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THE UNSOLVED ISSUES OF THE NEW ECB BAZOOKA*

By Marcello Minenna

Ten years after Mario Draghi's famous *whatever-it-takes*, last July was once again a historic month for the ECB. Frankfurt raised interest rates by 50 basis points and presented the new anti-spread shield, the so-called *Transmission Protection Instrument* or TPI. The Eurosystem will be able to make targeted purchases of securities to safeguard the transmission of monetary policy if this is affected by the deterioration of the financing conditions of a member country. The purchases will concern securities with a residual maturity of 1 to 10 years in the public sector (possibly also private) of the jurisdiction concerned, without ex ante quantitative limits.

In economics, however, there are no free lunches and the TPI is no exception. First of all, the worsening of the funding conditions of the beneficiary country will have to depend on disorderly market dynamics that aren't justified by its fundamentals. Then there are the eligibility criteria: no excessive deficit procedures or other procedures due to excessive macro-economic imbalances, compliance with the commitments made to access the Recovery and Resolution Fund and an ECB positive assessment on the public debt sustainability. These criteria can be revised: therefore, in theory, if they prove to be too rigid, Frankfurt could loosen them a bit (but the opposite is also possible). In addition, to avoid the stigma of the markets, TPI activation will not require the subscription of a macro-economic adjustment program, as provided for the

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other anti-spread shield of the Euro area, the *Outright Monetary Transactions* (OMTs).

The Governing Council will decide on the activation of the new tool on the basis of an overall assessment of the market and transmission indicators, the eligibility criteria and a judgment on the proportionality of the intervention with respect to the objective of price stability. Thus, *de facto* with a wide degree of discretion. It's also worth noting the explicit reference to the principle of proportionality, clearly aimed at reassuring core countries that the new instrument will be used with the utmost prudence. All the more so since the TPI openly violates the capital key, that is the criterion that commensurates the purchases of securities of each country to the share of the respective National Central Bank in the ECB capital.

In this regard, it is important to underline the positive evolution in the attitude of Frankfurt. After the PSPP, which complied (with minimal deviations) to the capital key, the PEPP – the purchase program launched in response to the pandemic emergency – has already provided ample flexibility with respect to the criterion in question and now the TPI foresees its open violation with selective purchases for the benefit of certain countries.

Apart from the OMTs (which however provide for strict conditionalities and which in any case have never been activated so far), the other historical precedent was the Securities Markets Programme (SMP), the program of purchases of peripheral securities launched in May 2010. At that time, however, there was a crisis underway to manage (with Greece on the verge of default) and some governments had already pledged to speed up fiscal consolidation and ensure the sustainability of their public finances. This time, instead, we are faced with a facility that Frankfurt has decided to set up in a preventive perspective and without specific commitments by any member country.

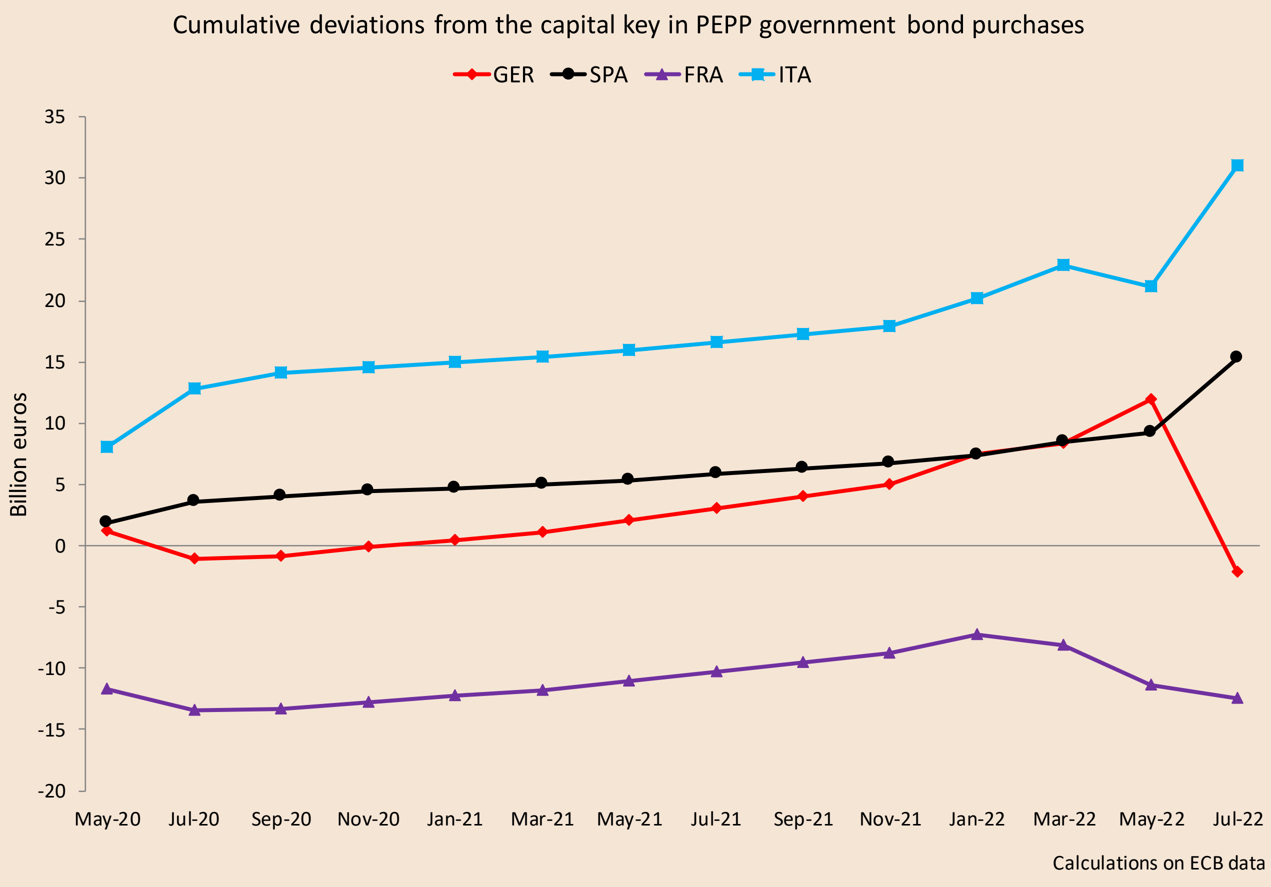
In the logic of compromise that characterized its definition, the TPI design includes a series of precautionary aspects from the point of view of Germany and the other core countries that act as a counterbalance to selective purchases.

Besides eligibility criteria, the rules envisaged for the deactivation of the new instrument and for its coordination with the monetary policy stance are also framed in such logic. On the first point, it was specified that purchases will end when there is a lasting improvement in the transmission of monetary policy but, alternatively, also when it is considered that the persistent tensions are due to the fundamentals of the country concerned. As for the impact of securities purchased following any activation of the new shield, there is no explicit commitment to sterilization (as was the case for the SMP). However, it is difficult to imagine that a long-term liquidation of securities can be avoided, since it was decided that the purchases should not have a persistent impact on the overall Eurosystem balance sheet.

One of the most controversial aspects of the TPI architecture then concerns the risk sharing on the purchased securities. In the most recent programs (PSPP and PEPP), risk sharing was residual as the ECB has directly bought only a small share of the public debt securities issued by individual member countries. Most of the purchases were instead made by the National Central Banks, each for the securities issued by its own jurisdiction. In this way, each National Central Bank has taken exposure to its own country risk but not to that of other countries, so it would not suffer losses if one of them defaulted. In the PSPP this aspect was clarified from the beginning, while it was not addressed in the least in the presentation of the new instrument. However, it seems unlikely for the structure to be very different from that of recent programs, also considering that Germany has already raised legitimacy objections regarding the PSPP despite the very low degree of risk sharing.

More details came instead from the ECB about the placement of the new instrument with respect to the two already present in its toolbox to counter the fragmentation risk of monetary policy: the PEPP and the OMTs. The pandemic program, and in particular the flexibility in the reinvestment of redemptions on maturing securities, will remain "*the first line of defense*" against fragmentation risks related to the pandemic. The confirmation arrived with the subsequent dissemination of data on the distribution of reinvestments between the different jurisdictions in the two-month period June-July 2022. Indeed, data show that reinvestments have clearly favoured peripheral countries to the disadvantage of core ones. In particular, Italy and Spain were awarded purchases of 9.8 and 5.9 billion euros respectively with liquidity largely coming from the redemptions of German government bonds (€ 14.3 billion) and, to a much lesser extent, French ones (€ 1.2 billion). As a result, the cumulative deviations of actual PEPP purchases from those consistent with the capital key criterion have increased considerably.

Figure 1



However, it should be recalled that PEPP reinvestments have a limited capacity, not to mention that there are no guarantees that in the coming months they will remain so much biased in favour of peripheral countries. Also for this reason it is crucial to understand what are the real conditions foreseen for the use of the new tool.

Some clues have leaked – albeit indirectly – from the statements on OMTs released in July by Lagarde. The ECB President said that OMTs are the tool available to the Eurosystem to manage problems in the transmission of monetary policy "*caused by redenomination risks and that are country-specific*". The old anti-spread shield would therefore seem addressed to the management of pathological cases, those in which a country is close to exiting the monetary union because its fundamentals are not in order. The new (TPI), which has less binding activation criteria, would appear instead intended for the management of situations attributable exclusively to irrational and disorderly market dynamics (see Figure 2).

Figure 2

The ECB anti-fragmentation tools

	PEPP reinvestments	OMT	TPI
Scope	Fragmentation risks related to the pandemic	Fragmentation risks caused by redenomination risks and that are country-specific	Fragmentation risks caused by unwarranted and disorderly market dynamics
Firepower	Limited	Unlimited	Unlimited
Risk sharing	Marginal	YES	NO*
Conditionalities	NO	Strict	Intermediate
Capital key	Broad flexibility	Violation	Violation

*Assumption of the author

In practice, however, a country's financing problems often derive from a mix of idiosyncratic factors and disorderly and uncontrolled market reactions. For example, when Italy's redenomination risk reached very high levels between the second half of 2011 and the first half of 2012, was it due to markets' irrationality and speculation against Italian public debt, or to the country's specific fundamentals (even if at the time half of the Eurozone was collapsing)? While we may never have a clear answer to this question, its implications seem relevant to ensuring the effectiveness of the new ECB bazooka.

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