ECB: ADDRESSING UNWARRANTED SPREAD WIDENING

Next Thursday's meeting of the ECB Governing Council is eagerly awaited. The rate hike decision has been pre-announced so the more important question is whether the new tool to address unwarranted sovereign spread widening will be unveiled. The rationale for such an instrument is well understood but its design and use raise several questions. One is easy to answer. To avoid a conflict with the monetary policy stance, bond purchases by the central bank would need to be sterilized. The others are more challenging. Where is the threshold to call a spread widening 'unwarranted'? Should the ECB be clear or ambiguous on this threshold and on its reaction when it would be reached? The final question concerns moral hazard and, hence, conditionality. When the ECB intervenes to address unwarranted spread widening, what are governments supposed to do in return in terms of fiscal policy?

Next Thursday's meeting of the ECB Governing Council is eagerly awaited. The rate hike decision has been pre-announced so the focus will be on whether there is any finetuning of the guidance against the background of weaker survey data.

The more important question however is whether the new tool to address unwarranted sovereign spread widening will be unveiled. The purpose of this Transmission Protection Mechanism[1] is to fight fragmentation risk inside the euro area that would result from a disconnect between government bond spreads and their fundamentals.

Back in March, Christine Lagarde had insisted on the Governing Council's readiness to *"use a wide range of instruments to address fragmentation"*, adding that, *"if necessary, we can design and deploy new instruments to secure monetary policy transmission as we move along the path of policy normalization."*[2] A sense of urgency grew in June when sovereign spreads widened significantly, triggering an *ad hoc* meeting of the Governing Council on 15 June to discuss the market situation and leading to a statement that flexibility will be applied in reinvesting redemptions in the PEPP portfolio. Moreover, it had been decided *"to mandate the relevant Eurosystem Committees together with the ECB services to accelerate the completion of the design of a new anti-fragmentation instrument for consideration by the Governing Council."*[3]

Addressing fragmentation risk is of major importance to avoid that monetary transmission would be impacted by an excessive increase in bond yields in certain countries, giving rise to a negative feedback loop and destabilizing dynamics. However, the design and use of the – yet to be announced – tool require that several questions be answered.

Firstly, when is a spread widening considered to be unwarranted? Answering this question is a challenge because years of asset purchases as well as the Covid-19 pandemic and the ECB's policy reaction (PEPP) have influenced interest rate differentials between euro area countries. Moreover, the recent spread widening occurred in an environment of rising yields on German government bonds, which are considered risk-free and are therefore used as a benchmark in the euro area (chart 1).[4] According to recent work by the Bank of Italy, *"a level of the spread between the 10-year Italian and German bonds lower than 150 basis points would currently be in line with the market valuations*

1. Source for the name of this new instrument: ECB Tool Has Name, But Arrival on July 21 Seems Uncertain, Bloomberg website, 7 July 2022; ECB's Stournaras: We will agree on transmission protection mechanism, Reuters, 7 July 2022.
2. Source: *"Monetary policy in an uncertain world"*, Speech by Christine Lagarde, President of the ECB, at *"The ECB and Its Watchers XXII"* conference, Frankfurt am Main, 17 March 2022.
3. Source : ECB, Statement after the ad hoc meeting of the ECB Governing Council, 15 June 2022.

4. For more detail see : *Unwarranted spread widening : measurement issues*, Ecoweek, BNP Paribas, 20 June 2022; *Unwarranted spread widening : measurement issues (part 2)*, Ecoweek, BNP Paribas, 27 June 2022.

SPREAD WIDENING IN 2022

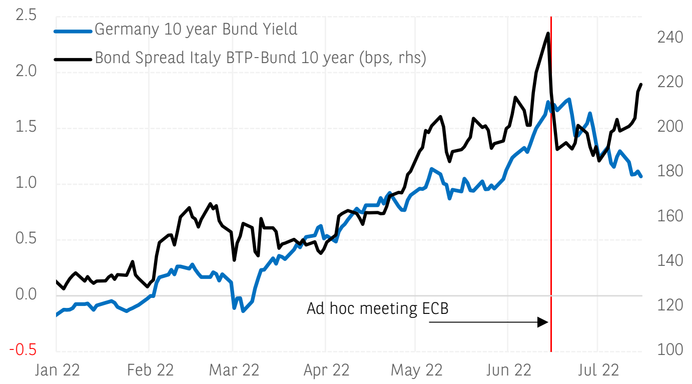

CHART 1 SOURCE: REFINITIV, BNP PARIBAS

> The ECB, when unveiling its new Transmission Protection Mechanism, will have to answer challenging questions: when is a spread widening 'unwarranted'? Should the ECB be clear or ambiguous on this threshold and on its reaction when it would be reached? How will moral hazard be handled?

consistent with the macroeconomic fundamentals, while levels higher than 200 points would not be justified."[5]

These results lead us to the second question: should the ECB be clear or ambiguous on its reaction function? The former would imply that thresholds - such as, according to the Bank of Italy calculations, 200 basis points for the BTP-Bund spread - are communicated with the hope that this would slow down speculation when the market is approaching this level: investors might fear that intervention by the ECB would be imminent. However, the opposite cannot be excluded, with investors testing the determination of the central bank in defending a certain spread.

This would call for keeping some ambiguity, although this would inevitably trigger questions during the press conference that follow the Governing Council meetings. The reaction function not only concerns the threshold level for spreads but also, if the spread would have moved beyond, how quickly the central bank would try to bring it back below.

Moreover, what is the appropriate frequency of communicating on the market interventions? Under the Outright Monetary Transactions (OMT), which were introduced in September 2012 following Mario Draghi's famous speech in July that year but never used (chart 2), the aggregate holdings of the Eurosystem and their market value would have been published on a weekly basis and the country details on a monthly basis[6]. Frequent communication about the threshold and market interventions would show decisiveness, but it would also suppose that the policy is effective. Otherwise, there would be a credibility problem that would make matters worse.

Another question concerns the monetary consequences. Bond purchases by the central bank imply the creation of high-powered money. This would need to be sterilized if it would run into conflict with the monetary policy stance, e.g. during a rate hike cycle. Under OMT, the transactions would also have been sterilized.

The final question concerns moral hazard and, hence, conditionality. When the ECB intervenes to address unwarranted spread widening, public finances of the targeted countries benefit - a significant increase in the borrowing cost is being avoided -, which raises the question of what governments are supposed to do in return in terms of fiscal policy?[7] Bundesbank president Joachim Nagel recently argued in favour of designing the bond buying scheme based on the experience of OMT to avoid giving *"the impression of discouraging fiscal policy consolidation"*.[8][9]

SPREAD WIDENING IN 2012

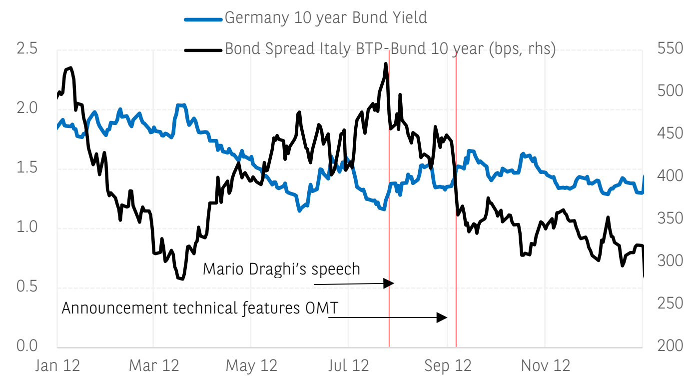

CHART 2 SOURCE: REFINITIV, BNP PARIBAS

Isabel Schnabel, Member of the Executive Board of the ECB, on the other hand noted in February this year that due to the stigma effect, there had been a reluctance to resort to an ESM programme but that Next GenerationEU had shown it is possible to have conditionality without strong stigma effects.[10] This message was recently echoed by her colleague Fabio Panetta, who insisted that the PEPP and Next Generation EU *"clearly show that there are other possibilities that involve flexibility and cooperation, rather than confrontation, between Europe and its Member States."*[11] The debate within the Governing Council will probably be intense.

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5. Source : Banca d'Italia, Economic Bulletin, 3/2022, July. The fair value spread is calculated using a panel model that includes the main euro area countries. The explanatory variables are debt levels as a share of GDP, short- and medium-term growth expectations and medium-term inflation expectations and the unemployment rate.
6. Source : *ECB, Technical features of Outright Monetary Transactions*, 6 September 2012
7. Absence of fiscal consolidation would influence the warranted spread -as shown in the calculations by the Bank of Italy mentioned in footnote 5, the debt level influences the spread- but it could also increase the likelihood of speculative attacks.
8. Source : *"ECB should model new bond scheme on old one"*, Nagel says, Reuters, 11 July 2022.
9. Under OMT, a necessary condition was *"strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme."* Moreover, the involvement of the IMF would *"also be sought for the design of the country-specific conditionality and the monitoring of such a programme."* (Source: see footnote 6).

10. Source: ECB, Interview with Financial Times, Interview with Isabel Schnabel, Member of the Executive Board of the ECB, conducted by Martin Arnold on 14 February and published on 15 February 2022.
11. Source: ECB, Interview with La Stampa, Interview with Fabio Panetta, Member of the Executive Board of the ECB, conducted by Marco Zatterin, 5 May 2022.