

OUTRIGHT MONETARY TRANSACTION



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On 6th September, the ECB announced that it will buy unlimited amounts of sovereign debt from troubled countries of the euro zone, subject to certain conditions. The ECB has named this “Outright Monetary Transaction” or OMT.

When we say that the ECB will buy debt, it means that the ECB will buy government bonds of troubled economies of the euro zone.



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What this means that countries with troubled economies will get the much needed liquidity. However, simply by infusing liquidity, would the troubled economies see their pain evaporate? Is it enough to inject liquidity or is there something else that is the need of the hour?



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To get a better insight into this problem, let's look at the following example:-

Let's say Sunil is a brilliant lad. He is 20 years old and goes to a one of the most prestigious colleges of the city. His father is the CEO of a company and he lives in one of the best locations in the city.



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Everything seems to be on track for Sunil except for one problem. Sunil suffers from obesity. His weight weighs him down and prevents him to attain the potential that he deserves.

There is a constant tussle between his health and weight and of late, his health has been on the receiving end. Sunil has been suffering from intense back pain.



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The doctor prescribes pain killers which gives Sunil immediate relief.

So Sunil continues to live life and does little to cut down his weight.

As a result of his lackadaisical ways, the back pain returns with increased intensity. This time when he visits his doctor, he is advised bed rest along with pain killers.



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Moreover, the doctor tells him that the bed-rest and pain killers is necessary for getting relief but it not sufficient enough to cure him of the problem. For a sustained solution, he should follow a disciplined exercise and diet regime.



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Now let us revisit the OMT relief for the troubled economies and establish the connection. What would be taken as the pain killer and what would construe to be the discipline exercise and diet regime?



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A closer analysis would reveal that the OMT can be interpreted to be the “Pain-killers” while structural economic reforms and austerity measures would be taken to mean the disciplined regime.

So just as in the case of Sunil, these economies will certainly get some respite due to this sudden injection of liquidity.



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But if they do not embark upon the disciplined course of reforms and take some measures to bring in a culture of voluntary austerity, the problems that these countries have got entangled with may not get solved.



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Moreover, this infusion of liquidity, will give the troubled economies immediate relief by ensuring that their borrowing costs don't spiral beyond control. But one should bear in mind that higher liquidity could see money getting diverted towards commodities, putting upward pressure on their prices.



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In India, the liquidity could translate into euphoria in the stock market, for which the markets rallied by 2% after the announcement.

But at the same time, if commodity prices continue to increase it could put adverse pressure on the fiscal deficit as well as cause the rupee to weaken due to crude purchase at higher prices.



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Hope this lesson has helped you
in understanding the term
Outright Monetary Transaction



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