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Cross-Asset- and Strategy-Research

No need to expand the ECB toolbox

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Attempts to cap government bond spreads are dangerous

The ECB's monetary policy turnaround remains piecemeal. At its meeting yesterday, the Governing Council met the minimal expectations: an end to net purchases of government bonds and the smallest possible interest rate hike of 25 basis points in six weeks time. A victory of the hawks would have looked different.

During the press conference president Lagarde hinted at the introduction of another monetary policy instrument, which would allow the ECB to selectively purchase government bonds of an individual member country. The ECB could chose to use such a new tool if it were to hold the view that the capital market risk premiums ("spreads") represent an undesirable financial fragmentation of the Euro area.

Monetary and fiscal policy would become harder to disentangle

The proposed tool is unclear, dangerous and unnecessary

Unclear! The design of the instrument remains vague. According to which criteria should the envisaged new tool be used? At what risk premium would ECB intervention be necessary? Is a risk premium of Italian over German government bonds of 3% "too high"? Or 2.5%? And would it make a difference if, despite widening spreads, the inflation-adjusted interest rates payable by, say, Italy are still negative, as they are at present? Do the same rules apply for all, or do the "permitted" spreads rather depend on the diverging credit risk of member countries? Could this then lead to profit-oriented U.S. rating agencies having through their decisions an even greater influence on the conduct of European monetary policy? And will the ECB intervene to support the market even if the widening of risk premiums is self-inflicted, such as, for example, after the 2018 general elections in

The proposal of a spread instrument raises more questions than it answers

Italy, when chaotic coalition talks spooked investors? Questions upon questions, all of which await answers and fuel speculation.

ECB "interest rate insurance" undermines economic reforms incentives

Dangerous! An instrument to cap spreads would stunt incentives to implement economic policy reforms. Why should, say, Italy implement unpopular measures to boost growth or consolidate public finances if the ECB issues an insurance policy protecting the government from adverse capital market reactions? I see furthermore an acute risk that the German Constitutional Court will classify the spread instrument as direct government financing, which is expressly forbidden by the EU Treaty. Such a judgement would massively damage the credibility of the ECB. And it would likely encourage investors to sell off peripheral bonds. The opposite of what the ECB wants.

Unnecessary! With the instrument of Outright Monetary Transactions (OMT), the ECB already has a hitherto unused but constitutionally validated tool at its disposal through which it can purchase government bonds of individual countries in a targeted manner. However, OMT purchases would have to be accompanied by policy conditionality on those countries that want to benefit from OMT. The OMT option, including conditionality, was introduced in 2012 by then-ECB president Mario Draghi. It is therefore a little ironic that resistance against conditionality is particularly vocal in Italy, a country now run by Prime Minister Draghi. I guess it's all a matter of perspective…

There is no way back now

Even if the new spread instrument is conceptually counterproductive, it will be next to impossible to walk away from the expectations that have now been raised of a "Lagarde-put" that would cap interest rates of sovereign bonds. By reneging on the spread instrument, the ECB would likely provoke the very sovereign debt crisis that the new tool precisely seeks to prevent.

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