savings (on this see below; see also, for details, Viterbo, 2016: pp. 511-12).

The conditionality imposed on Greece was rather explicit, but the pressure applied by the ECB for the adoption of fiscal rebalancing measures could also be felt in other countries through what Viterbo (2016: p. 504) deems *implicit* conditionality: it was not necessary for other troubled economies to reach a limit situation (i.e. a rejection of their public debt as eligible collateral) in order to accept the adoption of a number of painful rebalancing measures. Greece was used as a scapegoat to force other

countries to move in the direction indicated by the ECB.

Emergency Liquidity Assistance

This is a mechanism by means of which a single national central bank that belongs to the Eurosystem of Central Banks provides liquidity to those financial institutions in its own jurisdiction which lack eligible collateral (i.e. cannot borrow reserves in refinancing operations) and face liquidity problems, although they must be solvent. ELA is not part of the single monetary policy. The interest rate of ELA funds is higher than the official interest rate and all costs from the provision of ELA fall on the national central bank in question. The ECB has the power to limit the amounts of liquidity that national central banks provide through the ELA. For details, see ECB (2017).

As Viterbo (2016: p. 515) states, the ECB conditioned the provision of ELA to Ireland, Cyprus and Greece upon their request for financial aid from the Troika, whose granting was in turn conditioned upon the adoption of fiscal consolidation and structural reforms. This was quite evident in the case of Ireland, as the ECB disclosed certain letters sent by Jean-Claude Trichet, the president of the ECB, to Brian Lenihan, the Irish Minister of Finance (see Whelan, 2014: pp. 13-15), where mentions of such conditionality are quite explicit.¹⁴

In the Greek case, in 2015, when the ECB decided not to accept Greek public debt as eligible collateral in refinancing operations, it forced the Central Bank of Greece to provide liquidity to Greek banks through the ELA. And when Tsipras announced a referendum on the implementation of austerity measures and the end of the adjustment program, the ECB did not accept a petition by the Central Bank of Greece to increase the ELA facility. This forced the Greek government to impose capital controls and bank holidays to stop massive withdrawals of bank deposits. The Greek Government withdrew its proposed referendum and imposed further austerity measures a few days later (Tooze, 2018, chapter 22, section III; Seccareccia, 2015). In August, 2015, an agreement was reached on the third adjustment program, and the ELA was maintained at pre-existing levels. Greek bonds were again admitted as collateral in refinancing operations one year later.

Conditionality on Public Bond Purchase Programs: SMP, OMT and PSPP.

The Securities Market Program started in May 2010, and its purpose was to restore the monetary policy transmission mechanism through the outright purchase of sovereign debt in secondary markets. All liquidity created for

the purchase of public securities was then sterilized. In principle the program was conceived for the purchase of the public debt of Greece, Ireland and Portugal. However, in mid-2011 it was extended to Italy and Spain (see Tooze, 2018, chapters 16 and 17).

In the context of negotiations for a second bailout of Greece, the ECB agreed to a restart of the SMP. Italian and Spanish bond spreads were soaring considerably, as a consequence of a generalized sovereign default risk in EZ crisis countries followed by the threat of a euro breakup and a return to previous currencies. The ECB took the opportunity on that occasion to exert some pressure on these countries to force them to adopt more fiscal consolidation and wage devaluation. In the Spanish case, the restructuring and recapitalization of the banking sector was also required. Letters to prime ministers Berlusconi and Rodríguez Zapatero had been submitted by J.C. Trichet by August 2011,¹⁵ and two days later (once both countries agreed to assume such measures) the ECB extended the SMP to include Italy and Spain (Viterbo, 2016: pp. 520-51; Tooze, 2018, chapter 17, section I).

It should be noted here that neither Italy nor Spain had requested financial assistance from the Troika. Thus, the ECB was not hiding behind the Troika's conditionality, but was rather directly requesting rebalancing measures in exchange for the ECB's support of sovereign debt.

Despite the SMP and large refinancing operations (LTRO) amounting to more than one trillion euros, neither Italy nor Spain were seen by investors as a safe place where they could keep their money (the proposal of a referendum in Greece on the Troika financing package, political instability in Greece and Italy, a downgrade of Spanish banks, et cetera, made room for a serious assumption that the euro might break up). The situation calmed down with Draghi's famous words "whatever it takes..." in mid-2012, followed by the announcement, in September, of the OMT, an ECB program to purchase in secondary markets unlimited amounts of public debt from governments that are beneficiaries of aid from the EFSF or the ESM and are, therefore, subjected to the ensuing conditionality, stated in the corresponding memoranda of understanding.

In March 2015, the ECB put in motion another program involving massive purchases of public debt called the Public Sector Purchase Programme, or PSPP. Its purpose was not to keep bond prices under control, as was the case with SMP and OMT, but rather to raise inflation. Actually, one of the main differences with those programs was that within the PSPP the reserves created for the purchase of securities were not sterilized. In

any event, the PSPP was subjected to conditionality as well: the securities that the ECB would buy had to reach a minimum rating, and governments under a Troika program have to comply with the required conditionality. The rising Italian bond spread that happened after the announcement in mid-2018 by the Italian Government of tax cuts, the implementation of a basic income (actually an unemployment benefit) and some changes in the pension system, which would cause some additional fiscal deficit, makes it clear that the ECB is opposed to these measures. It should also be noted that Greek bonds were not included in the PSPP.

CONCLUSIONS

The Eurosystem, through the Bank of Spain, had a responsibility, by omission, in the unfolding of an extraordinarily strong debt-led period in Spain, from 1997 to 2007, which ended abruptly in 2008 when the real estate bubble, which had been growing for a decade or so, burst.

And the Eurosystem, now through the ECB, had a clear responsibility, by action, in the transition towards a seemingly export-led growth model, through depressing domestic demand. Although more actors got involved in the forced transition to the new model, the ECB participated by actively conditioning the provision of reserves to banks in impaired economies upon the adoption of a conditionality, which in essence means fiscal consolidation and wage devaluation (plus some restructuring and recapitalizing of the banking system in certain cases).

Although the significant indebtedness in the first decade of the euro explains, to some extent, the adjustment that took place over 2008-13, the ECB went beyond its mandate with the management of collateral eligibility, and conditioning ELA funds and benefits from SMP, OMT and PSPP, upon the adoption of some conditionality. We concede that this happened in the context of a deep financial crisis, when the institutional architecture in the EZ was poorly organized so that the ECB was the only institution able to adopt measures in favour of financial stability, it had to protect its balance sheet as it was involved in operations with troubled assets, and it had to make clear that it was not violating the no-bailout clause in Art. 125 of the Treaty on the Functioning of the European Union. Notwithstanding, in the future the ECB should limit itself to providing assistance and advice “avoiding any involvement in the design and monitoring of the future adjustment programs” (Viterbo, 2016: p. 530; see also Gros, 2015).

Further, the ECB should explain why it forced debtors to tighten their belts and not creditors, who benefitted markedly from the massive injections

of central bank reserves in the troubled economies of the EZ that then flowed through the Target2 system, allowing banks in the core -where creditors reside- to replace those reserves with troubled assets in which they had invested in search of a higher yield (see for instance Thompson, 2015). Without those reserves, governments in the core EZ would have had to spend a lot of taxpayer money in the recapitalization of their banking industry.

Finally, we add that fiscal austerity-cum-wage devaluation have not been a success at all even in Spain, where the rate of growth of GDP returned to socially acceptable levels, compatible with a trade surplus: the contribution of exports was not higher than in the debt-led period, and the relatively high rate of growth of output was possible because of several tailwinds beyond the control of the ECB.

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Notes

- 1 To be precise, with its “one-size-fits-all” approach, the ECB did contribute to inflating the housing bubble in Spain because it set an interest rate that was too low for the Spanish economy in that period of time.
- 2 The rate of unemployment in Spain was around 20% in 1997 and it fell sharply to 8% in 2007. Employed people shifted from 13.2 to 20.2 million people during that time.
- 3 Property valuers, very often intimately connected to banks, often inflated the price of houses to allow banks to comply with the rule of granting mortgage loans amounting to less than 80% of their market value.
- 4 This explains the fact that while the ratio between the price of a dwelling and a household’s yearly disposable income increased from 3.4 in 1997 to 7.4 in 2004, the effort to buy a house (the percentage of income going to repay the corresponding debt -80% of the price of the house) only rose from 29.4% to 36.2%. The evolution of requirements for borrowers can be seen in the Bank Lending Survey, periodically published by the ECB.
- 5 In that period of time, accumulated external debt driven by current account imbalances was below 40% of GDP.
- 6 The reader may see in Figure 1 that part of the OMFI’s external debt in mid-2011 was replaced by the Bank of Spain’s external debt in 2012. The explanation for this fact is that the Eurosystem lent reserves to Spanish banks (especially in large LTROs in late 2011 and early 2012), which the latter then used to cancel debts held by German (and to a lesser extent French) banks. These

inter-bank debt settlements with central bank reserves took place through the TARGET2 system with the Bank of Spain acquiring liabilities to the system and central banks from creditor countries acquiring claims against the system. For a clear description of the functioning of the TARGET2 system see for instance Cesaratto (2013).

- 7 See here three letters submitted to the Minister of Economy by the Association of Banks Supervising Inspectors of the Bank of Spain: <https://ataquealpodere.files.wordpress.com/2012/12/informe-i.pdf> informing him of the alarming situation of increasing risk assumed by Spanish banks and the probability of a chaotic correction of imbalances in the real estate market.
- 8 See the letter sent by Trichet (and co-signed by Draghi) to the Spanish Prime Minister on August 5, 2011, in Rodríguez Zapatero (2013: pp. 248-251). Another similar letter was sent to Berlusconi: see Tooze (2018, chapter 17).
- 9 From the multiplier-accelerator viewpoint, in 1997-2007, GDP growth was higher because of residential investment, which is part of the autonomous demand. In 2014-18, GDP grows more slowly because of exports. For further details, see also IMF, 2016, p. 26.
- 10 For further details see Villanueva *et al.* (2018).
- 11 Ironically, one could find some coherence between the German position and the ECB's monetary policy during the Great Financial Crisis. As Thompson (2015: pp. 858-59) suggests, the former's preference for debt restructuring could be seen as a strategy to make other governments to believe that, with the ECB's injection of reserves, Germany was making a great effort that had to be compensated with fiscal consolidation and wage devaluation in debtor countries. And at the same time, it calmed far right political positions that were against rescues in the periphery. However, those reserves saved a large amount of German taxpayer money, which otherwise would have been needed to recapitalize part of its banking industry.
- 12 A similar situation occurred with Ireland and Portugal, in late 2010 and early 2011, when the ECB first rejected and then accepted their respective sovereign debt as eligible collateral, once these countries had adopted an adjustment program, consisting of a combination of fiscal austerity and wage devaluation in order to increase their ability to repay their external debt. The contribution of the ECB should be seen as complementary to external aid packages.
- 13 See Merler (2015) and references listed there regarding the role of the EFSF bonds.
- 14 Whelan (2014) questions why, *de facto*, the ECB shifted the burden of the Irish banking crisis to the government without asking.
- 15 Fazi (2019) uses the term blackmail.

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