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The ECB's Toxic Bond-Purchase Program

It is unclear why the European Central Bank has introduced a new asset-purchase instrument instead of using its existing Outright Monetary Transactions facility. By shielding countries from both market forces and political commitments, the Transmission Protection Instrument risks destabilizing European monetary union.

With eurozone inflation rising rapidly, the European Central Bank recently increased its benchmark interest rate by 50 basis points and introduced a new asset-purchase program – the Transmission Protection Instrument (TPI) – aimed at limiting yield differentials between member states' bonds. But the ECB's latest anti-fragmentation tool risks destabilizing the single currency.

Market interest rates in the eurozone, including those on government bonds, have risen sharply since the end of 2021, because investors want to be compensated for higher inflation and have already priced in monetary-policy tightening. Alongside higher yields, interest-rate differentials within the eurozone also have increased, with interest rates rising more sharply in countries with higher public-debt-to-GDP ratios and deteriorating growth prospects. For example, while yields on ten-year German government bonds climbed from –0.33% to 1.75% between the beginning of December 2021 and mid-June 2022, yields on ten-year Italian bonds increased from 1.02% to 4.27% over the same period. The yield differential thus increased by 1.17 percentage points.

In recent years, the ECB has bought more bonds than were newly issued by eurozone member states, and has thus indirectly financed substantial new government debt. Since the central bank will now no longer purchase additional bonds on a large scale because of rising inflation, there is considerable uncertainty about the interest rates at which private investors will be willing to buy government debt. The necessary interest-rate level, including risk premia, first needs to be established on the capital market. Highly indebted eurozone countries are now facing rising interest-rate differentials partly because the ECB has so far used a more or less fixed capital key in its asset-purchase decisions, while private investors are selective and demand higher interest rates in return for assuming greater risks. In view of this, the ECB has launched the TPI to contain interest-rate differentials by buying individual eurozone countries' bonds. Insofar as the fight against inflation requires that the ECB's overall bond holdings do not increase further, the purchases could be designed in such a way that the central bank's portfolio is restructured. Maturing German or Dutch bonds, for example, could be replaced with Italian debt.

But it cannot be ruled out that – contrary to current plans – the ECB's overall government bond portfolio will expand. The ECB is thus deviating from principle: It usually purchases government bonds according to the capital key in order to avoid undesirable fiscal redistribution effects and to protect the independence of its monetary policy.

The ECB's Argument for its New Purchase Program Is Problematic

ECB relies on two arguments to justify its new TPI. First, especially in times of significant interest-rate hikes, some countries' risk premia could rise above the levels dictated by their economic fundamentals. Investor pessimism or speculation could drive up interest rates to the point of endangering a country's solvency. In this case, ECB bond purchases could ensure that lower interest rates and positive expectations prevail in the market. But this argument is problematic in two respects. In practice, it is hardly possible to determine precisely which interest-rate premia are justified from a fundamental perspective. And in any case, this is primarily a task of fiscal policy, not monetary policy: The objective is for individual countries to finance their national budgets on appropriate terms. Second, the ECB argues that sharply rising interest-rate differentials disrupt the transmission of monetary policy, undermining its intended effect in the countries concerned. In order to ensure that transmission works, therefore, the rise in yields must be stopped.

ECB Support for Individual Countries Should Be Subject to Conditions

During the euro crisis, the ECB announced – through its Outright Monetary Transactions (OMT) program – that it would buy government bonds of eurozone member countries in financial difficulty and thus deviate from the capital key. The justification was similar, and the European Court of Justice and the German Constitutional Court declared that the OMT instrument was in accord with European law and German constitutional law, respectively. Some economists and lawyers continue to dispute whether the OMT program is covered by the ECB's mandate. But what was not in question when the scheme was introduced was that strict conditionality was required in order to prevent countries from being supported by the ECB despite unsustainable public finances or further expanding their debt. To limit this risk, the ECB envisaged that countries receiving OMT support would accept policy conditionality as part of a European Stability Mechanism (ESM) program. Then-ECB President Mario Draghi argued that this conditionality was essential because central-bank assistance would otherwise undermine incentives for sound fiscal policy. Moreover, Draghi said, conditionality would protect the ECB's independence and help governments to implement the necessary reforms.

If Countries Are Shielded from the Market and from Political Commitments, This Is Toxic for the Monetary Union

Given this background, it is not acceptable that the ECB now wants to support individual eurozone countries with government bond purchases, but without the conditionality of an ESM program. The conditionality announced now is vague and essentially allows the ECB to buy bonds whenever it wants. It is unclear why the ECB has introduced a new asset-purchase instrument instead of using the OMT facility. Some claim that applying for an ESM program would be politically toxic, especially in larger eurozone countries such as Italy. And it is true that conditionality requires governments to take political responsibility for implementing reforms. But by shielding countries from both market forces and political commitments, the ECB's new TPI risks generating its own toxic effect on the stability of Europe's monetary union.

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