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The legacy of the ECB's bond buying program

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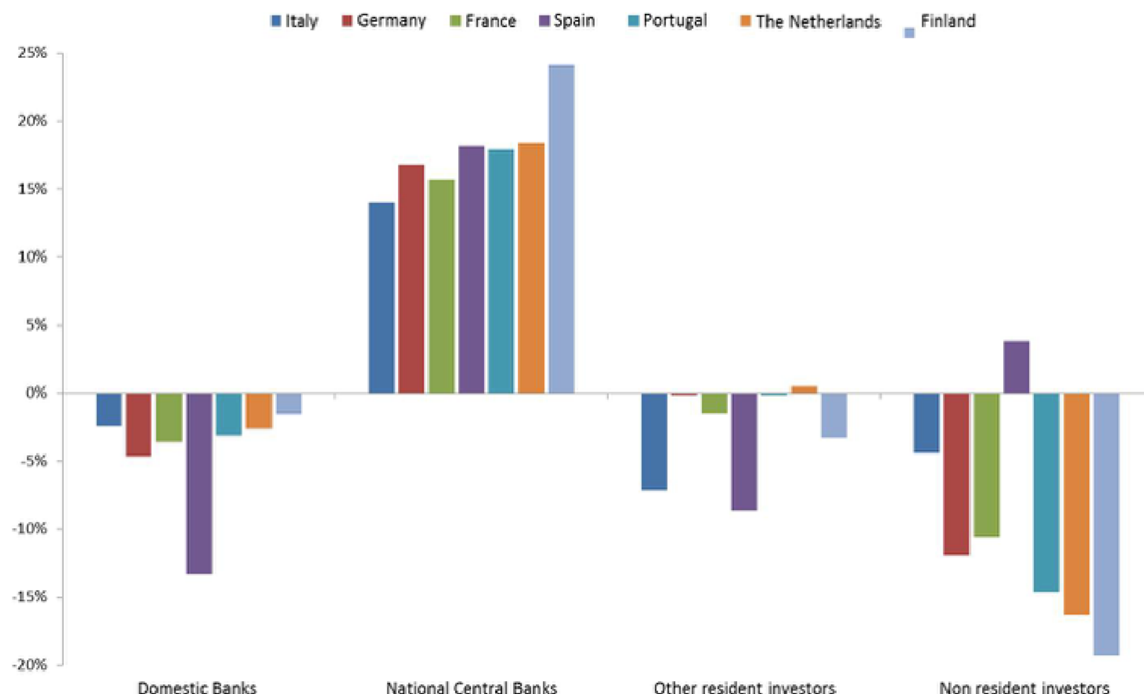
In December 2018, the European Central Bank's bond buying program drew to a close. Over 45 months, it had injected €2.6 trillion of liquidity into the system.

The main addition to the ECB's balance sheet was €1.9tn of government bonds purchased via the national central banks. This represented 90 per cent of the bonds issued by European governments.

In short, quantitative easing shifted sovereign risk from the private sector (both domestic and foreign) to the public sector. This is likely to take a long time to rebalance.

To get a sense of just how much the landscape has changed over the past four years, it is worth looking in detail at the distribution of Eurozone public debt ownership before and after QE:



On average over this period, over 15 per cent of total Eurozone public debt has moved on to the balance sheets of the national central banks of the Euro-system, up from about 4 per cent before QE began.

The Bank of Italy has increased its holdings of Italian debt by a smaller amount — adding 14 per cent of the outstanding market — than the central banks of the Northern European nations such as the Netherlands and Finland. This may be because the total outstanding debt of the Northern countries either shrank or grew less than that of Italy during QE. However, several other factors were at play over that period, including differences in the average residual life of the securities purchased, and deviations from the capital key criteria the ECB implemented.

At the programme's launch it was hoped that national banking sectors would, as a result of central bank purchases, reduce their holdings of government debt, in turn weakening the link between sovereigns and banks which contributed to the aggravation of the crisis in 2011-2012.

This did not happen, at least in the size that was hoped for, and relative to the size of each sovereign bond market. Italian banks closed 2018 with a modest reduction (2.5 percentage points) in their holdings of domestic government bonds. At the peak of the economic recovery (end of 2017) the reduction had reached 5.1 percentage points, but the pressures on spreads that followed the establishment of the new government and the flight of international investors (who sold holdings equal to 3.5 per cent of the total market between March and September 2018) have inevitably increased the weight of domestic banks in underwriting new debt issues.

European banks on average did not do much better, with a reduction in sovereign debt holdings of 3 percentage points over the period. Of course, it could be argued that Northern European banks did not particularly need to reduce their exposures to domestic government debt, either because they had started from very low levels (Finnish banks only held 3 per cent of Finnish sovereign debt, for example) or because investors perceived a far lower risk of default in countries such as Germany and the Netherlands. In contrast to the first point, Italian government bonds make up 20 per cent of its national banks total assets — one of the highest ratios in the world — according to the Bank for International Settlements.

The only noteworthy exception over this period is Spain. Its banks held 30 per cent of domestic sovereign debt in 2014; the figure is now below 17 per cent.

It's also worth highlighting that non-financial private investors took advantage of the ECB's purchases of Italian and Spanish sovereign debt to reduce their holdings. The holdings of other domestic institutional investors, such as insurance companies and pension funds, were not significantly changed over the course of QE.

Foreign investors also reduced their holdings. From a broad perspective, foreign investors were the main sellers to the ECB, as the decline in government bond yields made alternative investments outside the Euro area more attractive.

This rebalancing of non-EU investors' portfolios partly explains the growth of Target2 claims of the national central banks of countries that traditionally intermediate transactions with countries outside the eurozone: Germany and the Netherlands (with USA and Japan) and Finland (with Sweden and Norway). If a US investor sells a French government bond to the Banque de France, he will access the Target2 payments system via, say, the Deutsche Bundesbank, and the transaction will be accounted for as if it had occurred between the French and the German central banks. It will therefore appear as a capital inflow towards Germany, but in

reality the final beneficiary is a counterparty located outside the Euro area.

However, this explanation should be treated with caution. In fact, the data show a clear difference between countries in the core area, such as Northern Europe and France, and those in the periphery, such as Italy and Spain.

In the latter two cases, foreign investors have either shrunk their holdings slightly (the percentage of outstanding Italian sovereign debt they held fell 3.8 percentage points) or even increased their holdings (by 3.4 percentage points in Spain) over the course of QE. A closer look at Italy reveals that apart from the flight that occurred in connection with the recent increase in spreads, until March 2018 the holdings of foreign investors had remained roughly unchanged. A possible explanation is the persistent spread (on average 120 bps) that these securities have maintained with respect to core government bonds, even in the most extreme period of convergence between 2015 and 2016.

In any case, for Italy and Spain there is no clear connection between the rebalancing of foreign investors' portfolios and the worsening of the Target2 balances that denotes a net capital outflow. Rather, as I highlighted in recent research with Giovanni Dosi and Andrea Roventini, with these two countries other factors explain the balances, including a growing preference of the non-financial private sector for overseas investments in mutual funds, stocks and bonds. The clear pattern emerging from a joint analysis of the data reveals that the excess liquidity obtained from the sale of domestic government bonds to the central banks has been used to fund an increase in the foreign component of the portfolio of assets held by this category of investors. A capital outflow related to higher foreign financial investment is also observable in other Eurozone nations, although to a lesser extent. However, in Italy and Spain it is not counterbalanced by growth in foreign capital inflows to the banking sector (as is true in the case of France), or by a corresponding increase in capital inflows deriving from a trade surplus (see Germany).

Based on the ECB's indications regarding the duration of the reinvestment program for maturing securities, it appears likely that about a fifth of Eurozone public debt will remain on the balance sheets of the national central banks for at least a couple of years. The experiences of the Federal Reserve in its own attempt to normalise its balance sheet (there are already rumours of a probable halt) induces caution; significant deleveraging does not appear to be viable, especially now that the economic cycle is rapidly deteriorating. In fact, in a similar framework, any acceleration in the process of deleveraging would have an impact on the yield curves of the eurozone member countries. This further aspect would obviously interact with inflation levels — levels that, as my last paper argued, are mainly governed by external sources of risk. It would therefore further interact with real rates of interest, and finally on how monetary policy affects the real economy. Moreover, the Federal Reserve's caution in its attempts to deleverage come despite a domestic GDP growth rate that is significantly higher than in the Eurozone. The debt legacy of European QE could remain with us for a long time.

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