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Government bond purchase by the ECB

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Whatever it takes

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Coming on the heels of ECB President Draghi's speech in London in late July, the ECB's Governing Council meeting in early August attracted a great deal of attention in spite of the summer holidays. It was at this meeting that the ECB announced its intention to undertake a new round of government bond purchases, which represents a major shift in policy strategy inasmuch as the ECB's Security Market Program (SMP) was conducted largely on an ad hoc basis. However, Mr. Draghi's explanation of the program at the press conference that day and various subsequent discussions suggest there remains a number of issues that must be addressed before the plan can be finalized and implemented.

Government bond purchases as monetary policy

First, Mr. Draghi described the new bond-buying program as a monetary policy tool at the press conference following the August Governing Council meeting. In the subsequent question-and-answer session, he explained that the new bond purchases, intending to lower the short end of the yield curve, were both "squarely within our mandate" and "squarely amongst the instruments of monetary policy," making them very different from the Securities Market Program (SMP).

Given that rising government bond yields are at the crux of the fiscal problems in Europe today and have contributed to a vicious cycle between government finances and the financial system, many may have questioned the ECB's decision to present the new bond purchases as a monetary policy tool. However, Europe differs fundamentally from the US in that financial conditions are still tightening —bank lending is falling, new bond issuance (except for those by banks) remains stagnant, and private credit spreads are widening— in spite of an ultra-low interest rate policy and the supply of large quantities of funds. As such, I think the use of government bond purchases to bolster even modestly the effect of monetary accommodation falls within the realm of post-financial crisis monetary policy (whether it falls "squarely" within the category or not is another issue).

Nevertheless, at least one reason Mr. Draghi used this rhetorical tool was probably to pre-empt criticism within the ESCB that the ECB was going beyond its mandate of maintaining price stability.

While Mr. Draghi may have presented the new program as a monetary policy tool, there are a number of arguments that can be made in favor of a cautious approach when we take national finances into account. First, it could be argued that bond purchases should be avoided because they represent a fiscal transfer within the Eurozone, which is prohibited under the Treaty. Second, from a more fundamentalist standpoint, it might be argued that purchases of government bonds by the central bank are inherently undesirable because they lead to a relaxation of fiscal discipline. This issue is closely related to the outcome of the so-called fiscal union, since both concerns would largely disappear once fiscal union reaches a certain stage of development and fiscal discipline takes hold across the Eurozone under a well-defined framework. However, the concern is that ECB purchases of government bonds under current circumstances would instead lead to disorderly fiscal transfers across the Eurozone or a relaxation of fiscal discipline within individual countries.

Of course Mr. Draghi was well aware of these concerns and proposed a framework designed to defuse them, including a declaration that the ECB would not underwrite government bond issues. This point will be reviewed in further detail below.

Government bond purchases as financial stability measure

As noted above, the ECB's new government bond purchasing program has the potential to function as (broadly defined) monetary policy by easing financial conditions. It is clear, however, that —regardless of Mr. Draghi's rhetoric— the program is largely a response to problems in the financial system inasmuch as it props up financial institutions by keeping the bond yields of distressed governments in check.

If the new bond purchases are presented in this way, one alternative (which would be attractive to those who are skeptic about bond purchasing) would be to conduct another three-year LTRO. And in fact there are still strong expectations of a third LTRO among market participants. The two rounds of three-year LTROs, implemented in December last year and March this year, bolstered the financial system by giving a big boost to market sentiment.

Effectively the role played by the two LTROs was to reduce funding pressures on Eurozone financial institutions. However, bond issuance by those institutions declined on a net basis in Q2 amid a marked drop in bank lending, suggesting that —at least from a macroeconomic perspective— funding pressures have eased, reducing the need for another LTRO. And regardless it was purposed or not, the two LTROs prompted financial institutions in distressed nations to buy their own countries' debt. This was not attributable directly to the LTROs; instead, institutions had an incentive to buy their own governments' debt to use as collateral to gain access to ESCB funding through the LTROs. However, the resulting increase in these institutions' sovereign exposure did little to enhance financial system stability.

In summary, the need for more LTROs may have diminished, and there are certain side —effects associated with them— at least for now. Meanwhile, the purchase of government bonds as a tool for stabilizing the financial system has the advantage of directly reducing banks' sovereign exposure, although it could be done at the cost of ballooning exposures of the ECB to sovereign risks.

Issues presented by new government bond purchases

I would now like to take a look at several issues presented by the government bond purchase program from the perspective of financial stability measures.

First is the question of whether such purchases actually fall within the ECB's mandate. As noted above, it is possible to present these purchases as a kind of monetary policy tool, but helping distressed countries finance their fiscal deficits is the role of the EU or IMF and obviously exceeds the ECB's mandate. Meanwhile, it is now clear in a de facto sense that the ECB is working to stabilize a financial system weighed down with sovereign risk, and there should also be no doubt that the ECB is playing a leading role in the ESRB.

But if the ECB's role in preserving financial system stability continues to expand "recklessly" over time, the concern is that coordination costs will become unnecessarily large whenever policymakers respond to future developments in the European crisis. If this would be the case, we could always have uncertainties about the boundary of the ECB's mandate. There is also the risk that the ECB will take on an excessive role as market participants and politicians come to expect too much from the ECB. I hope that the purchase of government bonds will be appropriately positioned in discussion regarding the ECB's role within the integrated financial supervision for Europe, just as the ECB is said to have won political approval by declaring its intentions prior to the EU summit at the end of June.

Second, there is the more practical issue of how to decide which country's bonds to buy. The ECB president's view on this issue was relatively clear. At the August press conference he said such purchases would be conditional on the implementation of EU/IMF economic programs by the nation in question and a commitment to conditionality.

This approach is not only desirable in the sense that it provides distressed countries with incentives for structural reform including fiscal consolidation from all policymakers, but it also helps mitigate the lack of transparency in policy decisions that has been noted with regard to the SMP. It could also help answer the objections of those opposed to positioning new government bond purchases as a form of monetary policy. In other words, tying government bond purchases to economic programs and conditionality might help ease concerns about a gradual but disorderly increase in fiscal transfers to distressed nations and a relaxation of fiscal discipline over time.

Of course there remains the question of how to decide how much debt to buy from distressed governments. I think some ceilings will be derived naturally by tying the purchases to economic programs and conditionality. As for the purchases' role in preserving financial stability, it will be important to ensure a certain amount of flexibility regarding their timing and pace. Perhaps the ECB could be given discretion over specific purchases within a limit each period authorized either by itself (ie Governing Council) or by some international entities.

Third is the relationship with purchases of government debt by the EFSF and ESM. Without even bringing up last autumn's EU summit, the EFSF is already supposed to be buying government bonds, and the ESM is already established to carry on the EFSF's role. At present, however, neither effort has come to fruition. That is why the ECB is so concerned about the sharp rise in yields on Spanish and Italian government debt and why it declared it would do "whatever it takes" within its mandate to preserve the euro and announced a new program of government bond purchases.

Against this backdrop, one option would be for the ECB to fill in for the ESM, buying government bonds until the ESM has been established and starts to play its designated role on a full-fledged basis. This would make it easier to defuse concerns about a gradual but "reckless" expansion of the ECB's role, but there is also the risk that restraining the scale of bond purchases would not do enough to remove concerns about government bond markets in distressed nations.

If the ECB emphasizes these risks to the Eurozone financial system and does not adopt a "bridge finance"approach, Mr. Draghi's stated focus on the short end of the curve, as noted in the earlier part of this report —ie the approach of limiting purchases to short-term bonds— could have unexpectedly large significance. Instead of disappointing market participants by declaring it would not buy any more government bonds than the ESM could eventually take on, a simple declaration that the ECB will buy only short-term government bonds would leave open the possibility for a smooth transfer of roles to the ESM as the bonds it buys gradually mature over the next few years when the ESM has more ability to take risks. This kind of strategy could also reduce the risk of delay in increasing the ESM's bond-buying capacity if it takes longer than expected to collect contributions from other Eurozone members.

Summer homework

While there are great expectations for the ECB's new bond-buying program, a number of issues must still be addressed, and there is only a few weeks between now and the September Governing Council meeting. I suspect ECB staff are facing another long summer of work.

Note from the author

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