ECB ACTION AND THE SPANISH ECONOMY DURING THE FIRST FIFTEEN YEARS OF THE EURO

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Introduction

The euro now has fifteen years of history. Spain's participation in the most advanced European integration project has been one of the most important determinants of its recent economic trajectory. To mark the anniversary, this article analyses the influence of ECB action on the Spanish economy during its fifteen years of existence, a period that saw the euro area itself transition from a prolonged initial stage of growth and stability to a far-reaching crisis that has thrown into relief its fragilities and inefficiencies and even called into question the viability of the project, as initially conceived.

The Spanish economy was among those that benefited most from the expansionary effects of the creation of the euro, but also among those that suffered most severely from the imbalances that built up. Eventually finding itself facing the necessity of making significant adjustments in a markedly adverse situation, Spain belongs to the group of countries that have suffered the greatest tensions and costs as a result of the crisis of the common currency. When analysing the influence of ECB action on the Spanish economy, it is therefore logical to distinguish between what happened in the period before the crisis and the events that have marked the development of the crisis. The structure of this article reflects this distinction.

The influence of the ECB on the Spanish economy before the crisis

The influence of ECB action on the Spanish economy, before the crisis revealed the mounting imbalances and vulnerabilities, was marked by the huge step that joining the euro entailed for the modernisation and galvanisation of the economy.

The change of macroeconomic regime resulting from membership of an area of monetary stability unleashed potent expansionary forces that were conducive to major gains in the process of catching up with the levels of welfare of the most advanced European countries. The adoption of the single monetary policy and the transfer of sovereignty in this area to the ECB were the most successful steps on the long path towards European standards of progress and stability for the Spanish economy: a goal formally pursued by economic policy since the late 1950s, although efforts had been repeatedly frustrated by the numerous structural, institutional and political constraints affecting the Spanish economy. There is an abundant literature and a barely discussed consensus regarding the great achievement that participation in Stage Three of EMU from the outset represented. Distinguishing the proportion of these beneficial effects that is attributable to ECB action from the proportion that must be considered to stem from the far-reaching structural change to which numerous actors and factors contributed is not easy. However, there is no doubt that these expansionary impulses could not have materialised without the anti-inflationary credibility that the ECB's monetary policy had from the very start. In the absence of this credibility such a drastic change in interest-rate expectations as that which occurred in Spain would not have been possible in an economy with such deep-rooted inflationary tendencies. Through the traditional substitution, income and wealth effects, this change in expectations acted as a powerful engine boosting demand and activity. On the credit side of the impact of ECB action is the significant contribution of its monetary policy to the major gains made by the Spanish economy in the process of real convergence between 1998 and 2007.

Throughout this stage, however, the monetary policy stance was predominantly expansionary. This was a consequence of the difficult digestion of German unification in the very heart of the euro area and the looseness of global financial conditions during the “Great Moderation” which, as subsequent events have dramatically shown, led to a serious underestimation of risks and significant real-estate and financial bubbles in the industrialised countries. This expansionary stance was especially inappropriate for the needs of the Spanish economy, which had not fully converged with European levels of stability and faced a particularly strong stimulus as a consequence of the aforementioned change in interest rate expectations. Sufficient illustration of this is provided by the behaviour of the long-term-interest-rate spread vis-à-vis Germany between 1995 and 2005 and a comparison of the interest rates set by the ECB between 1999 and 2005 with the rates that would have been consistent with the specific requirements of the Spanish economy according to the Taylor Rule. Such monetary looseness led to a veritable explosion of lending to the private sector, which was channelled mostly towards construction and real-estate activities, these being the most sensitive to long-term interest rates, with a resulting expansion in bank balance sheets and increase in risk incurred (see Chart 1).

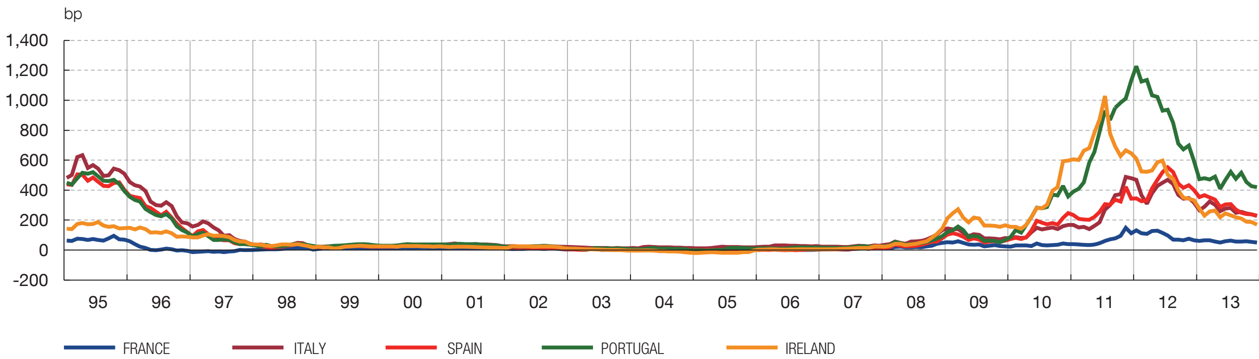
Membership of the euro area meant not only giving up the exchange rate as a tool of economic policy, but also the loss of control over the behaviour of lending to the domestic economy. The ECB’s monetary policy set the determinants of lending growth at the area level, but the distribution of this growth among the various member counties remained in the hands of financial intermediaries, through their relations with the end-users of financing.

During the long expansion that followed the introduction of the euro, the looseness of monetary conditions was one of the determinants of the build-up of serious imbalances in the Spanish economy, in the form of high levels of debt, real-estate excesses, competitiveness losses and external deficit. The free movement of liquidity and financing within the integrated monetary area enabled larger external imbalances to be financed, that would not have been possible when each country had had its own currency, and led to the warning signs implicit in the large size of the external deficit being largely ignored. In fact, the 2005 issue of the Annual Report of the Banco de España had already pointed out that “the growing net borrowing of the nation is indicative of a pattern of growth that cannot be sustained indefinitely” [Banco de España (2006)], in line with the analysis according to which the relief of the external financial constraint within a monetary union has the negative corollary of “weakening one of the most effective mechanisms, that analysts and economic policy managers are most accustomed to, for stopping and channelling excessive spending growth” [Malo de Molina (2007)]. Accordingly, “the deterioration in competitiveness underlying the external balance and the increase in private sector debt […] may affect both the financial stability of the various agents and sectors and the sustainability of spending and growth” [Malo de Molina (2006)].

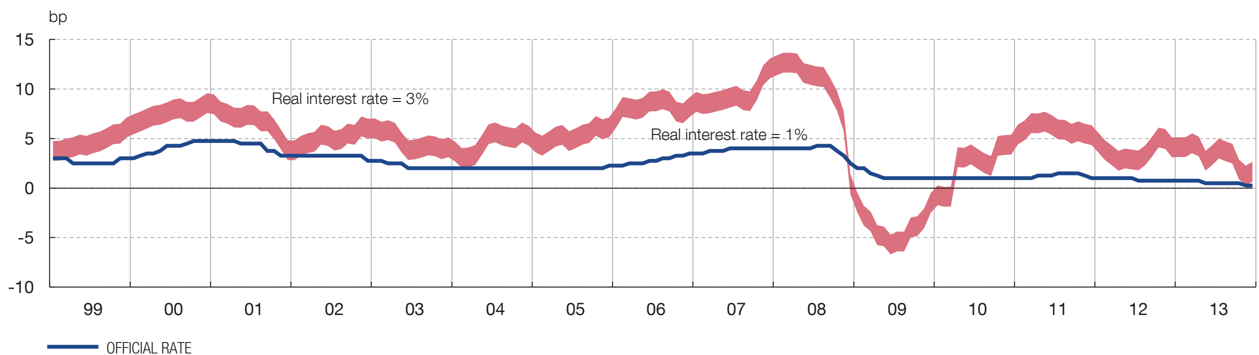
Even so, one thing is the undeniable influence that the looseness of the monetary conditions set by the ECB had on the build-up of imbalances in the Spanish economy. Quite another is to place the responsibility for them on the debit side of the ECB’s account, for two important reasons: first, because belonging to a monetary union involves accepting that monetary conditions have to be aligned with the requirements of the area as a whole and that the other economic policies that remain under national sovereignty must play the role of offsetting any misalignment between the common monetary policy stance and specific national requirements. In the case of Spain, a more countercyclical fiscal policy was needed to guarantee the sustainability of public finances, which was threatened by the weakness of the institutional framework to secure fiscal discipline in a highly decentralised

FINANCIAL CONDITIONS **CHART 1**

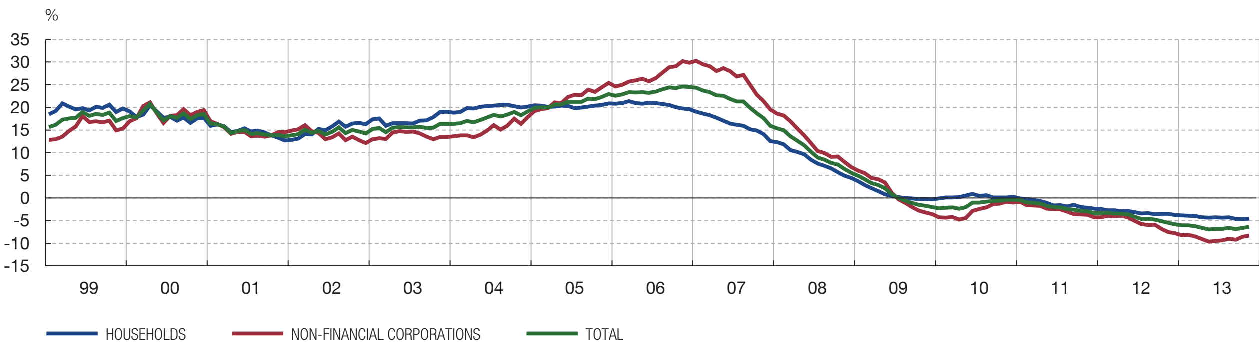
10-YEAR SOVEREIGN SPREADS OVER GERMANY



OFFICIAL INTEREST RATE AND TAYLOR RULE
INFLATION TARGET = 2%



CREDIT TO NON-FINANCIAL PRIVATE SECTOR ADJUSTED FOR SECURITISATION AND SALES
Year-on-year growth



SOURCES: Reuters, ECB and Banco de España.

state and by the vulnerability of the pay-as-you-go public pension system in the face of an ageing population. Likewise, deeper changes to the institutional structure and market organisation should have been implemented, to make the economy more flexible and to strengthen the mechanism of adjustment through costs, margins and prices, counteing the predominance of adjustment through quantities (output and employment).

It is obvious with the benefit of hindsight that the economy had not sufficiently adapted to the requirements of EMU and that the euphoria generated by rapid growth led to a

relaxation of the efforts still needed for the economy to be able to live with the monetary conditions of countries with a deeper rooted tradition of stability and greater productive potential. Indeed, financial policy measures were even adopted to ensure that the loose financial conditions should reach private agents as quickly and as intensely as possible. This was the case, for example, of the boost given to variable rate loans, which was intended to accelerate the transmission of ECB rates.

That said, it would not be correct to attribute the whole responsibility for the imbalances to the failings of the economic policy pursued by Spain since it joined the euro area. There is a second, equally powerful reason, originating in specific failures in the design and governance of EMU, which were conducive to a lack of surveillance of the development of imbalances within the euro area and failure to prepare for a systemic crisis like the one that eventually emerged. Monetary union was, of course, not conceived of as the final destination, but only as a stop on the way. The founders themselves, aware that the single currency did not meet some of the requirements for an "optimum currency area", hoped that the project would continue to advance towards more ambitious goals of integration in other areas apart from the purely monetary. Unfortunately, this expectation was not fulfilled because it was based on two assumptions that proved to be over-ingenuous. Supposedly efficient markets were expected to raise risk premiums and make financing more difficult for countries that failed to maintain a certain level of stability or to make sufficient progress with the structural transformation still needed for the country to be able to survive inside a strong currency area. It was thought that the ability of markets to discriminate would trigger the appropriate adjustments and responses. Also, governments were expected to be capable of reacting in time to risks of divergence that might jeopardise competitiveness, growth and employment. And this was expected both of the governments of countries with potential problems of overheating and imbalances and of the European authorities, who were expected to monitor and identify in time the emergence of internal tensions and to sustain the political pressure for integration.

None of this happened. The markets generously financed countries with imbalances, as if they were as solvent as the most stable countries in the area. Some governments, as already mentioned in the case of Spain, occasionally mistook the exuberance for an improvement in the fundamentals of their economies. And the EU authorities were paralysed by a nationalist backlash. Instead of making headway with integration, budget and balance of payments deficits and large amounts of public and private debt were allowed to build up in some countries, which eventually led to a systemic crisis that, within a very short time, undid much of the progress that had been made on integration.

All this ended up revealing that the foundations of the ECB's single monetary policy were insufficiently solid to resist the severe blows dealt by the crisis, which meant that the precarious institutional architecture of the single currency had to be reviewed wholesale while the ECB's responsibility to ensure the stability of its currency within the strict margins of action defined by the founding treaties was stretched to the limit. The ECB was forced to be unusually innovative in order to make sure that the pace of institutional reform of EMU kept up with the development of the crisis.

The second part of this article analyses the impact on the Spanish economy of the action taken by the ECB in the exceptional circumstances of the crisis, in which significant financial instability, markedly adverse cyclical factors and serious shortcomings of economic governance have all played a part.

The influence of ECB action on the Spanish economy during the crisis

The ECB's reaction to the first symptoms of crisis was to deploy the usual liquidity providing mechanisms to accommodate the surge in the demand for liquidity stemming from the rise in uncertainty and risk aversion triggered by the US subprime mortgage crisis. To accommodate this demand, the ECB refrained from its usual practice of calibrating its provision of liquidity to the needs considered compatible with the stance it wishes to give to its monetary policy. Also additional tenders were introduced for three-month liquidity, the longest maturity that had been available at ECB tenders, and the first tenders of six-month liquidity were conducted in order to increase certainty regarding future access to basic liquidity, at a time when mistrust between counterparties had brought the interbank market to a standstill. These actions were hailed as proof of sensitivity, helping to reduce uncertainty and limit the spread of US tensions to Europe. A significant innovation consisted of the agreements reached between the world's main central banks, which enabled the ECB to offer dollar liquidity to euro area banks. This possibility was very important for some European countries with banks exposed to the subprime crisis and suffering from a serious dollar shortage, although Spain was not among them. The Spanish economy entered a phase of cyclical downturn and unwinding of imbalances. The coincidence of this first episode of financial instability with a cyclical turning point intensified the slowdown in demand and exacerbated the real estate correction. In any event, the tranquillity supplied by the accommodation of the demand for liquidity by the ECB was conducive to the significant adjustments that needed to take place.

The first reaction of the ECB was limited to relaxing the terms on which it supplied liquidity, while the interest rates on its main refinancing transactions were left unchanged at 4%. In an economy like the Spanish one (in which lending to the private sector was still growing at rates of around 20%, domestic demand was growing by more than 4% and the correction of the housing overvaluation had still to begin), this level of central bank financing costs was conducive to the rebalancing that the Spanish economy had to undergo.

THE GREAT RECESSION

The need for changes in the modes of operation of monetary policy was brought into stark contrast by the worsening of the financial crisis that followed the collapse of Lehman Brothers. This put the advanced countries on course for a deep recession and called for emergency policies to stabilise the financial strains and mitigate their pass-through to real activity and employment. In particular, demand expansions were needed to counter the collapse of confidence and strongly contractionary spending developments. In this situation, the ECB started by immediately cutting interest rates by 100 basis points (bp), the first of seven successive reductions between October 2008 and May 2009, which reduced interest rates by a total of 325 bp. These rate cuts were accompanied by a very significant change to the ECB's liquidity tender system: the switch from a variable rate tender procedure with limited satisfaction of applications to one based on a fixed rate with full allotment of the amounts demanded. This important change involved the renunciation of any control over the amount of liquidity and the complete substitution of the interbank market in its intermediation role, which it had stopped playing owing to its deep paralysis. At the same time, the maturities at which the liquidity was supplied were extended to six months, and the amounts assigned and the numbers of tenders of medium-term liquidity were considerably increased. Liquidity was even offered in currencies other than the euro to satisfy the needs of some European banks for US dollars and Swiss Francs. Finally, the requirements for assets to be eligible as collateral for Eurosystem funds were loosened, on an exceptional basis, while the financial tensions continued.

These emergency ECB actions were especially appropriate for the needs of the Spanish economy, where the sudden change in the international economic climate was threatening

to transform the cyclical slowdown into a sharp loss of confidence and an abrupt contraction in spending. The intensity of the Great Recession in Spain was no greater than in other European countries, but the size of the imbalances that had built up in the immediate past and the lack of structural adaptation in some parts of the economy to the requirements for integration into the Monetary Union made the incubation of deeper problems likely. Such was the case, most notably, of the developments in the real-estate market. The possibilities for a smooth adjustment of the overvaluation and overproduction of housing suddenly evaporated as the market launched into a sharp correction of unknown extent, leading the Spanish economy for the first time in recent history to experience the bursting of a real-estate bubble. Given its high exposure to real-estate risk and its great dependence on wholesale funding on international financial markets, the stability of a significant segment of the banking system was seriously eroded as a result. To complicate the situation further, the problems were concentrated among savings banks, most of which were affected. Owing to the lack of definition of their ownership regime and the political interference in their governance, they lacked the necessary capacity to adapt to such adverse circumstances. The weakening of the financial system threatened to increase the financial fragility of the Spanish economy since, given the high levels of corporate and household debt, the ability to cover its financial needs abroad depended substantially on the perception of the solidity of financial intermediaries, which channelled the flows of foreign savings to domestic agents. The worsening of the international financial crisis and the Great Recession had hit the Achilles heel of a growth model that had already been shown to be unsustainable. Monetary and financial conditions had tightened significantly, contrary to the specific requirements of the Spanish economy in that situation. The action of the ECB was aimed at relieving this tension, although the problems that had emerged extended far beyond the scope of monetary policy. The new tender systems proved very helpful in avoiding the strangulation of Spanish credit institutions, and the loosening of collateral eligibility requirements was also very beneficial. The ECB's decision to launch a programme for the purchase of covered bonds, such as *cédulas hipotecarias*, was particularly directed at facilitating the transmission of its expansionary policy towards those segments of the European banking system, such as the Spanish one, that were most affected by the paralysis of the wholesale financing markets. In any case, the weakening of the banking system prevented the relaxation of monetary conditions engineered by the ECB from being adequately transmitted to the Spanish economy, and what began as a cyclical adjustment of credit growth turned into a rapid, sharp contraction in the amount of credit available. From competing to expand their balance sheets, the institutions had switched to reducing their high levels of exposure and leverage, and this was compounded by the need to restructure those savings banks that had begun to experience solvency problems.

The specific financial difficulties of the Spanish economy were heightened by the emergence of latent structural problems in the labour market. The lack of sensitivity of wages to the cyclical situation proved disastrous for absorption of the serious shock suffered. In 2009, when the economy contracted by 3.7%, wage compensation grew by around 4%. In conjunction with the sharp real-estate contraction, this led to rapid job destruction and a pronounced increase in unemployment, which not only eroded the foundations of domestic demand, but also damaged the perception of the Spanish economy abroad.

At the same time, the leeway available for expansionary fiscal measures to mitigate the serious weakening of the private propensity to spend was much more limited than the favourable values of general government aggregates appeared to imply. Although

the budget was in surplus to the tune of 2% of GDP, and public debt was 35% of GDP, well below the average euro area level, a significant part of government revenues came from the excess spending in the real-estate sector and on other activities that would prove to be unsustainable. Notwithstanding this, Spain put itself at the head of the advanced countries in the resort to fiscal stimuli. However, following the recommendations of international agencies in this regard did not sufficiently take into account the structural weakness underlying the public finances. Within two years the fiscal position had deteriorated by more than 13 GDP percentage points and a dynamic of sharply rising public debt had been set in motion, increasing the financial vulnerability of the Spanish economy to external shocks [Malo de Molina (2009)]. As a result, the expansionary monetary policies applied by the ECB in response to the Great Recession were barely felt by the Spanish economy, where financial pressures and the contraction in lending increased, with an intensification of their restrictive impact on spending, activity and employment.

THE SOVEREIGN DEBT CRISIS AND THE DOUBLE-DIP RECESSION

In the euro area, the Great Recession gave way in 2010 to the resumption of modest growth, reflecting a favourable response to the monetary and fiscal stimuli introduced. However, the reaction was not uniform, because the severe shock had revealed hidden vulnerabilities in certain periphery countries that had failed to adjust fully to the requirements of monetary integration and internal imbalances that continued to exist within the euro area. These eventually emerged in the form of the "sovereign debt crisis", which precipitated a double-dip recession and threatened the very survival of the single currency in the form it was created, posing challenges to the ECB's capacity to act of unusual transcendence.

The sovereign debt crisis involved the sudden emergence of numerous imbalances and misalignments that had been building up, with varying degrees of severity, across a broad group of countries of the area. In order of importance, these included ongoing competitiveness losses, oversized financial systems heavily exposed to real-estate risks, high levels of debt and public finance fragilities that emerged as a consequence of the deficits incurred during the crisis and the financial assistance needed to contain the financial system instability. The conjunction of these phenomena, which exposed the inadequacies of the institutional framework for economic governance and the lack of instruments to address the systemic shocks that threatened the very stability of the euro area, resulted in a lack of confidence in the ability of some of these economies to guarantee the sustainability of their debts and in the ability of the euro area authorities to resolve the situation. The result was a drastic increase in sovereign risk spreads, reflecting a bet by the markets that some of these Member States would be unable to cover their financing requirements without some kind of external assistance or bailout. The process started with the crisis and bailout of Greece, soon spreading to Ireland and Portugal. Within little more than a year there was a serious possibility that this dynamic might even extend to Italy and Spain, overwhelming the authorities' capacity to react, with the consequent risk of break-up of the euro and a currency redenomination in the most severely affected countries. As a result of the sovereign debt crisis, the situation changed from one of markets that were manifestly incapable of distinguishing between sovereign, bank and corporate risks, to excessive discrimination, market disintegration, renationalisation of financial flows and fragmentation of monetary policy transmission.

In particular, this financial fragmentation proved to be fertile ground for the development of dangerous vicious circles. Sovereign and bank risk tensions fed off each other, making it impossible for certain governments to bail out and shore up vulnerable banks without

jeopardising the sustainability of their own finances, while simultaneously increasing the risk of banks as a consequence of the perceived weakness of their sovereign's financial situation, regardless of the solvency of the banks themselves [Gual (2013)].

This is not the place to analyse this process and the nature of the review of the institutional framework of EMU to which it has given rise [Sapir and Wolff (2013), Millaruelo and Del Río (2013)]. What is appropriate here is to consider the challenges it entailed for ECB action and the repercussions of such action on the Spanish economy.

The great financial crisis of the 21st century has posed significant challenges for all central banks, calling into question the validity of the anti-inflationary paradigm that had held sway since the mid-1970s. However, it is the ECB that has had to face the greatest complications, stemming from the exceptional nature of its single monetary policy, conducted in a large area made up of various countries that retain sovereignty over other spheres of economic policy. Nor has the ECB had the benefit of a lengthy track record, having existed for little more than a decade when the sovereign debt crisis broke.

The sovereign debt crisis and the doubts regarding the survival of the euro in its current form called for ECB action on a broad range of fronts. In response to the resurgent contractionary forces that aborted the recovery and triggered the double-dip recession the expansionary monetary policy stance needed to be intensified. And this had to be done within a complex territory delimited by proximity to the zero lower bound and by the dampening or nullifying impact of the instability itself on the effectiveness of expansionary impulses, as evident in the contractionary dynamic of lending. Also, there was an urgent need to contain the forces destabilising the euro area, curbing the disintegration and renationalisation of markets and re-establishing the effectiveness of the monetary policy transmission mechanism. Effective ECB action on the numerous and complex fronts that had opened up required the use of a broad repertoire of innovatory, standard and, especially, non-standard monetary policy measures [Lenza *et al.* (2010); Woodford (2012); Cour-Thimann and Reinhart (2013)]. This was an unexplored area, peppered with the complications inherent in the ECB's unique status as the central bank of 17 sovereign states (now 18, with Latvia) and the difficulties of delimiting the monetary responsibilities of actions with fiscal implications. And this action was needed just when the shortcomings of the institutional framework had been revealed and a far-reaching review of the latter had been commenced, in the midst of significant controversies over contrasting approaches to the steps needed for progress towards fuller and more coherent integration [Basu and Stiglitz (2013); De Grauwe (2013); Furceri and Zdzienicka (2013); Darvas (2013)].

The standard measures included further reductions in official interest rates, as the impact of weaker growth prospects and the entry into a scenario of inflation persistently below the price stability definition became evident. These developments did not entail a high risk of deflation, but they clearly posed obstacles to the relative-price and competitiveness adjustment required for the internal imbalances to be absorbed. The main refinancing rate was reduced as low as 0.25% in November 2013, while the deposit facility rate was held at 0%, narrowing the corridor between the credit and deposit facility rates, and even making it asymmetric. The ECB also announced, in this respect, that it was prepared to apply negative rates to the deposit facility if the risks to stability so required. This set of standard actions amounted to a maximum expansionary monetary stance, which was supplemented by additional actions in the area of liquidity providing arrangements, with further extensions to maturities (to three years, to address the uncertainty over liquidity access that sovereign or banking system problems may cause) and the adoption of

guidelines on the future behaviour of the tender system and on the continuation of the low interest-rate policy. The ECB announced that the system of providing unlimited amounts of liquidity at a fixed rate would remain in force for a long time and promised to keep interest rates low, or even lower, for a prolonged period (see Table 1).

The most complex area was the ECB's intervention in securities markets to repair the damage caused to the monetary policy transmission channel by the sovereign debt crisis. Securities purchases were activated in 2009 to boost the markets for covered bonds, such as *cédulas*, and to stimulate lending to the private sector. The sovereign debt crisis gave rise to a need to counter the expectations spreading through the markets, that threatened to become self-fulfilling, regarding default on the debts of some sovereigns and even, subsequently, of the redenomination of sovereign debt, following a country's abandonment of or expulsion from the euro area.

In May 2010, when the Greek crisis and its spread to other potentially vulnerable countries had reached a critical point and a bailout for Greece had been agreed, the ECB, given the lack of agreement to establish an inter-governmental or European mechanism for debt market intervention, decided to approve the securities market programme (SMP). This consisted of secondary market purchases of the public debt of countries suffering speculative attacks on the bond markets. The exclusive aim of this monetary policy operation was to ensure the transmission of monetary impulses to countries facing exorbitant borrowing costs and difficulty obtaining financing owing to the uncertainty regarding their solvency. Their monetary nature limited the scope of these operations and made them conditional upon the adoption of necessary measures both by the authorities of the countries concerned and by the European authorities to ensure the sustainability of their public finances and the improvement of the governance of the area. Under no circumstances could the ECB surreptitiously carry out the mutualisation of risks that the fiscal authorities or national parliaments were not prepared to assume. Even so, the ECB's performance of this type of operations led to criticism in the public opinion of some countries, and even public differences between members of the ECB's Governing Council. This programme had two phases: the first, in 2010, was focused on the bailouts of the Greek, Irish and Portuguese economies; and the second, in summer 2011 concentrated more on Italy and Spain, when the risks for these economies of contagion began to become more imminent.

The most critical moment came in summer 2012. The doubts over the Spanish economy had been intensified by the release of high budget deficit figures and the escalation of the banking crisis following the nationalisation of Bankia and the announcement of a European financial assistance programme for the recapitalisation of Spanish banks. The political uncertainties in Italy overshadowed the possibilities of progress with the necessary adjustment and the eventuality that Greece might abandon the euro raised the risk of redenomination to unprecedented levels. The ECB's response was unequivocal. The President announced that it would, within its mandate, do whatever was necessary to save the euro. This announcement was followed by the design of the new Outright Monetary Transactions (OMT) Programme, under which the ECB can purchase unlimited amounts of the public debt of countries vulnerable to the sovereign debt crisis, when they suffer pressures that are not justified by the developments in their fundamentals. The programme is designed for countries that maintain the capacity to finance themselves on the markets and submit themselves to the conditionality of the EU precautionary support programmes, to ensure that their economic policies are consistent with correction of their imbalances. This new instrument is basically capable of deterring speculative processes and it is designed to limit the assumption of risks by the Eurosystem, avoiding a permanent presence in the markets.

CHRONOLOGY OF EUROSYSTEM MEASURES (a) **TABLE 1**

Year	2007	2008	2009	2010	2011	2012	2013
Month	8 9 10 11 12	1 2 3 4 5 6 7 8 9 10 11 12	1 2 3 4 5 6 7 8 9 10 11 12	1 2 3 4 5 6 7 8 9 10 11 12	1 2 3 4 5 6 7 8 9 10 11 12	1 2 3 4 5 6 7 8 9 10 11 12	1 2 3 4 5 6 7 8 9 10 11 12

MRO interest rate	
	4% · 4.25% · 3.75% (b) · 1% · 1.25% · (b) 1% · 0.75% (b) · 0.5% · 0.25%
Standing facilities: rate corridor width	
	100 bp · 200 bp · 150 bp · 100 bp · 75 bp
Weekly ordinary operations (MROs) and longer-term operations (LTROs)	
MRO	liquidity > *benchmark* neutral · Fixed rate with full allotment
3-month LTROs	Fixed rate with full allotment · Fixed rate with full allotment
Supplementary LTROs. At a fixed rate and with full allotment since October 2008	
	Special LTROs with a maturity of one maintenance period
	Additional 3-month LTROs · Rollover at a fixed rate with full allotment
	6-month LTROs · 6-month LTROs
	1-year LTROs · 1-year LTROs
	3-year VLTROs
Currency operations	
	USD · USD
	CHF
Securities purchase programmes: covered bond purchase programmes (CBPP1 and CBPP2), Securities Markets Programme (SMP) and Outright Monetary Transactions (OMT) programme	
	CBPP1 (€60 bn) (c) · CBPP2 (€40 bn) (c)
	SMP (c)
	OMTs
Reserve requirements	
	2% · 2% · 2% · 2% · 2% · 1% · 1%
Forward guidance	
Liquidity	
Interest rates	

SOURCES: ECB and Banco de España.

a The colour red indicates that the operations in question were carried out during that month, while blue indicates that although no new operations were carried out that month, the liquidity provided by previous operations remained outstanding. The OMT programme is available, but no debt purchases have been made since it was initiated.
b Between October 2008 and May 2009 the ECB reduced interest rates on seven occasions, by a total of 325 bp. In November and December 2011 the ECB reduced interest rates twice, by a total of 50 bp.
c CBPP1 ended in June 2010, the outstanding amount peaking at €61.1 billion. CBPP2 ended in November 2012, the outstanding amount peaking at €16.4 billion, well below the programmed amount of €40 billion. The SMP peaked at an outstanding amount of €219.3 billion in February 2012.

Along with the steps taken by European political authorities to establish a banking union and the progress made with fiscal consolidation and structural reform at the country level, these ECB actions marked a turning point in the development of the sovereign debt crisis, since they were interpreted by the markets as sufficiently effective protection against the extreme (tail) risks of a euro break-up. The exponential growth of sovereign risks subsided and the tendency for markets to fragment began to ease, although the return to normal was still a long way off and not without risks of setbacks and resurgence of instability.

All these actions had an especially favourable impact in the case of the Spanish economy which, following the bailouts for Greece, Ireland and Portugal, had stood, along with Italy, on the front line of the crisis. Interest rate reductions helped to ease the extremely adverse financial conditions to which the economy had become subject but, since the monetary policy transmission process was not fully repaired, these declines did not lead to any easing in the financing conditions of Spanish firms and households or to any improvement in the credit conditions offered by the banking system, which was undergoing a far-reaching restructuring and recapitalisation process.

The most visible part of the effectiveness of the ECB action was evident during the period from summer 2011 to summer 2012. That was when the expectations that the Spanish economy might, together with the Italian economy, eventually require a bailout programme of a magnitude difficult for the current structures of the Monetary Union to handle and the dangers of a Greek exit from the euro were at their greatest.

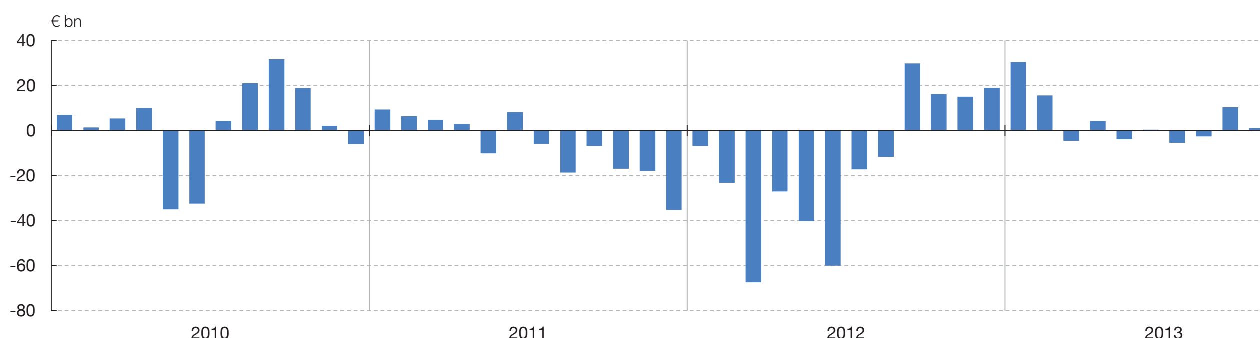
In the summer of 2011, reactivation of the securities market programme, with the focus on Italy and Spain, served, along with the economic policy measures adopted in these two countries, to halt and turn around the rise in sovereign risks. Nonetheless, the persistence of the uncertainty was evident in the inability of the Spanish economy to roll over significant amounts of debt held by non-residents, which led to increasing dependence of Spanish credit institutions on Eurosystem financing. The ECB's decision to embark on further massive injections of three-year liquidity was decisive in avoiding a financial collapse in the Spanish economy. As can be seen in Chart 2, during the year that ended in summer 2012 there was a net financial outflow of €300 billion of funds, which could only be covered by means of an increase in Eurosystem financing, to a total of €400 billion. Most of this financing came from special tenders of three-year funds which, apart from effectively substituting for the total absence of market financing, helped eliminate the uncertainty regarding the possibility that the evaporation of external financing might end up choking off any possibility of early emergence from the double-dip recession, which in Spain threatened to be more intense and persistent than in the euro area as a whole. The Monetary Union functioned correctly, financing the acute balance of payments crisis suffered by the Spanish economy as a result of the conjunction of high external indebtedness and market distrust, exacerbated by the frailties of the banking system revealed by the banking crisis and by the need to resort to a programme of assistance to recapitalise the banks. Eurosystem financing was only a temporary solution. That a growing part of Spain's external debt should end up on the balance sheet of Eurosystem central banks through Target account balances would be inconceivable. In fact, there was harsh criticism in some countries, based on misguided analyses, directed at the risks for borrower countries that Target balances represented.

As a result, the sovereign risk of Spain continued to grow, reaching 630 bp, very close to the level at which other Treasuries lost access to the markets and had to request a bailout. The situation of the Spanish economy would only start to stabilise when the ECB adopted

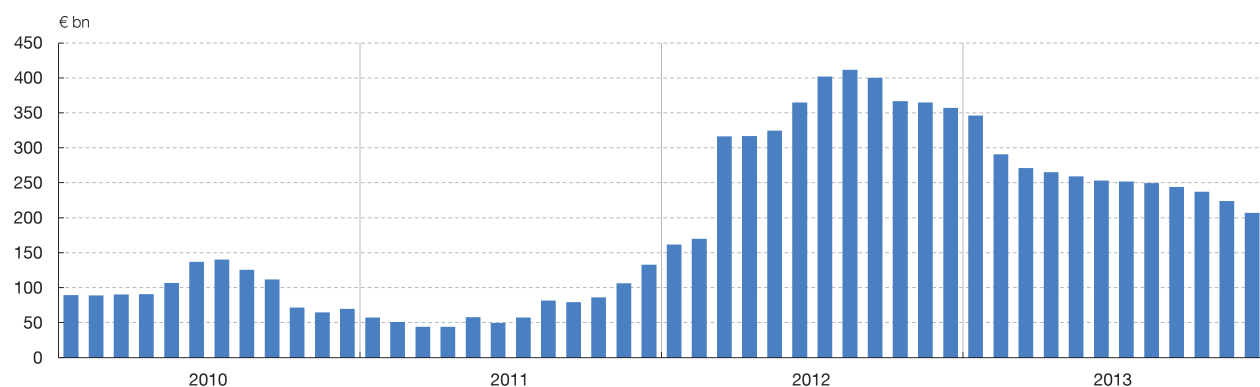
FINANCING OF THE SPANISH ECONOMY

CHART 2

NET FLOW OF FINANCING, EXCLUDING THE BANCO DE ESPAÑA



EUROSYSTEM BALANCE SHEET



SOURCES: Reuters and Banco de España.

its most decisive action to ensure the stability of the euro, i.e. the announcement and design of OMTs. From that moment risk spreads began to return towards less distorted levels, reaching by end-2013 their pre-summer 2011 levels. The recovery in confidence and the decline in risk enabled external financing to resume and dependence on Eurosystem financing to be progressively reduced to half its peak level.

Final considerations

The action taken by the ECB to combat the sovereign debt crisis and to ensure the survival of the euro has been especially effective in helping to avoid the financial strangulation of the Spanish economy and to facilitate its continued participation in the Monetary Union, without the need for a bailout. That said, the ECB's capacity to act is limited and resolution of the underlying problems ultimately depends on the strength of the Monetary Union's institutional framework and the ability of national economic policy to correct imbalances and lay the foundations for a new growth path.

Many problems remain to be resolved, including the re-establishment of homogeneous monetary policy transmission and repair of the short circuit between sovereign risk and bank risk. Both issues are fundamental for credit to flow normally to businesses and households when the recovery begins to take hold, and they, in turn, depend on the success of the ambitious banking union project. The ECB has a key role to play here, although its capacity to act is again limited, since it can be no substitute for the necessary fiscal contribution from the member countries that has still to be determined [Coeuré (2013)].

10.2.2014.

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