The Economic and Social Review, Vol. 53, No. 4 Winter 2022, pp. 261-280

POLICY PAPER

Where Do We Stand With "Whatever It Takes"?

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Abstract: It is ten years since Mario Draghi's "whatever it takes" speech and the announcement of the OMT programme designed to address financial fragmentation. This paper reviews the sources of financial fragmentation and discusses whether monetary tightening over the next few years will trigger concerns about unsustainable fiscal burdens in some euro area Member States. The paper discusses the evolution of ECB policy regarding fragmentation and the practical and legal issues involved. Legal limits on sovereign bond holdings may force the ECB into some difficult choices in the coming years.

I INTRODUCTION

This year marks the 10-year anniversary of the most crucial event in the history of the euro. On 26 July 2012, ECB President Mario Draghi gave a speech to an investment conference in London. The backdrop to the speech was an increasing sense that the euro project was at risk. The euro area economy was going through a "double dip" recession and several euro area Member States were undergoing painful EU-IMF adjustment programmes. Greece had defaulted on its sovereign debt, deposits were moving from banks in peripheral countries to the euro area's perceived "core" countries, and bond yields for many Member States were unsustainably high. There was widespread concern in financial markets not only that further sovereign defaults were possible but that one or more countries would

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choose to leave the euro. The phrase "redenomination risk" had entered discussions of the euro and fluctuating perceptions of this risk were playing a key role in driving volatility in financial markets.

In his speech, Draghi uttered the now-famous words "*Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough*."[1] Draghi's subsequent remarks were more wide-ranging than perhaps people remember today. He argued that the "financial fragmentation" that was occurring was partially due to poorly calibrated banking regulations and a collective mistake of European governments in pressuring banks to limit their activities to their home countries.

The key focus of Draghi's remarks, however, related to sovereign debt markets:

> *Then there's another dimension to this that has to do with the premia that are being charged on sovereign states borrowings. These premia have to do, as I said, with default, with liquidity, but they also have to do more and more with convertibility, with the risk of convertibility. Now to the extent that these premia do not have to do with factors inherent to my counterparty – they come into our mandate. They come within our remit.*
>
> *To the extent that the size of these sovereign premia hampers the functioning of the monetary policy transmission channel, they come within our mandate. So we have to cope with this financial fragmentation addressing these issues. I think I will stop here; I think my assessment was candid and frank enough.*

As Draghi sat down, nobody knew quite what the ECB was going to do to follow through on these remarks, but financial market participants agreed the speech signalled a major intervention. One week later, after an ECB Governing Council meeting, Draghi announced that the Council had agreed that they could undertake "outright monetary transactions" (OMT) to prevent risk premia related to fears about the reversibility of the euro from raising sovereign bond yields to unacceptable levels. The details of the OMT programme were announced the following month and the future of the euro was changed.

Today, nobody doubts that the OMT announcement played a crucial role in ending the euro crisis and in setting the euro area back on a more positive trajectory. With the perception in place that the ECB could deploy its "big bazooka" to prevent bond yields from spiralling out of control, the cost of borrowing for many countries began to decline. Financial conditions throughout the euro area began to improve and the various EU-IMF adjustment programmes were exited successfully. The

[1] The text of the speech is available at https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html.

effectiveness of the "whatever it takes" intervention was even more remarkable when you consider that no actual OMT intervention was ever triggered.

From today's perspective, it is interesting to see how rarely the OMT programme has been discussed in recent years. Notably, there was no mention of it in the ECB's monetary policy strategy review released last year. ECB Executive Board member Isabel Schnabel assured the *Financial Times* in February that "OMT remains an instrument in our toolkit" but it was not a tool that Governing Council members had wanted to talk about in recent years.[2]

In some ways this was a curious development. The design features of the euro area that required the OMT announcement to restore stability are not gone. And after a period of relative macroeconomic calm in the euro area, the future now looks more uncertain. High inflation is likely to trigger an increase in interest rates that will place governments, households, firms and some financial institutions under more pressure. As was true in the past, this pressure will not be equally spread across the euro area Member States and, indeed, sovereign yield spreads relative to German bund rates for high-debt countries like Italy are already rising. In recognition of these pressures, the ECB has announced that it will use reinvestments of its Pandemic Emergency Purchase Fund (PEPP) to counter fragmentation and, in July 2022, ECB announced a new Transmission Protection Instrument (TPI) as a new tool for this purpose. Many questions remain both about how PEPP reinvestments and the TPI will operate in practice.

This paper discusses the issue of financial fragmentation and the ECB's ability to counter it. The paper is structured as follows. Section II discusses why the design of the euro area leaves countries vulnerable to self-fulfilling dynamics that can produce sovereign defaults and why a tool like OMT should still a part of the ECB's toolkit. Section III examines the fiscal situation in euro area Member States and the possibility that the monetary tightening we are likely to see in the coming years could trigger financial fragmentation. Section IV outlines how the ECB's discussions about the financial fragmentation issue have evolved and discuss the new TPI. We outline some of the potential legal obstacles the ECB may face in its future efforts to fight financial fragmentation whether using TPI or some other instrument. Section V concludes.

II FRAGMENTATION RISK IN THE EURO AREA

An important message from the academic literature on sovereign debt markets default is that self-fulfilling dynamics are possible in the absence of a central bank "safety net" for government debt.[3]

[2] Full text of this interview is available at https://www.ecb.europa.eu/press/inter/date/2022/html/ecb.in220216~5ffb80137b.en.html.

[3] See, for example, Cole and Kehoe (2000) and Aguiar *et al.* (2020).

The early years of the euro illustrated a positive version of these self-fulfilling dynamics. With little historical experience of sovereign default in modern Europe, market participants viewed sovereign defaults in Europe as a highly unlikely event during the early years of the euro. As the currency devaluations that had previously occurred in European countries with higher public debt and higher inflation receded in the run-up to the euro and then (apparently) disappeared altogether with its introduction, bonds issued by countries with high levels of public debt became more attractive to investors. Yields on sovereign debt across all euro area Member States – which had previously differed substantially – converged within a narrow band and remained this way until 2009. See Figure 1 for the long-term sovereign bond rates of a selected group of euro area Member States.[4]

Reduced sovereign debt yields significantly helped to improve assessments of debt sustainability. For example, in 1995, Italy had a debt-to-GDP ratio of 119 per cent and allocated 11 per cent of its GDP to interest payments on public debt. In contrast, in 2007, with a debt-to-GDP ratio still standing at 104 per cent, Italy only spent 5 per cent of its GDP on government debt interest. High debt ratios seemed more sustainable for as long as low risk premia were in place.[5]

The euro crisis saw this self-fulfilling process work in reverse. Sovereign default risks largely occur when governments have difficulty rolling over their existing debts. For example, a government that has a debt-to-GDP ratio of 140 per cent with an average maturity of seven years may seek to run a budget deficit of 2 per cent, so the debt-to-GDP ratio would rise to 142 per cent with an unchanged level of GDP. It is possible that the government may fail to obtain funding for this 2 per cent and decide to restructure its debt. In practice, however, the risk of sovereign default stems from the possibility of failing to roll over the existing debt. So, in the example above, the government would each year be refinancing 20 per cent of GDP of sovereign debt.

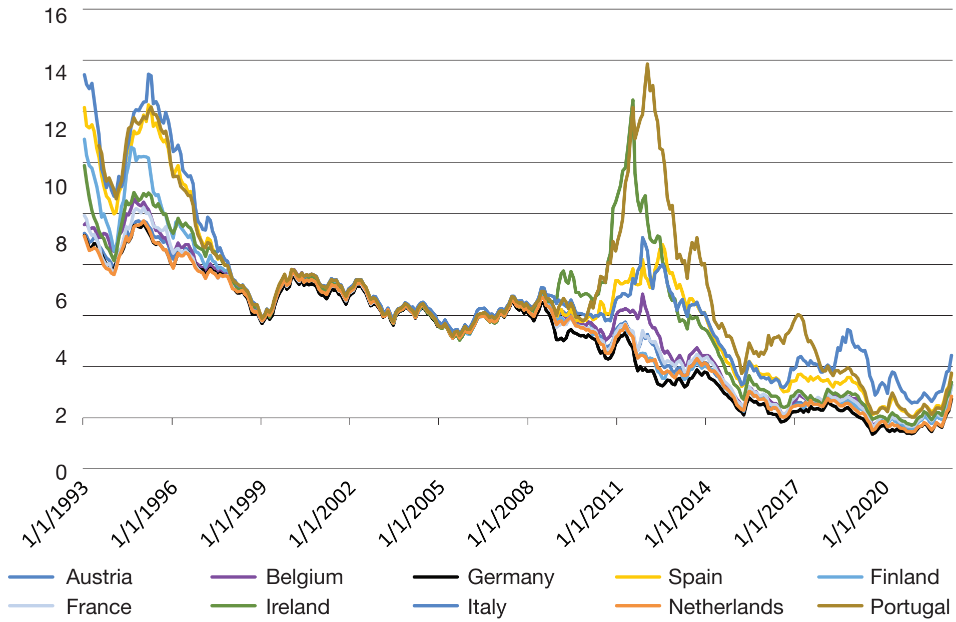
It is this rollover risk, stemming from a "buyers strike" for debt that needs to be refinanced, rather than difficulty in financing the addition of new debt to the total, that represents the key risk for sovereign default. A crisis occurs when investors don't wish to purchase sovereign bonds because they believe other investors are not going to purchase them and thus there will be a default, and anyone who purchases the bonds will make losses. Many sovereign bonds come with cross acceleration clauses, so failure to roll over any previous debt can lead to repayment claims from other creditors, triggering the need for a full sovereign debt restructuring.

[4] Data taken from ECB Statistical Data Warehouse. Greece is excluded because Greek bond yields went so high during 2011/12 that they require a different scale which obscures the other series.

[5] Data available from the European Commission's AMECO online database. Available at https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/macro-economic-database-ameco/ameco-database_en.

The behaviour of sovereign bond markets for some euro area members during 2011/12 provide examples of this kind of self-fulfilling crisis in action, though in the case of the euro crisis there was an additional twist. By 2012, markets were not merely worried that countries would default on their sovereign debt, they were also worried about potential "redenomination risk" due to countries leaving the euro and introducing a new lower-valued currency. For many, the future of the euro itself appeared to be at stake.

Figure 1: Long-term Sovereign Bond Yields for Selected Euro Area Member States



Source: Author's calculations based on data from ECB Statistical Data Warehouse. These rates are the average rates on bonds with residual maturities as close to ten years as the ECB could find at each point in time.

Ruling out this type of speculative self-fulfilling "buyers strike" default appears to have been the primary purpose of the ECB OMT announcement. In an important speech, ECB Executive Board member Isabel Schnabel (2020) outlined this exact scenario to justify the OMT programme:

> *financial markets are neither always rational, nor efficient. They can be prone to panic and instability. Acute periods of market stress can drive a considerable wedge between a country's cost of borrowing, as justified by economic fundamentals, and actual financial conditions, giving rise to self-fulling price spirals.*

> *Such periods of turmoil – if left unaddressed – can quickly turn a liquidity crisis into a solvency crisis, giving rise to huge costs for society as a whole. Central banks are best placed to protect the public from such destabilising forces.*
>
> *In the euro area, the ECB can only be a lender of last resort to financial institutions. The Treaty explicitly prohibits monetary financing of public debt.*
>
> *But the ECB can, and should, provide liquidity when the market fails to coordinate and when the risk absorption capacity of financial market participants is severely constrained. Central bank interventions quickly instil confidence and allow the market to coordinate on the "good" equilibrium once the initial fog of panic and fear has lifted.*
>
> *A prime example is the announcement of outright monetary transactions (OMT) in the summer of 2012. The "whatever it takes" speech by Mario Draghi constituted a coordination device and thereby calmed markets, whereby the euro area gained precious time for reforms.*

The OMT programme was clearly successful in reducing financial fragmentation and in contributing to a dramatic reduction in the perceived risk of sovereign default and of countries exiting the euro. The improvements in financial conditions supported the euro area economy to recover from recession and begin a long period of expansion. One can question of course whether OMT did facilitate any growth-enhancing reforms.

Viewed from today, one can ask questions about the level of concern in 2012 in policy circles and financial markets about sovereign defaults. After all, when Greece defaulted, there was no subsequent financial crisis across Europe. The Greek restructuring was by no means perfect. It was perhaps overly friendly to holdout creditors, and it should have involved a larger reduction in debt, but it showed a country could restructure its sovereign debt and still remain a member of the euro.[6] The creation of the European Stabilisation Mechanism (ESM) and its successful oversight of several adjustment programmes also provides a proven model for how countries can lose access to the bond market and subsequently regain it without default.

However, while these points are all positive, they don't necessarily negate the need for some form of sovereign backstop from the ECB. The potentially negative self-fulfilling dynamics discussed above do not require high levels of public debt to be triggered. They just require financial markets to have doubts about the capacity of a government to roll over its debts that are falling due. For example, a country with the low debt-to-GDP ratio of 70 per cent with an average maturity of seven years will tend to have debt worth 10 per cent of GDP falling due each year. Few

[6] Zettlemeyer *et al.* (2013) is an excellent summary of how Greece's debt was restructured.

governments have this amount of money available so loss of access to the bond market would require a large immediate increase in taxes and/or cuts in spending. If financial markets view that as politically impossible, then this can trigger self-fulfilling doubts about whether the debt can be rolled over. Indeed, it has been documented that defaults on external sovereign debt have often occurred when the ratios of such debt-to-GDP were quite modest.[7]

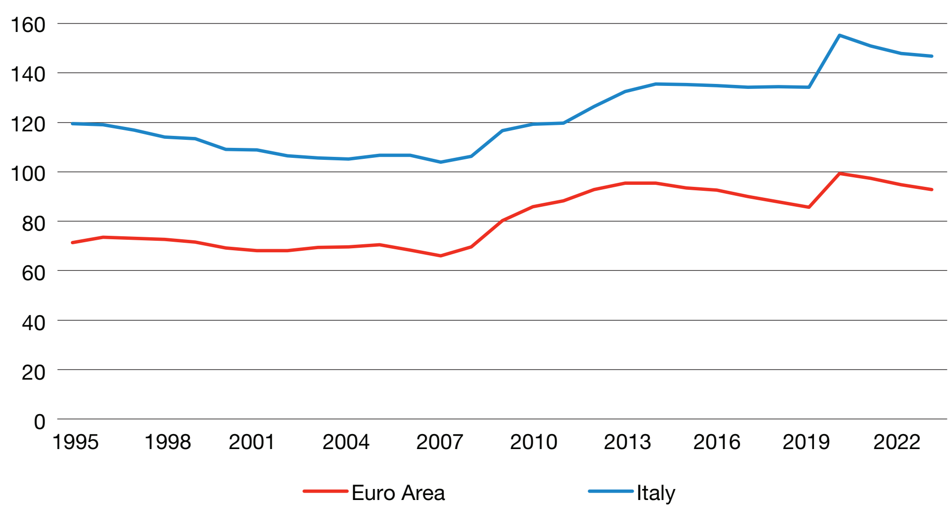
So, the ECB could decide to simply leave it to markets to decide whether countries are solvent but this would likely induce a lot of uncertainty into the euro area, adding an unnecessary level of risk that could regularly trigger avoidable crises.

III DEBT CONCERNS AS A TRIGGER FOR FRAGMENTATION?

Since it became clear that the ECB was likely to tighten monetary policy, the prospect of a sustained round of interest rate increases has triggered some concern in financial markets that it may generate more risk for some countries than others. Spreads for long-term Italian government bonds relative to their German equivalents have risen somewhat over the past few months raising the possibility of a return of financial fragmentation.

The premise behind these concerns is easy to understand. Italy for example had a debt-to-GDP ratio of just over 150 per cent in 2021 (see Figure 2). A rise in

Figure 2: Debt-to-GDP Ratios for the Euro Area and Italy



Source: Author's calculations based on data from Eurostat AMECO database. Includes 2022 and 2023 forecasts from the European Commission.

[7] See Reinhart *et al.* (2003).

funding costs on this large debt pile could place upwards pressure on taxes and may be politically unpopular. Also, data from ECB show that Italy's banks also have the largest credit risk exposure to the domestic government in the euro area, when measured as a share of GDP which adds a secondary financial stability risk to concerns about government solvency. The combination of these concerns during the euro crisis led to a crippling scenario of high bond yields and large outflows from the bank sectors of Member States perceived as higher risk. And if the ECB's current tightening was to trigger a recession then the denominator in the debt / GDP calculation could also shrink, putting further upward pressure on this ratio.

Despite the understandable concerns, one can point to several positive elements to the medium-term fiscal dynamics even of euro area members with relatively high debt.

First, the average financing costs of public debt in the euro area are starting out this period of tightening at a historic low: Figure 3 presents the average interest rate paid on sovereign debt for the euro area and Italy. Despite Italy's historically high debt levels, the share of GDP devoted to servicing this debt currently stands at 3 per cent which is a historically low level (see Figure 4).

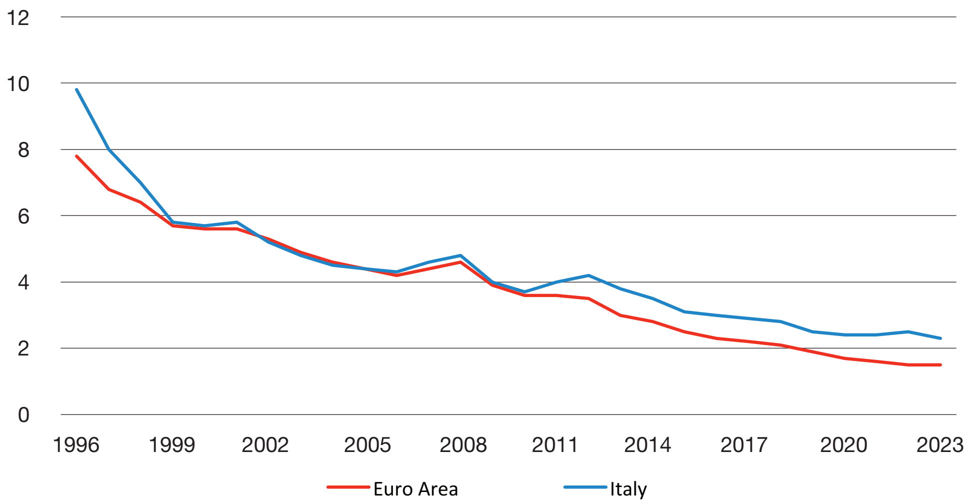
Second, even the modest debt burdens shown in Figure 4 overstate the underlying net cost of sovereign debt. This is because the ECB's asset purchase programmes have seen the national central banks build up large holdings of the sovereign debts issued by their governments. This means that much of the interest being paid on sovereign debt represents "the left hand paying the right hand". The interest income from sovereign bonds has been boosting the profits of the national central banks and these profits are largely paid back to central government.

These bonds have been purchased via the creation of money in the deposit accounts that commercial banks hold with their national central banks and, in recent years, the Eurosystem has been earning money via the negative interest rate that has been applied to these accounts. This policy is likely to be reversed over the next few years, so that there will be some cost to the Eurosystem stemming from the money created to purchase sovereign bonds. Nevertheless, it is likely that the net cost of sovereign debt will continue to be lower than the gross costs published in national fiscal accounts.

Third, while the high level of current inflation is clearly a problem for the ECB, ceteris paribus, higher rates of inflation raise nominal GDP growth. The European Commission most recent forecast anticipates 7 per cent GDP growth for the euro area in 2022, the fastest rates in years. This helps to reduce the debt-to-GDP ratio.

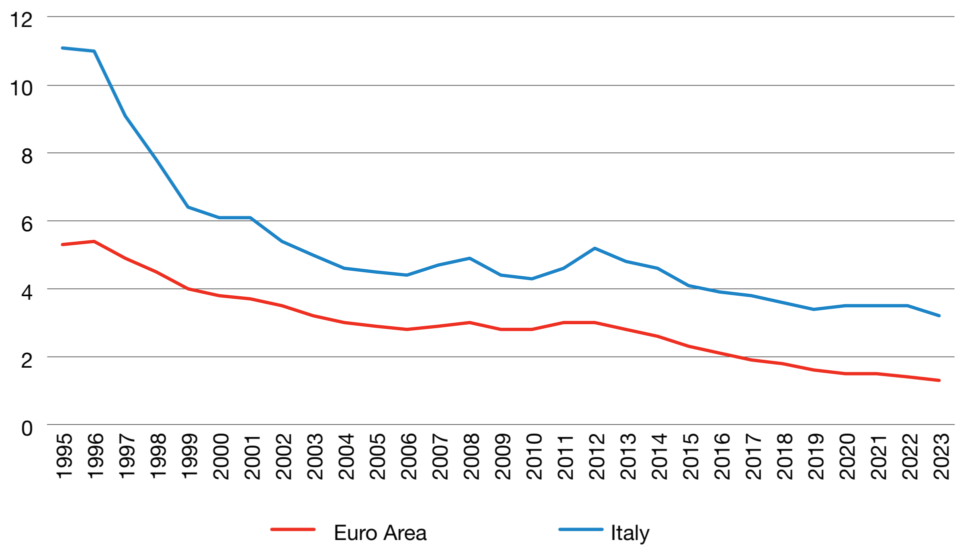
Fourth, even if there is a substantial tightening from the ECB, there is unlikely to be a sharp rise in the average interest rate paid by euro area sovereigns over the next few years. The average maturity of government debt in the euro area has risen over the last few years (see Figure 5) as governments have taken advantage of market demand for safe long-term securities (though somewhat disappointingly the increase in average maturity has been smaller for Italy). The vast majority of this

Figure 3: Average Interest Rate on Euro Area and Italian Public Debt



Source: Author's calculations based on data from Eurostat AMECO database. Includes 2022 and 2023 forecasts from the European Commission.

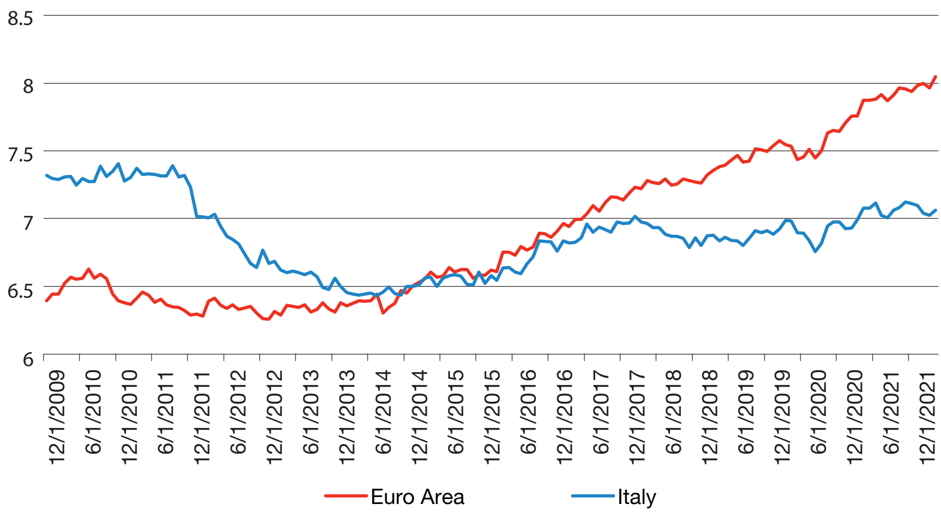
Figure 4: Government Debt Interest Payments as a Share of GDP



Source: Author's calculations based on data from Eurostat AMECO database. Includes 2022 and 2023 forecasts from the European Commission.

debt has been issued at low fixed rates and some of the older debt that will mature will still be replaced by lower yielding bonds. This means that even if the cost of issuing new debt starts to rise, it will take some time for this to pass through to increase the average interest rate across all public debt. Indeed, the European Commission's most recent forecasts, based on assumed tightening by the ECB, still project average interest rates on sovereign debt to be about unchanged over 2022 and 2023 (see Figure 3).

Figure 5: Average Residual Maturity of Euro Area and Italian Public Debt

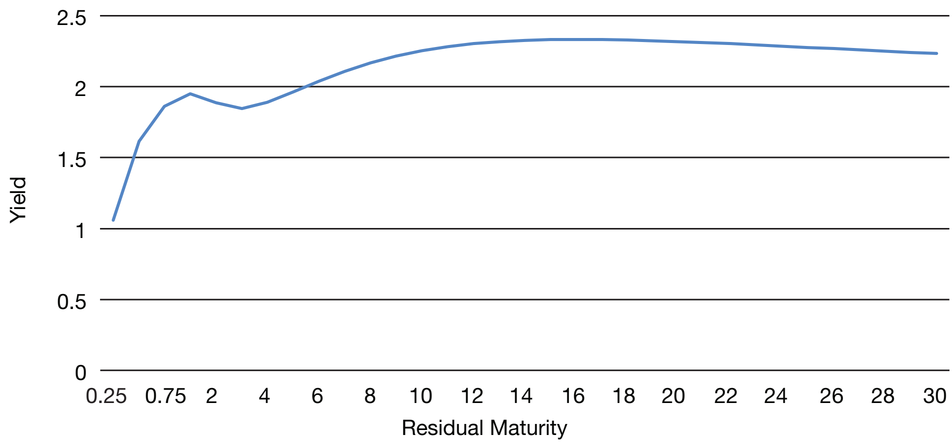


Source: Author's calculations based on data from ECB Statistical Data Warehouse.

Finally, it seems unlikely that the upcoming tightening of monetary policy will see interest rates return to the rates that prevailed prior to the 2008 global financial crisis. In recent months, a number of ECB Governing Council members have discussed the idea of the "neutral interest rate" in their speeches and interviews, where by "neutral" they mean an interest rate that will keep inflation stable at its 2 per cent target. They have suggested they believe the appropriate neutral policy rate for the euro area is about 2 per cent.

Financial markets appear to agree with this assessment. For example, Figure 6 shows the forward interest rates implied by the yield curve for AAA-rated euro area government bonds as of October 2022. They show the market expecting interest rates of between 2 per cent and 3 per cent in the coming year, with rates expected to move gradually back towards just over 2 per cent. Given that nominal GDP will be expected to grow at 2 per cent under a 2 per cent inflation target even if there is no real GDP growth at all, this suggests markets and policymakers believe we are still in the long-run situation described by Blanchard (2019) in which the average interest paid on sovereign debt is lower than the growth rate of nominal GDP. Blanchard has described how this turns much of the conventional wisdom about debt sustainability on its head: it allows governments to permanently run primary deficits and allows much higher levels of debt-to-GDP to be run without getting governments into difficulties.

Figure 6: Forward Interest Rates Implied by the Euro Area AAA-Rated Yield Curve



Source: European Central Bank. Chart taken from the link below on October 12, 2022. https://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/euro_area_yield_curves/html/index.en.html.

These positive factors do not imply there is no risk. As discussed above, the trigger for sovereign defaults is not necessarily the debt ratio or debt interest burden exceeding some threshold amounts but events occurring which make it difficult for a government to rollover the debts that it has falling due. Despite the reassuring data presented above, the amounts of debt that need to be refunded every year are still large, creating the possibility of a crisis occurring. For example, ECB data reported in the European Systemic Risk Board's September 2022 "risk dashboard" showed Italy had 22 per cent of its sovereign debt falling due between August 2022 and July 2023.

As a final observation on the possibility of future crises, I will note that the euro area has taken important steps forward in its institutional structures with the creation of the ESM, the ECB taking over as single supervisor of the euro area's banks and the resolution tools available as part of the Bank Recovery and Resolution Directive (BRRD) all helping with averting or coping with crises. That said, some aspects of the BRRD could exacerbate a crisis that has begun to escalate. In particular, the significant bail-in powers provided to the Single Resolution Board could lead to worsening outflows from banks if investors worry that a sovereign default could lead to those banks being put through a resolution process.

IV FIGHTING FRAGMENTATION: FROM OMT TO PEPP

In this section, I discuss the appearance and disappearance from prominence of the ECB's OMT programme and then move on to discuss more recent comments from the ECB about using the PEPP to counter financial fragmentations.

4.1 The Success and Subsequent Disappearance of OMT

Draghi's whatever-it-takes speech and the subsequent OMT programme announcement can be considered the ECB's greatest policy success. Many market participants who had previously been thinking there would be further sovereign defaults decided it was a bad idea to bet against the ECB because the ECB could use its "big bazooka" to support bond prices of the countries in question – the announcement of the details of the programme pointedly said "No ex ante quantitative limits are set on the size of Outright Monetary Transactions".[8] Various academic studies have documented the calming effects on financial conditions of the OMT announcement, though one does not have to do much more than examine Figure 1 to see that summer 2012 represented the crucial turning point in the euro crisis.[9]

So, OMT worked. Looking back, however, it is interesting the announcement worked so well given the range of questions that could have been asked about its potential effectiveness. One question was how the required conditionality would have worked. The ECB required the relevant country to agree to either a full macroeconomic adjustment programme (or at least a precautionary programme) negotiated with the European Stabilisation Mechanism (ESM) and involving the IMF. This raised the question of what would happen if a crisis was triggered because of the actions of a government that did not want to undertake an ESM/IMF adjustment programme?

Another question was what the process would be by which the ECB would choose to decide that financial conditions required an OMT intervention. Schnabel's discussion of the rationale for OMT described how market behaviour could "*drive a considerable wedge between a country's cost of borrowing, as justified by economic fundamentals, and actual financial conditions.*" But what would happen if the ECB staff assessed the country's fiscal situation and concluded that financial markets were correct and that, like Greece, it was best if the country's debt was restructured?

Finally, there were questions about the size of OMT interventions. Despite the announcement of there being no limit on the size of OMT transactions, elsewhere the technical documentation stated that "*Transactions will be focused on the shorter*

[8] This announcement can be found at
https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html.

[9] See Altavilla *et al*. (2016) for a comprehensive academic study.

part of the yield curve, and in particular on sovereign bonds with a maturity of between one and three years." So rather than being a broad-based intervention to purchase sovereign bonds across the full yield curve, the fraction of bonds that would be initially eligible for purchase would have been quite small.

Governments could have focused issuance of new bonds on these shorter maturities, knowing that OMT purchases would maintain a liquid market for them, but this could also have created dangerous "cliff edge" effect with a lot of newly maturing debt during the period in which the country should have been exiting its ESM/IMF programme. In addition, as I will discuss briefly below, subsequent legal cases that came before the European Court of Justice (ECJ) indicated that the monetary financing clause in the European Treaties would likely place limits on the extent of purchases of sovereign bonds by the Eurosystem.

These factors may help to explain why, despite the widespread perception that OMT was a huge success, it gradually faded away from the ECB's discussions of policy options. Indeed, remarkably, OMT was not mentioned in the comprehensive review of the ECB's monetary policy published last year.

Officially, OMT is not dead. In an interview with the *Financial Times* in February, Isabel Schnabel said:

> *OMT remains an instrument in our toolkit ... Yet, one may ask the question whether the eligibility criteria of OMT are the right ones in all circumstances. We know that there has been reluctance to resort to an ESM programme due to the stigma effect. At the same time, we are seeing that with NextGenerationEU, one can have conditionality without strong stigma effects. I think this is a discussion that we may want to have at some point."*

In other words, the political problems around conditionality are such that OMT is not a programme that the ECB is currently thinking about using.

The ECB's official account of its momentous March 2020 meeting also indicated that OMT was not considered the right tool to counter the widening of spreads that they were seeing.[10] The account states:

> *Regarding the OMTs, the programme had been designed to address a fundamentally different contingency, that of safeguarding the singleness of the ECB's monetary policy in the event of severe tensions in the government bond markets of one or several euro area countries which originated, in particular, from unfounded fears over the reversibility of the euro. The current situation was generally seen to be rather different.*

[10] This account can be found at
https://www.ecb.europa.eu/press/accounts/2020/html/ecb.mg200409_1~baf4b2ad06.en.html.

The impression these statements give is that OMT will only ever be brought back if there are concerns about the future of the euro and it will not be used to address market concerns about sovereign default in a specific Member State.

4.2 New Approaches to Fighting Financial Fragmentation

Another reason why OMT has disappeared from discussions is that it was a programme in which the ECB announced how it might, under certain circumstances, purchase sovereign bonds. However, we are now in a situation where the Eurosystem has been purchasing large amounts of sovereign bonds since 2015. What seemed potentially momentous in 2012 looks somewhat less so now.

Of course, when the ECB first outlined its plans to purchase sovereign bonds via the public sector purchasing programme (PSPP), the emphasis in communications was that this was strictly a policy to ease the stance of monetary policy in light of inflation that had fallen persistently below its target level. At that point, there was no official mention of PSPP as an instrument to fight financial fragmentation.

Still, it seems likely that PSPP had some impact in reducing bond spreads for many euro area Member States. The consistent presence of the ECB in the market likely boosted the perceived liquidity of the market and the steady flow of purchases from the ECB likely eased concerns among investors about getting stuck without being able to find a buyer. For these reasons, while research on US quantitative easing programmes such as D'Amico and King (2013) focused on the principal impact of these programmes on bond yields being through the "stock" effect of the central bank owning a certain fraction of the outstanding bonds rather than the "flow" effect of daily interventions, it seems likely that in parts of the Eurosystem, the flow effect has been quite important.

Perhaps in acknowledgement that this is the case, in contrast the ECB's explanations of the rationale of PSPP, it was clear from the start of the PEPP that the Governing Council considered these purchases to be focused on countering fragmentation as well as easing general financial conditions. The March 2020 announcement of the programme said its goals were "*to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the outbreak and escalating diffusion of the coronavirus*."[11] The "transmission mechanism" reference was clearly code for what has been more commonly since been termed "financial fragmentation". The success of PEPP in reducing spreads and thus countering fragmentation has been mentioned often by Governing Council members over the past few years.

Given the consistent focus on PEPP as an antifragmentation tool during the pandemic, it is not surprising that the ECB has decided that the PEPP could also be used to counter fragmentation due to the potential strains caused by monetary

[11] The announcement can be found here
https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html.

tightening. But exactly how this will work is unclear. The December 2021 Governing Council meeting included the following statement:

> *under stressed conditions, flexibility in the design and conduct of asset purchases has helped to counter the impaired transmission of our monetary policy and made our efforts to achieve our goal more effective. Within our mandate, under stressed conditions, flexibility will remain an element of monetary policy whenever threats to monetary policy transmission jeopardise the attainment of price stability. In particular, in the event of renewed market fragmentation related to the pandemic, PEPP reinvestments can be adjusted flexibly across time, asset classes and jurisdictions at any time.*

More recently, at the April press conference, President Lagarde said:

> *The first part of the birth certificate of PEPP was antifragmentation; the second part was monetary policy stance, and we were delivering that product in short order. It has proven very efficient, and I think it is learning from this and recognising that flexibility is important that we will continue to deliver our monetary policy going forward.*

A reasonable interpretation of these comments is that the earlier commitment to use PEPP reinvestments to counter fragmentation due to the pandemic has now been extended to post-pandemic conditions. Even if monetary tightening means that the total size of the PEPP portfolio was to remain unchanged, the ECB will still be purchasing bonds using the proceeds from interest and principal payments, and they are willing to adjust these purchases to be particularly focused on certain bonds if they experience market pressure.

This idea that PEPP would be used more flexibly than the original PSPP, which stuck strictly to purchasing bonds according to capital key, has been emphasised often by Governing Council members during 2022 but it is unclear how much of a deviation from the capital key proportionality would be tolerated by a majority of Governing Council members.

Without potentially large deviations from capital key proportionality, the use of PEPP reinvestments as a tool to counter fragmentation seems well short of previous talk of the ECB having "big bazookas". To give some relevant numbers, at the end of September, the Banca d'Italia had spent €288 billion purchasing Italian government bonds as part of PEPP. Since the average maturity of these purchases is about seven years, that suggests about €40 billion in principal repayments that can be reinvested. That seems a small figure when compared with the €366 billion due in principal repayments on Italian sovereign bonds over the next year.[12]

[12] Figures for PEPP holdings are available at https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html.

More broadly, the total size of the PEPP portfolio of sovereign bonds in September was €1,666 billion with an average maturity of 7.6 years. The same calculation suggests about €220 billion in principal repayments that can be reinvested, still well below the amount of maturing Italian debt. And it seems incredibly unlikely that the Governing Council could consider devoting all of its PEPP reinvestment funds to purchasing bonds issued by one Member State.

These uncertainties about whether flexibility with PEPP reinvestments would be a sufficiently powerful tool and increasing signs of tensions in sovereign bond markets were likely to have been key to the announcement in July 2022 of a new tool, the Transmission Protection Instrument (TPI). The ECB has emphasised that "*PEPP reinvestment flexibility will continue to be the first line of defence to counter risks to the transmission mechanism related to the pandemic*" but that it can also deploy the TPI should it be necessary. Some have interpreted this framing as implying that PEPP reinvestments will remain the front line tool in the coming years, but the legal framing of the PEPP as being pandemic-related seems to put a limit on its application to future situations.

The TPI is effectively the OMT with weaker eligibility conditions. The eligibility conditions relate to (i) compliance with the EU fiscal framework (ii) absence of severe macroeconomic imbalances (iii) fiscal sustainability and (iv) sound and sustainable macroeconomic policies. Specific explanations have been provided of what is precisely meant be these conditions. Taken together, this could be interpreted as though the criteria for TPI are perhaps tougher than OMT but the ECB has made clear that it will not require all of these conditions to hold and that a decision to activate the TPI :

> *will be based on a comprehensive assessment of market and transmission indicators, an evaluation of the eligibility criteria and a judgement that the activation of purchases under the TPI is proportionate to the achievement of the ECB's primary objective.*

Key here is that ECB will not be waiting around for a formal adjustment programme to be signed to activate purchases under TPI.

Two years after President Lagarde's widely criticised remarks that "we are not here to close spreads", the TPI is effectively a "standing facility" in which the Eurosystem would systematically intervene in sovereign bond markets, alternating purchases and sales of various sovereign bonds depending on market conditions. As with flexibility in the use of PEPP reinvestments, the effectiveness of such an approach could depend on how large the flows of purchases could be during times of financial stress.

4.3 Legal Issues

The most commonly-cited reason for OMT's success was the so-called "big bazooka" effect – the idea that the ECB could approve essentially unlimited amounts of money to be directed towards specific bond market interventions. However, once it began purchasing bonds via the PSPP in 2015, the ECB itself was aware that the monetary financing clause in the European Treaties would perhaps place a limit on how far it could go in purchasing sovereign bonds.

One issue that was clear from the beginning of the PSPP was that there could be a problem if the Eurosystem purchased a large enough position in any bond issue that it could block any restructuring under potential collective action clause (CAC) negotiations. For this reason, the ECB set a limit on how much of any country's sovereign debt it could own, initially at 25 per cent and later at the 33 per cent level consistent with the size of a blocking minority in most euro area CACs.

Once the pandemic occurred, however, the ECB signalled that it would no longer necessarily abide by these so-called "issuer limits" when carrying out its asset purchases. To explain why the ECB decided to consider waiving the issuer limits, note that in its most recent reporting, the Eurosystem owned almost €2.56 trillion in sovereign bonds in its PSPP portfolio and an additional €1.64 trillion in its PEPP portfolio.[13] To put that in perspective, the European Commission estimates that euro area gross government debt (GGD) was about €12 trillion by the end of 2021. There is an apples-and-oranges comparison in these figures since the GGD figures relate to the face value of debt while the ECB's figures relate to the total cost of acquiring their portfolio. These figures can differ because fluctuating market yields drive a gap between the face value of a bond and its market value. However, it seems likely the Eurosystem is close to or above the limits it had previously set for at least some Member States.

In its communications since the onset of the pandemic, the ECB have put forward two different positions to justify their new approach to issuer limits.

The first position is that it is essentially up to the Governing Council to decide whether to decide to stick with these limits. The PEPP announcement stated:

> *To the extent that some self-imposed limits might hamper action that the ECB is required to take in order to fulfil its mandate, the Governing Council will consider revising them to the extent necessary to make its action proportionate to the risks that we face.*

I make no claim to be a European constitutional law expert but this view of issuer limits as something the ECB imposed on itself and could just as easily decide not to impose seems questionable on legal grounds.

I have written about this topic previously (Whelan, 2020 and 2022) so I will not cover the arguments in detail here. However, it is clear from the ECJ's

[13] Data on PSPP holdings are from https://www.ecb.europa.eu/mopo/implement/app/html/index.en.html and data on PEPP holdings are from https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html.

judgement in the 2018 *Weiss* case on the PSPP that the legal approval for sovereign bond purchase programmes was highly conditional.[14] Ultimately, the key condition set by the Court for the programmes to not violate the monetary financing prohibition (Article 123 of TFEU) was that they should not undermine the need for euro area members to follow sound budgetary policy. In the *Weiss* judgement, the Court took comfort that the ECB's intended issuer limits were an important element in ensuring the programmes were consistent with Article 123. These limits are not necessarily something the ECB can simply decide to set or abandon as it pleases.

The second position is that the ECB's communications on this topic have suggested that while there is a legitimate debate to be had about applying issuer limits to the PSPP, these limits do not apply to the PEPP. I suspect the reasoning behind this position is that PEPP was prompted by a pandemic and, in an emergency, technical considerations like issuer limits should not have to apply. Again, the legal basis for this idea seems dubious. The European Treaties do indeed contain various emergency provisions that allow, for example, for temporary emergency derogations related to free movement of capital. The Fiscal Compact legislation allowed for the temporary emergency derogation of the EU's fiscal rules that has been in place over the past few years. But, to my knowledge, there is nothing in the Treaties that allows for a temporary derogation of Article 123's prohibition on monetary financing.

While TPI has not been activated yet, the same issues apply to the size of purchases that can be undertaken under this programme. The TPI announcement suggests that "*Purchases are not restricted ex ante*" but the same considerations that led to the ECB initially deciding to have issuer limits in its previous purchase programmes will apply to any programme that involves purchasing sovereign bonds.

Of course, the wheels of monetary financing justice do not grind quickly. It could be years before the ECJ takes a case on this topic again. However, with the TPI now approved, suggesting the possibility of regular active use of the balance sheet, the ECB should perhaps consider having a much smaller balance sheet in "normal times" to allow space for these policies to be implemented in future without getting into legal difficulties. The TPI announcement suggests that the programme "*should cause no persistent impact on the overall Eurosystem balance sheet and hence on the monetary policy stance*." Rather than committing to undo a future balance sheet increase due to TPI, the ECB should be considering a balance sheet reduction now to facilitate the potential future use of TPI.

[14] Materials on the Weiss case are available at https://curia.europa.eu/juris/liste.jsf?language=en&num=C-493/17.

V CONCLUSIONS

Draghi opened his famous speech in London with the interesting observation that "*The euro is like a bumblebee. This is a mystery of nature because it shouldn't fly but instead it does*." Ironically, one can now view the programme that followed this speech in a similar manner. The announcement of OMT worked but the closer you looked at it, the more questions arose. Under what conditions would the ECB decide to activate an OMT programme? How would the conditionality attached to OMT have worked in practice? Would the restriction to short-dated bonds have given the ECB sufficient ammunition to support bond prices? So, perhaps it shouldn't have worked in 2012 but thankfully it did.

From today's perspective, however, it is clear the ECB is not keen to introduce an OMT programme to counter financial fragility, partly because of the complications surrounding programme conditionality and perhaps also because existing asset purchase programmes allow for a wider range of maturities to be purchased. However, if you look at the current proposals to counter financial fragmentation, they also have a bumblebee feel about them. Would PEPP reinvestments really be large enough to counter significant market disruptions? The calculations presented here suggest not. Are sovereign bond holdings not already high enough to rule out legal troubles if there were to be a major intervention for one country or a number of countries? Relative to the days when investors respected the ECB's "big bazooka", current proposals for countering fragmentation seem a little weak.

Recent announcements indicate the ECB will tighten rates over the next few years while maintaining its balance sheet at close to current levels. This means that questions about whether the Eurosystem's bond holdings are inconsistent with monetary financing will remain, as will questions about whether there remains the room to mount another large intervention to support bond prices.

One option the Governing Council should consider is running down its portfolio of sovereign bonds faster than currently planned. From one viewpoint, this would seem a logical place to start monetary tightening. PSPP was brought in to ease financing conditions at a time when interest rate cuts had reached a practical limit. It seems logical that the first move to tighten financial conditions would be to start reversing PSPP and PEPP via bond sales. To the extent that this "quantitative tightening" is having a clear effect on financial conditions, the ECB could trade off rate hikes for bond sales, raising its policy rates at a slightly slower pace than currently planned (I use the term slightly, given that the empirical estimates of the impact of QE on bond yields are relatively modest).

The decision to maintain the current balance sheet size is likely related to concerns about financial fragmentation. However, as documented above, ECB policies of recent years and the likely low value of the "neutral" policy rate mean there are no good fundamental reasons for investors to be concerned about the fiscal conditions of even the higher-debt Member States such as Italy. Of course, market evaluations can sometimes differ from the "fundamentals" approach applied here to assessing fiscal positions. But there is a strong argument that the ECB should reduce its bond holdings to put it back in position to stage a major intervention in the future without triggering legal concerns.

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