TD Economics

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Data Release: European Central Bank bond buying program could buy time, but does not remove break-up fears

- The European Central Bank (ECB) maintained the interest rate on the main refinancing operations at 0.75%. It also decided to keep the interest rates on the marginal lending facility and the deposit facility unchanged at 1.50% and 0.00%, respectively.
- The ECB also announced it will engage in Outright Monetary Transactions (OMT) with the aim of "safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy". These operations will consist of sovereign bond purchases in the secondary market, targeting maturities of between one and three years.
- The ECB will decide the timing and size of its bond purchases based on a variety of indicators such as the level of sovereign bond yields, yield spreads, credit default swaps spreads, volatility, and liquidity conditions in those markets.
- A necessary condition for OMT is that the issuer country adheres to "strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) program". The ECB would suspend OMT purchases if its Governing Council deems the country does not fully comply with such conditionality.
- Regarding the seniority of Eurosystem bond purchases under OMT, the ECB will accept pari passu treatment with respect to private and other creditors. This means it will eventually face the same conditions as private creditors in a hypothetical future debt restructuring process.
- The ECB intends to fully sterilize the liquidity created through OMT.
- In terms of Eurosystem's credit operations collateral eligibility, the ECB has decided to suspend minimum credit rating threshold on government bonds and government guaranteed debt of countries that are eligible for OMT.

Key Implications

- The ECB has now formally stated what Mr. Draghi had signaled at the August meeting: ECB bond purchases in the secondary market will only materialize after a country has submitted itself to the conditionality of and adjustment program. This means that market pressure on Spanish bonds will have to increase in order to push the Spanish government into accepting the tough requirements of an adjustment program before the ECB starts buying Spanish debt.
- To allay inflation fears, especially in core countries, the ECB plans to withdrawal the liquidity injected via OMTs. Only time will tell whether the central bank will succeed in its sterilization efforts. And, even if does, nothing guarantees that the liquidity drained will necessarily come from those countries where the ECB deems liquidity conditions to be excessive. After all, what has been causing the capital flows from the peripheral countries into the core countries has been the fear of a euro zone break-up. As long as those fears persist, liquidity will always find its ways into those countries that less need it.
- The fact that compliance with program conditionality will be assessed by the ECB's Governing Council opens the door to potentially conflicting assessments between the ECB and the EU-IMF. Furthermore, if a country under a program abides by most of the policy recommendations and structural reforms dictated by the program, but still fails to deliver on the targets and continues to suffer market pressure, it

could prove very difficult for the ECB to suspend its bond market interventions at a time of market stress.

- In all, ECB interventions attached to conditionality under an adjustment program will eventually address liquidity concerns, and therefore it buys time for governments to implement reforms. However, ECB interventions will not remove the threat that the negative feedback loop between fiscal austerity and poor economic growth performances could make the adjustment processes unworkable. This threat is what ultimately feeds the fear of a break-up of the euro area, and therefore is the driving force behind the sovereign yield spreads. Ultimately, decisive action towards more integration by governments is required, but we know by now that that is a slow process.

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