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The ECB should do the national twist with its reinvestments

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The following guest post is from Marcello Minenna, the head of Quantitative Analysis and Financial Innovation at Consob, the Italian securities regulator. He argues the ECB's principal reinvestment programme could favor less indebted countries — Germany — unless the bank introduces some risk sharing. The views expressed here are his personal opinions and do not necessarily reflect the views of Consob.

This week the Governing Council of the European Central Bank will hold its first policy meeting since its decision to stop increasing its asset purchases — the "end" of quantitative easing. Going forward, monetary accommodation in the euro area will be limited: the bank will only reinvest principal redemptions generated by the maturities of the bonds purchased under the program. The ECB still has a kind of investment programme, though. It still has to decide where to allocate the cash from those redemptions.

According to some projections based on ECB estimates, in 2019 the total amount of sovereign paper involved in the repurchases of the eurosystem will hover between €170b and €200b. But more than the aggregate figure, it is the allocation of these purchases among the various national governments that matters. This explains why analysts and investors look at the future ECB re-investment strategy, with careful attention to the government bonds of the different member countries.

The current ECB rules on allocation help less indebted countries with shorter sovereign debt maturities — e.g. Germany. And they leave at a disadvantage more indebted countries, which tend to have longer maturities. The Governing Council should put aside its current allocation criteria, and announce that in the future reinvestments will be concentrated in the most indebted countries, and very long-dated bonds.

The capital key is procyclical, favouring countries with stronger growth

The ECB refers to a "capital key" to allocate its bond purchases under each member country. The key equals the share held by each national central bank in the ECB's capital. According to article 29 of the ECB Statute, the bank must review the key every five years to reflect the change in the contribution of each state to the growth in GDP and population of the European Community. Over the last years both variables have showed a positive trend in Germany and the Netherlands, negative in southern Eurozone countries. And so last November, the ECB Governing Council updated the capital key, with effect from January 2019:

Country	Capital key 1 Jan 2019	Capital key 1 Jan 2015	Difference
	%	%	%
Belgium	3.6313	3.5200	0.1113
Germany	26.3827	25.5674	0.8153
Estonia	0.2827	0.2739	0.0088
Ireland	1.6884	1.6489	0.0395
Greece	2.4839	2.8884	-0.4045
Spain	11.9784	12.5596	-0.5812
France	20.4059	20.1433	0.2626
Italy	16.9530	17.4890	-0.5360
Cyprus	0.2159	0.2149	0.0010
Latvia	0.3923	0.4008	-0.0085
Lithuania	0.5830	0.5870	-0.0040
Luxembourg	0.3261	0.2884	0.0377
Malta	0.1051	0.0921	0.0130
Netherlands	5.8429	5.6875	0.1554
Austria	2.9195	2.7888	0.1307
Portugal	2.3510	2.4767	-0.1257
Slovenia	0.4828	0.4908	-0.0080
Slovakia	1.1497	1.0974	0.0523
Finland	1.8254	1.7849	0.0405
Total	**100**	**100**	**0.0000**

Source: ECB

The Bundesbank's share has significantly increased — by .82%, from 25.57% to 26.38% (figures have been rounded to hundredths of a percentage point).

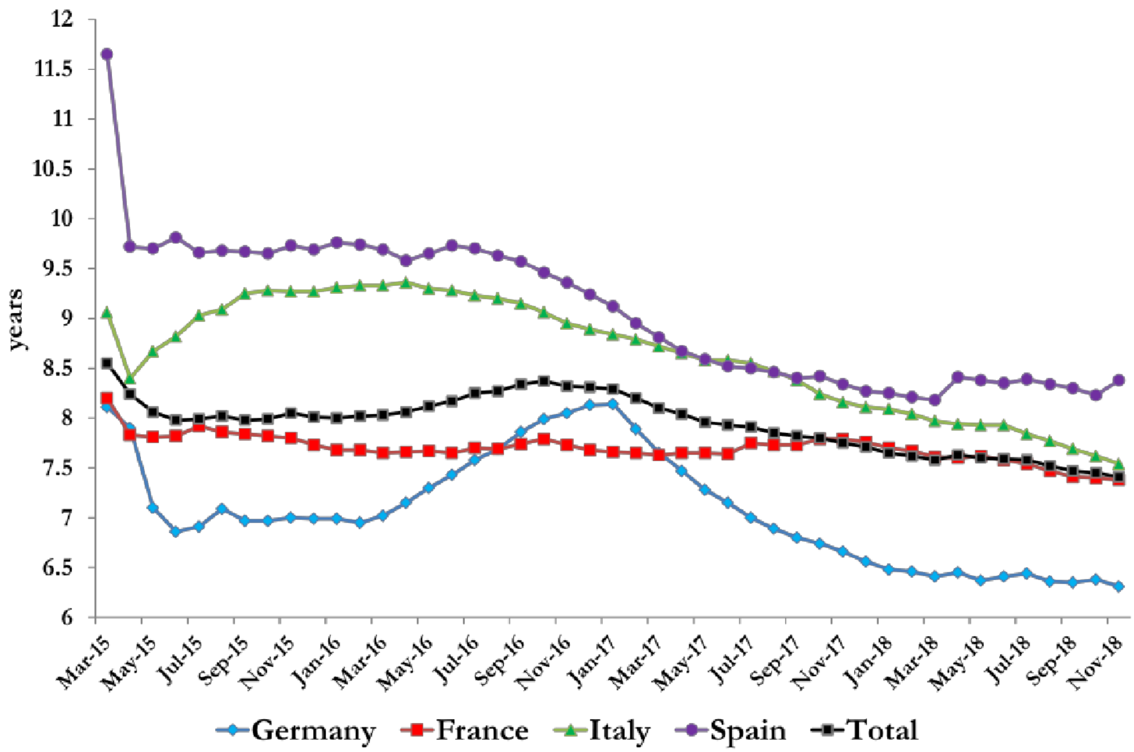
So have the Bank of France and the Dutch Central Bank's shares, at +0.26% and +0.16%, respectively. At the same time, the share of the ECB's capital held by the national central banks of peripheral countries (Spain, Italy, Greece and Portugal) has fallen by 1.6474%.
So now, apply these percentages to asset purchases (take into account Greece's exclusion from the purchase program). Reinvestment in both Italian and Spanish government bonds should decrease by about €1b apiece in 2019. Meanwhile, repurchases of German sovereign notes should increase by €1.24b.
The key itself, and the adjustment mechanism, are inherently procyclical.
Germany's position as the number-one recipient of bond purchases represents a major advantage. Bunds have enjoyed negative yields even in the medium and long term for about three years. And when debt costs nothing, the world smiles at you. The opposite happens in countries where high yields on debt continue to represent a burden, especially if they are already distressed.
(The capital key isn't everything, though. In practice, historical QE purchases have deviated from the capital key. In cumulative terms, until November 2018, we are talking about €7.1b of more Bunds, €18.3b of Obligations Assimilables du Trésor, €15.8b of Buoni del Tesoro Poliennali and €9.7b of Bonos.)

The ECB's shift to shorter maturities has favoured Germany

The ECB has at times had to deal with scarcity. Its QE program provides for issuer and issue limits, and also for maximum and minimum time to maturity, which is to say this: there aren't enough German Bunds for the bank's preferences. To manage this problem, the bank has not only deviated from the capital key, but has also updated its rules: in January 2017 the ECB reduced the minimum remaining maturity for eligible securities from two years to one year and removed the floor of the deposit facility rate.
This double move has allowed the purchase of short-term sovereign bonds – especially German ones. The weighted average maturity of the ECB's aggregate portfolio has dropped from 8.55 years in March 2015 to 7.41 years in November of 2018. The weighted average maturity of Germany's bonds in the portfolio was even lower, at 6.31 years. (Only Cyprus and Luxembourg government bonds have shorter average maturations, but the ECB has purchased only negligible amounts.)

Weighted average maturity of ECB asset purchases, total and selected eurozone countries

Due to the high incidence of government bonds maturing in 2019, Germany could benefit from a bonus of over €4.5 billion of extra-reinvestments by the Euro-system compared to those which it would be entitled to on the basis of the current capital key: €52.9 billion rather than €48.2. Italy could get a symbolic bonus (€1.3 billion), Spain could face an almost unchanged scenario, and France could see less re-investments than those it would be entitled to according to the new capital key.



Source: ECB

This might make it difficult for the ECB to remain compliant with its commitment to the market neutrality, that is: to distribute the purchases of sovereign securities in proportion to their outstanding amounts, in order not to disrupt the price discovery mechanism in the government bond market of the Euro area. In fact, countries more biased towards long maturities – such Italy and Spain – are also those entitled to a lower share of purchases because of the capital key. Should the ECB decide to remain faithful to the key (and follow its current path as it rolls over maturing debt), there would be almost certainly an increase in the duration risk borne by private investors with a consequent rise in some Eurozone yield curves.
In 2018, there were rumours of an ECB operation twist, similar to that implemented by the US Federal Reserve system between 2011 and 2012. Having become unable to intervene on short rates, which were already at zero, the Fed swapped short-dated securities in its portfolio with long-dated securities, in the belief that the drop in borrowing costs for business and households would spark both investments and consumption.
A twist would be very difficult for the ECB to operate, because it has to act on 19 different sovereign debt markets. Frankfurt carries out only a small part of the purchases *directly*, whereas the bulk is delegated to the national central banks, which in buy securities on the secondary market issued by their own national governments.
There is almost no risk sharing in this architecture; each national central bank is exposed to potential losses on its own country's sovereign debt. And each of those banks has high discretion on which securities to buy, including a choice of time to maturity.
So after net purchases ended in 2018, the ECB will still have its work cut out to

make sure that reinvestments will be consistent with all the QE rules: in some cases (e.g. market neutrality) it's not easy to verify the effective compliance by the NCBs, in others these rules can conflict with each other, and in others because the QE architecture has already had varied impacts on different yield curves.
A revision of the rules of QE is almost inevitable.

A modest proposal: scrap the current allocation criteria, allow the "national twist"

But, rather than country-specific operation twists, the ECB should put aside the capital key criterion and announce that in the future reinvestments will be concentrated in the most indebted countries: a "national twist."
This would look a little like the ECB's Securities Markets Programme (SMP), which ran from 2010 to 2012. Under the programme, ECB bought some sovereign debt from the eurozone's periphery to ensure liquidity, but distributed the coupon on that debt among the national banks, according to the capital key. That is: under the SMP, the Bundesbank received about 30 per cent of the coupon on Italian government debt.
Under a national twist, however, the ECB would return coupons on its sovereign debt holdings to the national government that paid them, then remove its cap on the residual life of eligible securities, rolling over its QE holdings, through the national banks, to the very long-term segment of the curve (20-50 years). This way, part of the public debts of peripheral sovereign issuers would be frozen in the national central banks' balance sheets, offering relief in funding costs.
An example: by selling 20-50 year bonds, a third of which are allocated to the Bank of Italy's QE reinvestment, the Italian government could lower its cost of debt. And it could ease tensions in the short-medium term segment (2-8 years) without having to spend much more on the cost of long-term debt precisely thanks to the support from the rest of the eurozone.
More in general, the context outlined by the proposed intervention would introduce an implicit risk sharing across Eurozone members. As a consequence market participants would reduce the risk aversion towards the most indebted countries thus favouring the normalisation of the shape and slope of the yield curves.

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