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Sovereign bond purchases and risk sharing arrangements: Implications for euro-area monetary policy

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Project framework

- Scientific advisory services
  - » Regular briefing papers (4+ per year)
  - » Contract period: 2015-2020
- European Parliament
  - » Committee on Economic and Monetary Affairs
  - » Monetary Dialogue (EUP ⇔ ECB)
- IfW-Coordinator: Nils Jannsen

This paper (joint work)

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Outline

- Programme specification
- National separation of risks
- Quantitative feasibility
- Financial risks for the Eurosystem
- Implications for monetary policy

Public Sector Purchase Programme

- Extended Asset Purchase Programme (EAPP) *monthly*
  - » Asset-Backed Securities Purchase Programme (ABSPP) 10 bn
  - » Covered Bond Purchase Programme (CBPP3)
  - » Public Sector Purchase Programme (PSPP) 50 bn
  - ⇨ 1.1 trillion in assets in total until September 2016 (approx. + 50 % of Eurosystem‘s consolidated balance sheet)

- PSPP
  - » March 2015 to September 2016 (or later)
  - » Assets of supranational institutions (explicit risk sharing) 6 bn
  - » Central government bonds, securities of national agencies
    - – Held by ECB (explicit risk sharing) 4 bn
    - – Held by National Central Banks (no explicit risk sharing) 40 bn

Eligibility criteria and quantitative limits

- Eligibility criteria for sovereign bonds
  - » Remaining maturity of 2 to 30 years
  - » Collateral quality for ECB monetary policy operations
    - – High credit rating
    - – EU financial assistance programme (not under review)
  - » Yielding at least ECB deposit rate (currently -0.2 percent)

- Limits (for Eurosystem as a whole)
  - » Not more than **33 percent** of the debt of any single issuer
  - » Not more than **25 percent** of any given issue (no blocking minority)
  - ⇨ **Irrelevant with respect to monetary financing**

Risk separation

- Credibility
  - » Loss absorption capacity of NCBs
  - » Recapitalization rules for national central banks
  - ⇨ **Central bank equity matters**

- Central bank independence
  - » “In the event of an NCB’s net equity becoming less than its statutory capital or even negative would require that the respective Member State provides the NCB with an appropriate amount of capital at least up to the level of the statutory capital within a reasonable period of time so as to comply with the principle of financial independence.” (ECB, 2010 Convergence Report)

Quantitative feasibility (1/2)

- Aggregate euro-area bond market

» Outstanding debt issued by central governments	6,666 bn
» … of which 25 percent (issue limit)	1,666 bn
» … SMP programme (prior to PSPP)	194 bn
» … Bonds held by NCBs (prior to PSPP)	240 bn
» **Gross eligible central government debt**	**approx. 1,250 bn**
» Outstanding securities issued by national agencies	350 bn
» Securities issues by supranational institutions	567 bn
» **Gross total eligible securities**	**approx. 2,150 bn**

⇨ Not binding until September 2016 (but increasingly so after)

- Maturity spectrum hardly relevant
- Currently market values higher than nominal values, and minimum yield limit not binding

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Quantitative feasibility (2/2

- Country-specific bond markets

Small countries without “sufficiently” high issued debt	Luxembourg, Lithuania, Latvia, Estonia
Highly indebted countries without sufficiently high eligible outstanding debt	Greece, Ireland, (Portugal)
Large countries (80 percent of euro-area sovereign bond market)	Italy, France, Germany, Spain

⇨ **Limiting criteria binding for small countries only**

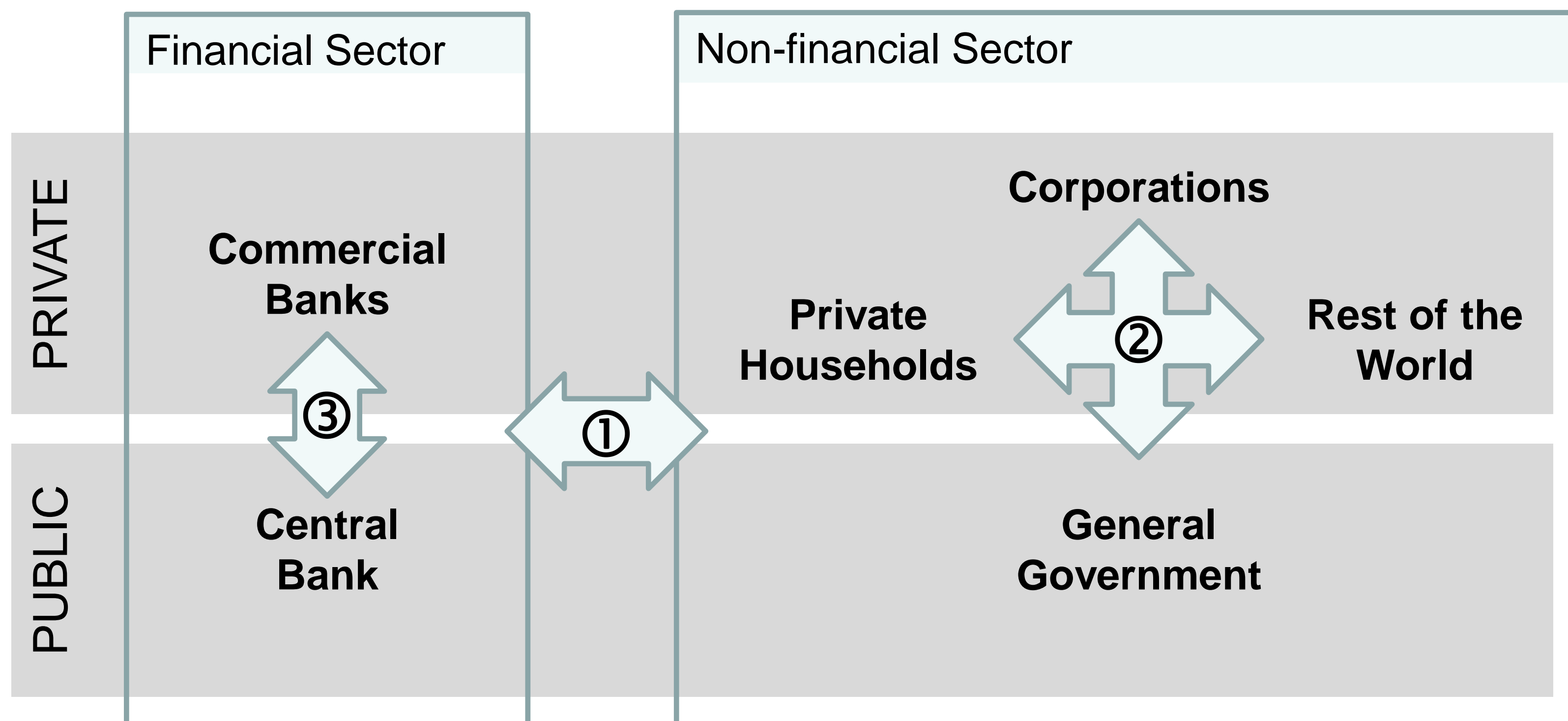
⇨ **By and large, the programme can be carried out as foreseen**

⇨ **Enlarging the programme would face relevant limits (e.g. German bonds, supranational institutions)**

Financial risks for the Eurosystem

- Central banks
  - » Technical insolvency vs. political insolvency
  - » Strong financial health is a key factor to ensure independence
- Money
  - » Functions as a general means of exchange
  - » Excessive money creation destroys this function
- Default risks and loss absorption capacity of NCBs
  - » Eurosystem strong enough to deal with even a 100 percent default
- Interest rate risks and accounting principles
  - » QE operations necessarily earmarked as "held to maturity" (otherwise substantial capital provision to cushion against QE)
  - » Significant losses under a fairly broad range of assumptions

Economic sectors, money creation, and financing



① Liquidity provision: money demand vs. money supply (and financial intermediation)
② Financing: saving (lending) vs. investment (borrowing)
③ “Quantitative Easing”: monetary base

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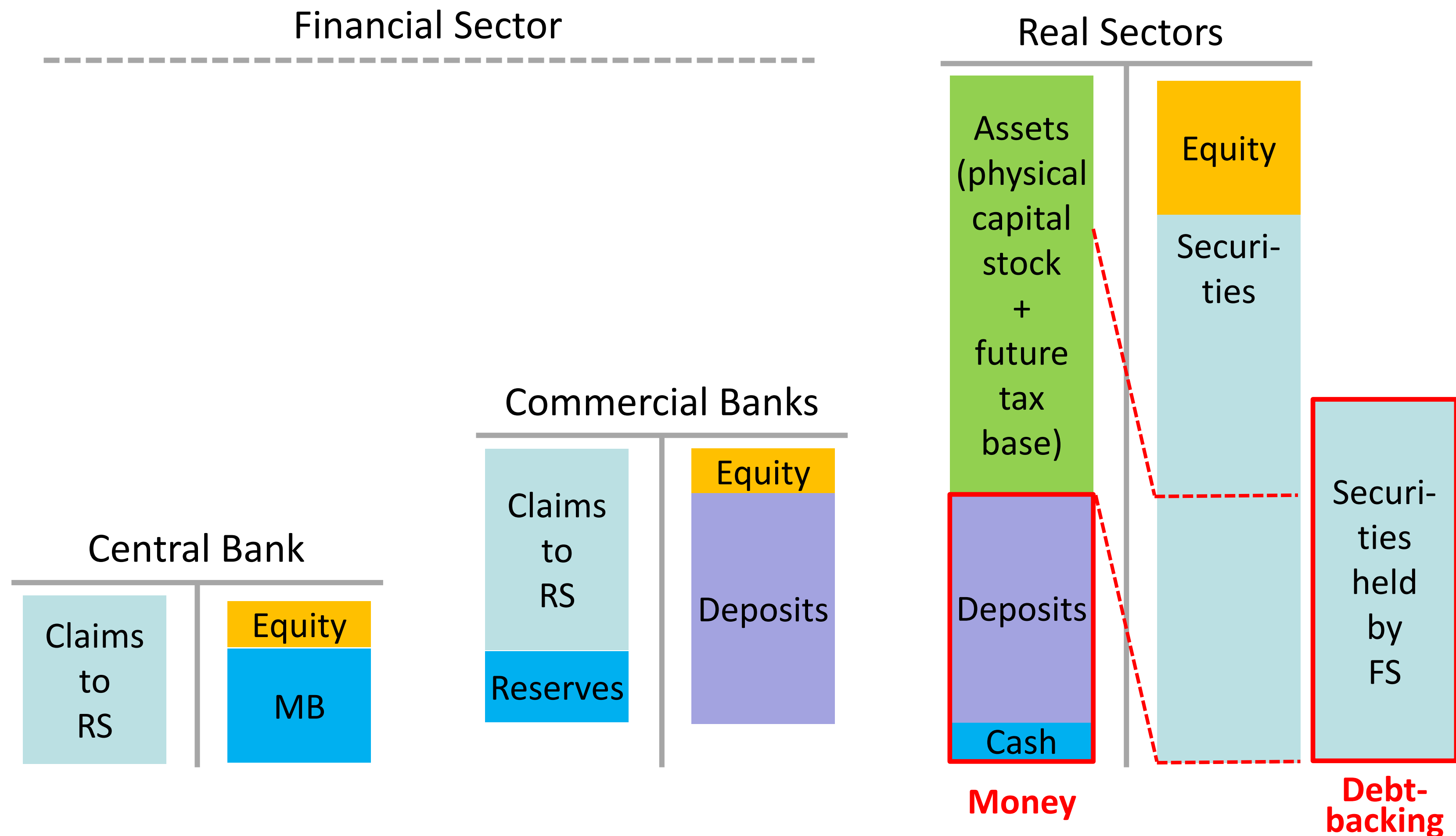
Financial framework of a debt-backed monetary system



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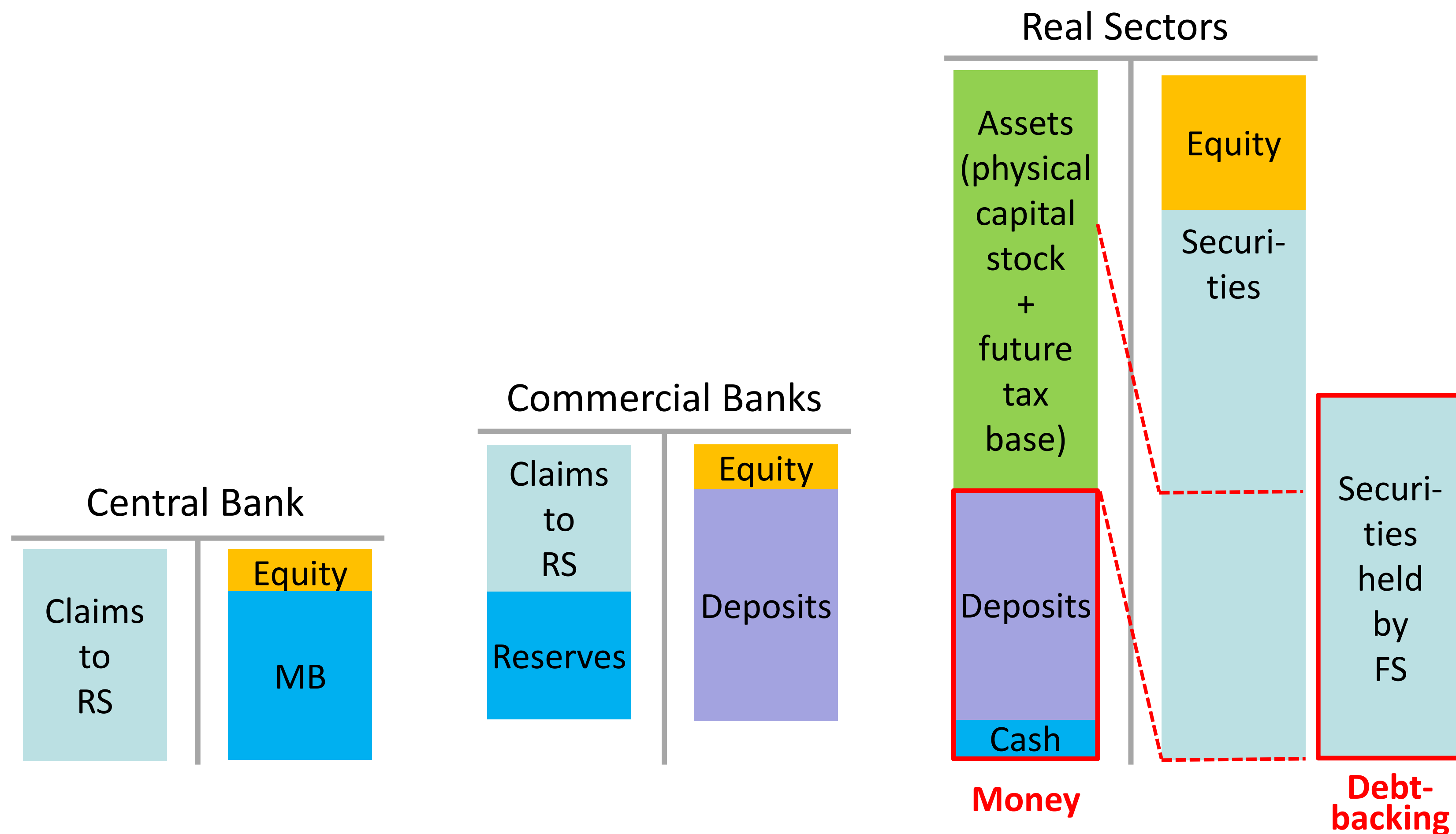
“Quantitative Easing” inflates central bank’s balance sheet



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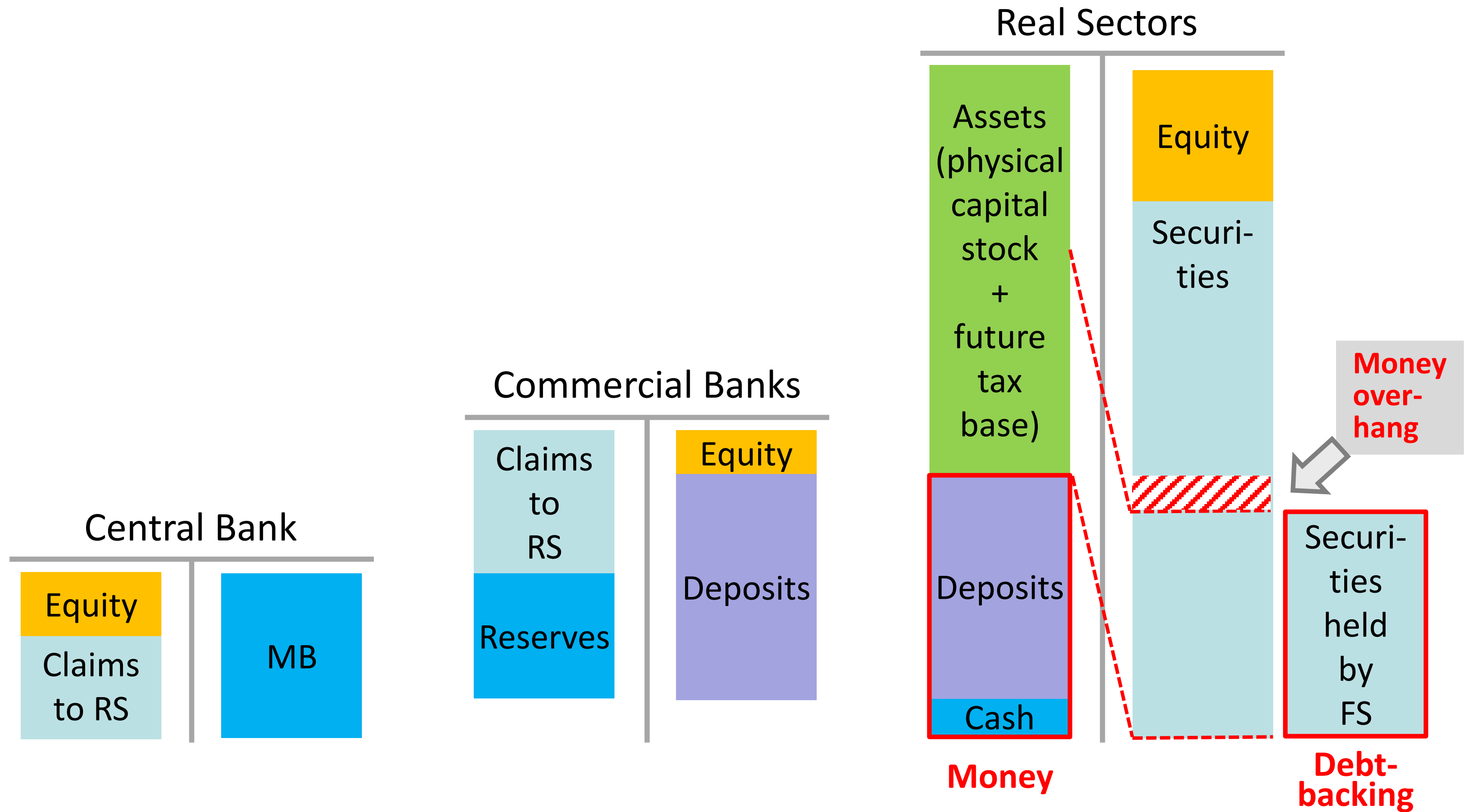
Serious default scenario



Overall implications for monetary policy

- Increased risk of policy insolvency
  - » Stronger incentives to choose a too-accommodative monetary policy stance
- Central bank independence
  - » May weaken the independence of the ECB by making the Eurosystem more dependent on the fiscal soundness of member states
- Signalling
  - » Financial risks may be perceived by market participants as a signal that interest rates will remain low for an even longer period than they would otherwise be
- Price stability
  - » In extreme scenarios, the financial health of the Eurosystem could be significantly harmed, reducing its capacity to ensure price stability
- Market distortions
  - » Higher volatilities in bond markets (due to less market depth), associated with the risk of asset price bubbles
- Future room for manoeuvre
  - » Future attempts to expand its asset purchase programmes may force the ECB to loosen current limits and eligibility criteria

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