Radical risk-sharing rethink

ECB needs to reshape reinvestments

by Marcello Minenna in Milan

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The European Central Bank has decided on a gradual approach to adjusting its reinvestments of maturing bonds according to its adjusted capital key – the proportion of the ECB's share capital held by participant countries in economic and monetary union. The main focus of action by the national central banks that make up the Eurosystem is 'to safeguard orderly market conditions' – in other words, to prevent a crisis in EMU by a ballooning of the bond yield spreads between Germany and outlying member states.

Now that the ECB's four-year €2.6tn bond-buying programme is coming to an end (despite this, the 'balance of risks is moving to the downside'), there are other ways, more overt and effective, to stabilise monetary union, through a more concentrated form of risk-sharing.

The first step would be to remove the capital key criterion and to concentrate future NCBs' reinvestments only on highly indebted countries, along the lines of what was done between 2010-12 with the securities markets programme. A second step would be to remodel the programme so that interests received on purchased securities are returned to the sovereign issuers which have disbursed them. Additionally, future Eurosystem reinvestments should be focused on very long-term debt (20-50 years) as part of a coordinated intervention with national Treasuries. This would stabilise inside the NCBs' balance sheets part of the public debt of peripheral countries' sovereign issuers, with a corresponding drop in the funding costs. A final – more radical – step would be to replace NCBs with the ECB itself as direct securities buyer: this would send to market participants the important message that all sovereigns are regarded in the same way by their 'mother central bank'.

These proposals would be controversial and would almost certainly run into legal difficulties at the German constitutional court and, perhaps, the European court of justice. But it is necessary to put them forward now as part of an effort to overcome the persistent fragility of the euro area, despite four years of massive asset purchases. The limited risk-sharing under the current bond-purchasing set-up has played a key role in keeping segregated the public debt markets of member states and fuelling capital movements from southern to central-northern euro area countries. Maintaining the same rules in the future will promote further divergence and keep alive threats of disintegration. We need a radical rethink, which cannot come without a political effort to give the ECB more wiggle room in order to support re-convergence across the yield curves of the various member states and across their inflation rates.

For the time being, though, the ECB is sticking to the status quo. It decided last week that redemptions will be reinvested in the jurisdiction in which principal repayments are made. The portfolio allocation across countries will continue to be adjusted with a view to bringing the share of the public sector bond portfolio into closer alignment with the ECB capital key.

The total amount of reinvestments next year will be around €170bn-€180bn in public sector bonds. In light of recent recalibration of the capital key (which will enter into force from January), reinvestments should favour Germany and penalise other countries, especially in the euro area periphery. Adapting to the economic and demographic dynamics of the last five years, the Bundesbank's share in the ECB capital will rise by around one percentage point and reduce that of southern states, led by Spain (-0.58 percentage points).

It is also important to recognise that German government bonds purchased so far (over €515bn) have a weighted average maturity of 6.31 years, significantly lower than the aggregate public sector purchase portfolio (7.41 years). Assuming that in 2019 total reinvestments in public debt securities amount to €175bn, the German share would be about €52.9bn, corresponding to a 'bonus' of over €4.5bn of extra reinvestments according to the new capital key. If in future German government bond reinvestments continue to favour short-term maturities, the Eurosystem's absorption of inherent euro area duration risk would fall compared with the current estimated 20% share, driving up the cost of debt financing for many countries.

The ECB could theoretically carry out its own 'operation twist', similar to the US Federal Reserve's 2011-12 action aimed at expanding investment and consumption with an intervention focused on the long-term part of the yield curve. Some analysts have suggested that in the euro area this could be done through simultaneous purchases of long-dated Italian government bonds and short-dated German debt securities.

However, so far the Governing Council has discarded such a move, probably because it would be complicated to implement. Unlike its US counterparty, the ECB has to manage member states' heterogeneous credit risks and keep these risks segregated within NCBs, which carry out directly 90% of sovereign bond purchases, buying only securities issued by their own national government. In addition, NCBs have large discretion in their choice of specific bonds, even in terms of residual maturity. Coordinating the implementation of 'multiple twists' would therefore require changes in the QE rulebook.

All these factors explain why the ECB is trying to make the reduction of monetary stimulus as painless and gradual as possible without renouncing the status quo. The problem is that with risks of a US recession growing in the next two years, and with an economic slowdown in the euro area, the ECB is ending its asset purchases at an unfortunate time. Unless the ECB and euro governments reshape the set of 'weapons' available to the monetary authority, the next crisis could prove even more difficult to resolve than the last one.

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