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## The ECB At A Dangerous Crossroad As Berlin Endangers QE

by Marcello Minenna on 20 July 2016 [@MarcelloMinenna](#)



Marcello Minenna

In the stormy aftermaths of *Brexit*, with Eurozone stock markets losing 8% on average and Sterling crashing, government bonds have remained substantially unperturbed. The ECB shield, in the form of the €80 billion of Public Sector Purchase Program (PSPP) monthly asset purchases, has been remarkably effective and has reduced volatility to the bare minimum. Even so, the markets' shock and the threat of recession have been so strong as to induce many analysts to consider a further extension of QE beyond its natural limits (March 2017) as the most obvious response by the European authorities.

Few have observed that *Brexit* has finally exposed the first evident cracks in the complex machinery behind the PSPP. The weakness nests in the purchase mechanism of German government bonds: too few and characterized by too low a yield. The ECB is constrained by strict rules: on one side it has to buy – via the *Bundesbank* – at least €12.5 billion of *Bunds* every month according to the ECB *capital key*; this explicitly recognizes that the German central bank enjoys its leading role of *primus inter pares*. On the other side, all the bonds that have an implicit yield below the -0.4% threshold are automatically excluded from the PSPP. This “magic” number of -0.4% is the ECB's deposit rate; since it is negative it means that the banks pay for the privilege to park liquidity in the central bank accounts.

When the ECB buys government bonds with implicit negative yields, it pays a very high price that allows the banks to obtain a riskless profit represented by the negative rate. According to the PSPP rules, the liquidity freed by the sale of the bonds is parked in the deposit account and charged at the -0.4% rate. In this way the banks are paying a rate that is lower than -0.4% since the ECB is returning via the PSPP purchases part of the “toll” gained through the deposit rate. Now it’s clear why the ECB cannot purchase bonds that have a negative yield lower than the deposit rate: the ECB would be returning to banks an amount greater than what the banks pay and this would correspond to an outright transfer of financial resources towards the banking system that the ECB should account as a loss..

Already in ordinary times, this mechanism has encouraged the Eurozone banks to stock up *Bunds*, in the perspective of taking a riskless profit from the PSPP trades by selling at rising prices (a strategy of *frontrunning*). But if prices rise, yields decline; then high demand inevitably pushes an increasing share of bonds below the ECB deposit rate, making them ineligible for the PSPP. The ECB is then forced to readjust the limit at a lower level in order to enlarge the pool of eligible assets; from March 2015 this behavioral scheme has already repeated itself twice, with a first deposit rate cut in December 2015 to -0.3% and a second move in March 2016 that has set the threshold at the current value of -0.4%. The privileged status of *safe haven* enjoyed by *Bunds* goes with the downward pressures on yields in every phase of a bear market, as traders shift liquidity from risky assets towards government bonds.

During the *Brexit* aftermath, these effects have worked in synergy, pushing the implicit yield of 57% of German *eligible* bonds under the -0.4% limit. Moreover, from the beginning of July the growing instability in the Italian banking sector is forcing more liquidity flows towards German assets. In fact, the non-performing loans (NPL) storm on Italian banks re-ignited by *Brexit* is intensifying, despite the official claims of “everything’s fine” from the Eurozone’s authorities. With a battery of ECB stress tests looming just around the corner and market evaluations at historical lows, an excruciating round of enforced recapitalizations seems inevitable. Monte dei Paschi di Siena, the most battered bank after an official request by ECB to wind down at least € 16 billion of bad loans as soon as 2018, risks being only the first of a long list. The trend of liquidity shift from Italy to Germany keeps strengthening and the ECB risks being cornered.

To keep QE running at least until March 2017 (or preferably beyond it), the ECB has limited room to maneuver. A further cut in the deposit rate to -0.5% or lower should be the logical response but would allow only a limited gain of time before, as we’ve already seen, the forces of demand and supply would come into play.

However, the empirical evidence clearly proves that the ultra-low interest rate environment is damaging the profitability of the Eurozone banking system. In fact, interest margins are being squeezed: if in 2007 the European banks gained €709 billion from their lending activity, in 2015 this sum has declined to €433 billion. Paradoxically, the rate cut could pressure the banks already in trouble (such as the Italian ones) – not exactly a wise move in this delicate market situation.

There could be an alternative strategy, albeit theoretically. The ECB could move away from the *capital key* and purchase those government bonds that are more widely available or more subject to tensions on yields (i.e. the peripheral ones). Normally, this would not be considered exactly a workable hypothesis, but rather a radical move with as much of the flavor of “monetary heresy” for the *Bundesbank* as *helicopter money*. However, we have to acknowledge that, behind the wall of ECB monetary orthodoxy, interesting rumors have filtered about the possible abandonment of the *capital key*. Obviously, they have been officially denied, but there’s a clear signal that the raw data confirm: the ECB is already shifting its purchases towards the Peripheral countries. In June 2016 the *capital key* has been significantly tweaked in favor of Italian (+2.15%) and Spanish (+1.64%) assets. This can be seen as a simple technical adjustment or interpreted in a different perspective. Anyway, one thing is clear: if the ECB want to preserve the QE protective umbrella, the coming months will see it need to take very complicated decisions, not least politically.