Implications of a new European Central Bank bond buying programme

- European Central Bank (ECB) bond buying programme should help contain periphery yields, at least for a while.
- It also helps support the wider financial system.
- But implementation risks remain.
- Eurozone crisis will continue to ebb and flow, and there are still a number of key events and hurdles over the next few months.

ECB gives some detail on new bond buying programme

This week’s ECB rate decision and accompanying press conference by ECB President Mario Draghi was one of the most closely watched in recent years. Although interest rates were kept on hold at 0.75%, Draghi explained that the ECB is about to engage in a new bond buying programme of eurozone government debt in order to attempt to stem the eurozone debt crisis. At the same time, he explained that he does not want to go beyond the ECB’s mandate by effectively monetising government debt.

On 26 July, Mario Draghi said he was prepared to do whatever it takes to defend the euro, adding that ‘believe me it will be enough’. Then on 2 August at the press conference following the ECB’s monthly rate setting meeting he explained that the ECB was considering a new round of purchases of eurozone government bonds and that the ‘modalities’ or details of this programme would be revealed in the coming weeks. Some of the details of this bond buying programme were announced this week.

The programme of bond purchases, called Outright Monetary Transactions (OMTs) will involve purchases of eurozone government bonds in the secondary markets. Draghi has made it clear that any renewed government bond purchases will be conditional upon a state having already applied to the EFSF (European Financial Stability Facility) or ESM (European Stabilisation Mechanism) bailout funds, or at least to a precautionary credit line from these funds, with conditions such as enacting economic reforms and austerity attached. This is presumably to ensure that eurozone countries continue with reform and enacting austerity programmes even after the ECB has started buying their bonds.

Draghi also said that the ECB bond buying would be ‘unlimited’, but that it could stop in the event of non-compliance. This is because the ECB became concerned in the past that some countries were not implementing reforms, once it had started buying their bonds under a previous ECB bond buying programme, called the Securities Market programme (SMP). The SMP, was first used in May 2010, when the eurozone crisis was concentrated in the smaller nations such as Greece and Ireland. In combination with other measures, it had some success in temporarily driving bond yields back down for a number of eurozone countries.

During most of the first half of 2011, the ECB refrained from making any further purchases of eurozone government debt, or only bought them in very small amounts, but in August 2011 and again later in the year, it intervened in size by buying billions of euros of government debt, as the eurozone crisis once again created extreme volatility in financial markets.

Since early January this year there have been no ECB bond purchases. But renewed stress in eurozone government bond markets over the past few months has forced the bank to act again, albeit with a more stringent set of conditions attached this time.

Bond purchases ‘unlimited’, but conditional

However, the question remains of what happens if a country does not meet the reform and austerity targets set out for it under a EFSF/ESM bailout or credit line? If the ECB then stops buying that country’s debt, as it has said it would do, yields could spike sharply higher.

There is another important aspect in which this new programme is likely to be different from the previous ECB government bond buying programme. The ECB will keep its buying of government bonds restricted to a narrow range of maturity, in the one to three years range, whereas previously it had bought across a range of maturities, including up to 10 years. The justification is that this is less likely to be seen as debt monetisation and still keeps pressure on governments to continue reforming their economies.
Investment implications

A new programme of ECB buying of government debt has some important positive implications. Even though no formal yield cap has been announced, it should serve to keep a lid on eurozone government periphery bond yields, at least for a while. This in turn should help support business and consumer confidence in the region as well as help stabilise the banking sector reducing the tail risk of extreme strains in the financial system.

However, a new bond buying programme will not be a panacea. Many eurozone countries are either in recession or entering recession, and weaker growth will put further pressure on public finances in many of these countries over time. In addition, as explained above, there remains the question of what the ECB will do if a country fails to meet targets set for it by the EFSF/ESM for reform and deficit cutting. If it then stopped buying bonds, yields could spike sharply higher making the crisis even worse. What’s more, there remain a number of hurdles and event risks over the next few months in Europe. In particular, on September 12, the German constitutional court must rule on the legality or otherwise of the ESM bailout. Early October, the so called ‘troika’ of the EU/ECB/IMF are expected to report upon whether Greece has met the terms of its bailout agreement and should be given its next tranche of funding or not.

Overall, the ECB announcement is an important step forward, but much more still needs to be done before the euro-zone crisis is resolved. We continue to think the most likely scenario is that the crisis continues to ebb and flow over the next few months and years, at times creating severe volatility for asset markets. But at other times, such as now, when policymaking becomes more constructive it could lead to a more positive environment for risk assets.

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