

IN-DEPTH ANALYSIS

Requested by the ECON Committee

Monetary Dialogue Papers, September 2022



The TPI: protecting the transmission mechanism or managing spreads?



Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
Authors: Ignazio ANGELONI, Daniel GROS, Farzaneh SHAMSAKHR
PE 733.981 - September 2022

EN

The TPI: protecting the transmission mechanism or managing spreads?

Monetary Dialogue Papers
September 2022

Abstract

The European Central Bank has announced a new facility, the Transmission Protection Instrument (TPI), to safeguard the monetary policy transmission mechanism (MTM). The euro area is more robust and resilient today than in past euro crises. The TPI should therefore focus on short-term instruments in which threats for the MTM may reside. The recent increase in Italian long-term spreads did not signal such threat. The ECB should create a Transmission Observatory, with data and analyses on the pass-through from the money market to bank credit conditions, to detect possible threats to the MTM and document the possible need for intervention.

This paper was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the Committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 26 September 2022.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs (ECON).

AUTHORS

Ignazio ANGELONI, EUI
Daniel GROS, CEPS
Farzaneh SHAMSAKHR, CEPS

ADMINISTRATOR RESPONSIBLE

Drazen RAKIC

EDITORIAL ASSISTANT

Catherine NAAS

LINGUISTIC VERSIONS

Original: EN

ABOUT THE EDITOR

Policy departments provide in-house and external expertise to support European Parliament committees and other parliamentary bodies in shaping legislation and exercising democratic scrutiny over EU internal policies.

To contact the Policy Department or to subscribe for email alert updates, please write to:

Policy Department for Economic, Scientific and Quality of Life Policies
European Parliament
L-2929 - Luxembourg
Email: Poldep-Economy-Science@ep.europa.eu

Manuscript completed: September 2022

Date of publication: September 2022

© European Union, 2022

This document was prepared as part of a series on "Anti-fragmentation: need for a new tool in the toolkit?", available at:

<https://www.europarl.europa.eu/committees/en/econ/econ-policies/monetary-dialogue>



Follow the Monetary Expert Panel on Twitter: [@EP_Monetary](https://twitter.com/EP_Monetary)

DISCLAIMER AND COPYRIGHT

The opinions expressed in this document are the sole responsibility of the authors and do not necessarily represent the official position of the European Parliament.

Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the European Parliament is given prior notice and sent a copy.

For citation purposes, the publication should be referenced as: ANGELONI, I., GROS, D. and SHAMSAKHR, F., *The TPI: protecting the transmission mechanism or managing spreads?* publication for the Committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg, 2022.

CONTENTS

LIST OF ABBREVIATIONS	4
LIST OF BOXES	5
LIST OF FIGURES	5
LIST OF TABLES	5
EXECUTIVE SUMMARY	6
1. INTRODUCTION	7
2. THE MONETARY TRANSMISSION MECHANISM	11
2.1. The MTM away from the lower bound	11
2.2. Some differences in the MTM are to be expected	12
2.3. The MTM in action	13
3. THE MTM AND LONG- VERSUS SHORT-TERM RATES	14
3.1. Flattening the risk curve as a key danger signal	14
3.2. Long- versus short-term debt and the cost of public debt	15
4. RECENT DEVELOPMENTS (JUNE/JULY 2022)	16
4.1. June 2022: false alarm?	16
4.2. Extreme flexibility in PEPP reinvestment June/July 2022	17
5. CONCLUSION	19
REFERENCES	20

LIST OF ABBREVIATIONS

bps	Basis Points
BTP	Italian Government Bond
Bund	German Bond
CEPS	Centre for European Policy Studies
ECB	European Central Bank
ECON	Committee on Economic and Monetary Affairs
EP	European Parliament
ESM	European Stability Mechanism
EUI	European University Institute
GDP	Gross Domestic Product
GFC	Great Financial Crisis
IMF	International Monetary Fund
PEPP	Pandemic Emergency Purchase Programme
MTM	Monetary Policy Transmission Mechanism
NCB	National Central Bank
NGEU	Next Generation EU
NPL	Non-Performing Loan
OMT	Outright Monetary Transaction
QE	Quantitative Easing
SMP	Securities Markets Programme
TPI	Transmission Protection Instrument

LIST OF BOXES

Box 1:	Italy, evolution of net foreign asset position of major sectors of the economy	9
--------	--	---

LIST OF FIGURES

Figure 1:	Bank lending rates to non-financial corporations, new business	13
Figure 2:	Spread on risky assets versus Italy's 10-year bond spread (vs Germany)	17

LIST OF TABLES

Table 1:	The term-structure of risk spreads, Italy	16
Table 2:	June/July PEPP 2022 reinvestments: extreme flexibility	17

EXECUTIVE SUMMARY

- **The European Central Bank (ECB)'s new Transmission Protection Instrument (TPI) was designed in a hurry at a time when the ECB was realising that its response to inflation was insufficient, and interest rates therefore had to be raised quickly and by large amounts.** This haste may explain why some important details were left unspecified, which in turn has rendered any assessment of the new instrument difficult.
- **The TPI is ostensibly supposed to protect the monetary policy transmission mechanism (MTM).** There is strong evidence that with interest rates above zero, the MTM in the euro area depends crucially on the link between money market rates (three-month maturity) and bank lending rates. It follows that TPI intervention should focus on the short side of the interest rate structure and on the pass-through of those rates to the banks' lending side.
- **Under these conditions, the costs and risks (as well as any returns) of TPI intervention should be shared among national central banks (NCBs) according to the ECB's capital key.** Burden-sharing of the TPI is an aspect that the ECB has left unspecified.
- **The new tool should be triggered if, and only if, high short-term spreads clearly signal imminent risks that the MTM may be jeopardised.** High spreads on long-term bonds should not be sufficient to trigger the TPI. There is no need for the ECB or any NCB to estimate normal or fair 10-year spreads.
- **Another crucial aspect left unspecified is the relation between the TPI and Outright Monetary Transactions (OMTs).** We argue that the TPI can at best be a first line of defence. Countries with strong fundamentals should be advised to "buy insurance" by using the European Stability Mechanism (ESM) precautionary line – whose preset conditions are now largely met by all euro area countries – to unlock the OMT. Countries with more fundamental imbalances should instead apply for a regular ESM credit line, which includes an ESM-sponsored adjusted programme.
- **The ECB has also mentioned flexibility in the reinvestment of maturing pandemic emergency purchase programme (PEPP) securities as another instrument to deal with pandemic-induced MTM fragmentation.** This flexibility was used to an extreme during the last reporting period (June/July 2022) as most of the maturing principal was used to purchase Spanish and Italian bonds (with a corresponding decline in the holdings of core government bonds).
- **The ECB has not provided any justification for this extraordinary deviation from past patterns,** though we see no indication that the MTM was threatened or that any threat was due to the COVID-19 pandemic – which would be required for any use of the PEPP.
- **The ECB should create a Transmission Observatory, focused on the aforementioned linkages between short-term rates and bank lending, to be able to detect future threats to the MTM and to document any need for intervention.**

1. INTRODUCTION

Following the Governing Council's meeting in June 2022 when the European Central Bank (ECB) announced that it would depart from its previous forward guidance and increase interest rates substantially this year, the risk premia on Italian government debt increased rapidly, with the 10-year BTP-Bund spread reaching a peak of 250 basis points (bps). On 15 June, the Governing Council arranged for an ad hoc meeting to evaluate the current market situation, and announced accelerated work on “a new anti-fragmentation instrument”, whose outline was then published on 21 July. Given that the spreads on other peripheral countries rose much less, this created the impression that the new instrument, the Transmission Protection Instrument (TPI), was created mainly to deal with the case of Italy¹.

Before discussing the details of the new instrument, let us briefly consider past experiences when the ECB sought to counter fragmentation risk through the Securities Markets Programme (SMP, 2010-2011), the Longer-Term Refinancing Operations (LTROs) of late 2011 which are now mainly forgotten, and the Outright Monetary Transactions (OMT), widely credited with having saved the euro area from collapse without essentially having to be used.

One needs to understand the OMT in view of the specific conditions of that time (2010-2012) when countries such as Spain, Portugal and Greece had faced a large build-up of current account deficits during the preceding boom period and had to attune to a sudden stop. Although Italy had a relatively much smaller current account deficit, it was somewhat affected by the sudden stop of capital inflows from abroad. This sudden stop called for a rapid adjustment in the external balance, namely an internal devaluation. Some therefore argued at the time that an exit from the euro, along with a devaluation, might be less painful than a deep recession compressing domestic wages and prices (e.g. Weisbrodt and Montecino, 2012 in the case of Greece).

The current situation is quite different. The peripheral countries no longer have substantial deficits, and Italy, the country with a high risk premium, has a large current account surplus. Moreover, the large gap in competitive conditions relative to Germany that had opened up by 2011-2012 has now largely been closed. The economic argument for a country potentially benefiting from leaving the euro area has largely vanished.

Another often overlooked element which differentiates today from 2012 is that the current inflation burst, not matched by corresponding increases in interest rates, is helping public finances. Today, the growth rate of nominal gross domestic product (GDP) is much higher than the interest cost of public debt. For Italy it is estimated to be around minus 4.5 percentage points in 2022 and minus 3 percentage points in 2023. In 2012 and 2013, this amount was equal to 7 and 5.7 percentage points of GDP respectively.

The current combination of nominal growth and interest cost at 10 percentage points better today than in 2012 has never been as favourable at any time in recent memory. The same consideration applies to Spain and Portugal, the other countries that in 2012 came under severe financial stress.

Moreover, the vast NextGenerationEU (NGEU) support programme, which benefits particularly those euro area countries that experienced financial tensions, has solidified political support for the euro. Revealingly, the term “euro crisis” has virtually disappeared as a topic in the Google trends search. The

¹ See Greene, M. (2022).

acute systemic tensions that 10 years ago put the survival of the euro area at risk, hence motivating the OMT, no longer exist at present.

Another difference between today and 2011-2012 is the increased stability of the banking sector. Non-performing loan (NPL) ratios in Spain² and Italy³ have fallen from peaks of over 13% and 17% respectively around the middle of the past decade to a little over 4% now for both countries. Moreover, banking supervision has been centralised in the Single Supervisory Mechanism at the ECB, thus ending national forbearance, and the Single Resolution Fund is on track to achieve its target of a fund of EUR 80 billion by the end of next year (De Carpentier, 2022). Though specific cases of weak banks persist, in Italy as elsewhere, all in all the banking system is no longer a source of major risks.

There is little need to discuss the case of Greece in this context. First, Greece has pursued a sustainable and prudent economic strategy in recent years, culminating recently in the anticipated reimbursement of its International Monetary Fund (IMF) debt. Second, its public debt is mostly towards official institutions (ESM, Greek Loan Facility, etc.) and very long term at very favourable rates. Market rates are thus of little relevance to Greek public finances, although the country has a debt-to-GDP ratio of close to 200%. What remains, in essence, is a high and volatile risk premium on Italian public debt. The special situation of Italy is illustrated by the fact that the movement in rates over the last months has been very different from 2012 – the spreads of countries like Spain and Portugal have increased much less (around half that of Italy). Italy's situation today should rather be compared to 2018, when the formation of a eurosceptic government led to a sharp country-specific widening of the risk premium (up to 250-300 bps), not accompanied by similar movements in other countries. The main risk that markets see today in Italy seems to be related to the fall of the government and the possibility that the upcoming elections may deliver a government less committed to fiscal prudence and NGEU reforms than the previous one.

Angeloni and Gros (2022) document in more detail the much stronger external position of Italy and its improved banking system.

² CEIC, Spain Non Performing Loans Ratio. <https://www.ceicdata.com/en/indicator/spain/non-performing-loans-ratio>

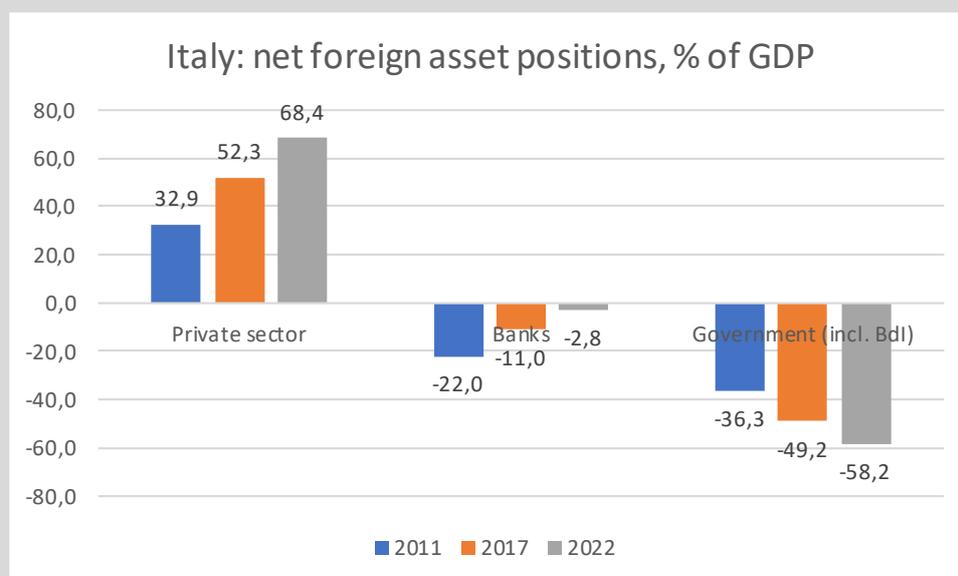
³ CEIC, Italy Non Performing Loans Ratio. <https://www.ceicdata.com/en/indicator/italy/non-performing-loans-ratio>

Italy has been running a persistent current account surpluses of 2% to 3% of GDP in recent years, which has yielded a positive net external position. The position is mainly driven by a large foreign asset position of the private sector, which has been offset by a relatively sizeable Italian government debt held abroad. Box 1 illustrates this development.

Box 1: Italy, evolution of net foreign asset position of major sectors of the economy

Italy was the country with the lowest external deficit at the outset of the euro debt crisis. Its current account deficit reached only about 3% of GDP (in 2011), compared to close to 15% of GDP for Spain, Portugal and Greece. Moreover, regular current account surpluses have helped to improve Italy's net foreign asset position, which has now turned positive.

However, as shown below, the improvement of the foreign asset position applies only to the private sector and banks, not to the government, whose negative position has deteriorated over the last decade and now amounts to close to 60% of GDP, compared to a net positive position of the (non-bank) private sector of close to 70% of GDP.



Source: authors' calculations based on Banca d'Italia data.

In a crisis the government usually has to save the banks. In a crisis scenario one would thus have to aggregate the banks and the government. From this perspective there has been no improvement since the external position of the aggregate banks+government amounted to -58.3% of GDP in 2011 versus -60.5% of GDP now.

As mentioned above, banks have strengthened their balance sheets throughout the euro area. Italian banks in particular have much reinforced their capital position, reducing their reliance on financing from abroad and greatly reducing the large stock of NPLs, which made their balance sheets so difficult to read during the last crisis, to a fraction of the value at the peak of the crisis.

Italian banks now show value for the key solvency ratio CET1 (high-quality capital as ratio of risk-weighted assets, as a percentage) very close to the euro area average (15.3% versus 15.5% for the euro area).

The only indicator that has not improved is the exposure of Italian banks to the Italian sovereign, which, as a ratio to total assets, has remained broadly unchanged, whereas it has declined markedly on average for the euro area, from 8.4% to 6.2%. As a ratio to CET1 capital, the exposure of Italian banks has actually increased and is now one of the highest.

2. THE MONETARY TRANSMISSION MECHANISM

Unique among major central banks, the ECB considers the MTM not merely as a *means* to diffuse the effects of its policy on the economy, but also as an *end* in itself, or in other words, another *goal* of monetary policy alongside others assigned to it by its statute. Consider a stylised example in which a central bank uses instrument A to achieve, through a set of cause/effect relations B, a final goal C. Normally, central banks adjust A in order to achieve C, taking B as a given. Virtually all monetary policy research is cast in these terms. The ECB, instead, uses A to influence *both* B and C, the effects on B being instrumental to improving the accuracy with which it attains C. Though conceptually meaningful, this approach is much more complex because it requires the factoring in of multiple distinct cause/effect relations operating simultaneously and interacting with each other.

It is also worth noting that this is not the first time the ECB has regarded the MTM as a policy objective. In 2011, ECB President Trichet argued that the financial and the euro crises had disrupted the functioning of financial markets, and thus the functioning of the MTM⁴. Unconventional monetary policy (meaning large asset purchases) was deemed necessary to calm markets and allow the MTM to operate properly. At that time, the expansionary stance of monetary policy benefited both the MTM and the final ECB goal because the financial crises were depressing both inflation and economic activity. Draghi's ECB returned to a similar concept a few years later⁵, the argument then being that the sovereign crisis affected the solvency of banks (the so-called "doom loop"), damaging the transmission process through bank credit. This argument was used to justify quantitative easing (QE). Again, the direction of policy was consistent, benefiting MTM as well as inflation and output.

The way MTM is brought into the picture now differs from these precedents in two ways. First, the contractionary overall stance of policy does not help the MTM, because the yield spreads between peripheral and core countries tend to rise with the general level of interest rates, hence making the MTM asymmetric across countries. For this reason, the TPI is directed towards controlling the spreads, more explicitly than was the case in the earlier instances.

Given the limitations of its mandate, the ECB cannot aim to finance governments. Its argument must therefore be that its purchase of bonds of a single government (possibly sterilised by selling the bonds of another government) is necessary to preserve the MTM and thus its ability to pursue its statutory goal of price stability. The implicit favourable financing the TPI provides to certain individual governments (perhaps at the expense of others) must thus be presented as an *unintended* side effect of its attempt to preserve the MTM.

In 2012, the danger of fragmentation was clear and systemic. The link between a breakdown of the MTM and a breakup of the euro was self-evident. Today's situation is different, as documented above. Most factors of a potential systemic crisis (external disequilibria, banks having low capitalisation and high NPLs) are no longer present today (especially for Italy). It is harder to argue today that the MTM is jeopardised. It follows that the ECB will need to provide strong arguments and conclusive analyses of why TPI intervention is needed to preserve the effective working of the MTM.

2.1. The MTM away from the lower bound

The MTM is one of the most extensively studied subjects in empirical economics. Academic papers studying the timing and strength of the effects of monetary policy number in the hundreds, if not the thousands. Central banks and other policymaking institutions such as the European Commission and

⁴ See Trichet, J.-C. (2011a; 2011b).

⁵ See Draghi (2017).

the IMF have also contributed many papers. Most of this literature flourished in the period between 1971 and 2008, i.e. between the abandonment of the Bretton Woods fixed exchange-rate system (after which central banks gained a central role in controlling inflation and short-term output fluctuations) and the Great Financial Crisis (GFC).

The GFC marked the end of this literature or, to put it differently, a radical change of it. Most of the earlier literature had concluded that short-term interest rate changes were the best measure of monetary policy decision.

After the GFC, those rates were bound by the zero lower-bound virtually everywhere or, for central banks that practised negative rates, by a so-called “effective lower bound”. The MTM literature changed course, refocusing on measuring the transmission mechanism of QE. Views on the interpretation and reliability of this literature differ, for example Fabo et al. (2020) argue that some of this literature may be biased by conflicts of interest. But two things are certain: first, measures of the transmission process of QE were never as consensual and solid as the earlier measures of the MTM based on short-term interest rates; and second, now that interest rates are again rising above zero, the literature relating to the QE period can be disregarded and the earlier literature is becoming relevant again.

In the early 2000s, the ECB coordinated a major study among the researchers of the NCBs aimed at measuring the MTM in the newly created euro area (see Angeloni et al., 2003). The main results can be summarised as follows:

1. In all countries of the euro area, and in the area as a whole, monetary policy is best measured by a short-term interest rate, typically of three-month maturity money market rate. This rate is influenced both by the market and the actions of the central bank.
2. In all countries of the euro area, a key role in the transmission of monetary policy impulses is played by credit institutions; specifically, by their credit supply behaviour, which in turn is affected by short-term interest rates. Under the single monetary policy, transmission may vary across countries because the market-determined component of the short-term rate differs across different jurisdictions. This is where the euro area MTM may not function well, and the single monetary policy may be jeopardised.
3. To some extent, the MTM may differ also because of differences in national financial structures (e.g. the strength bank competition, institutional features of the mortgage market, the presence of cross-border banking and the breadth of the stock market; see Angeloni and Ehrmann, 2003) or sectoral compositions of GDP. These differences are inherent in the economic structure and the central bank cannot eliminate them, nor should it try to do so.

2.2. Some differences in the MTM are to be expected

One implication of the above-mentioned analyses is that not all MTM cross-country asymmetries should be eliminated. Only when there is clear evidence that they derive from other extraneous elements, which then affect the financing conditions of households and the corporate sector, does the central bank have reason to intervene to “protect” the MTM.

Second, the key metric to gauge the presence of those MTM distortions are the short-term interest rate differentials and their impact on lending rates.

Third, in assessing those differences, close attention should be paid to the state of the banking sector(s). Differences in the levels and changes in bank lending rates, asymmetric credit rationing effects and unjustified differences in collateral or covenant policies may all be signals that the smooth transmission of monetary policy is compromised.

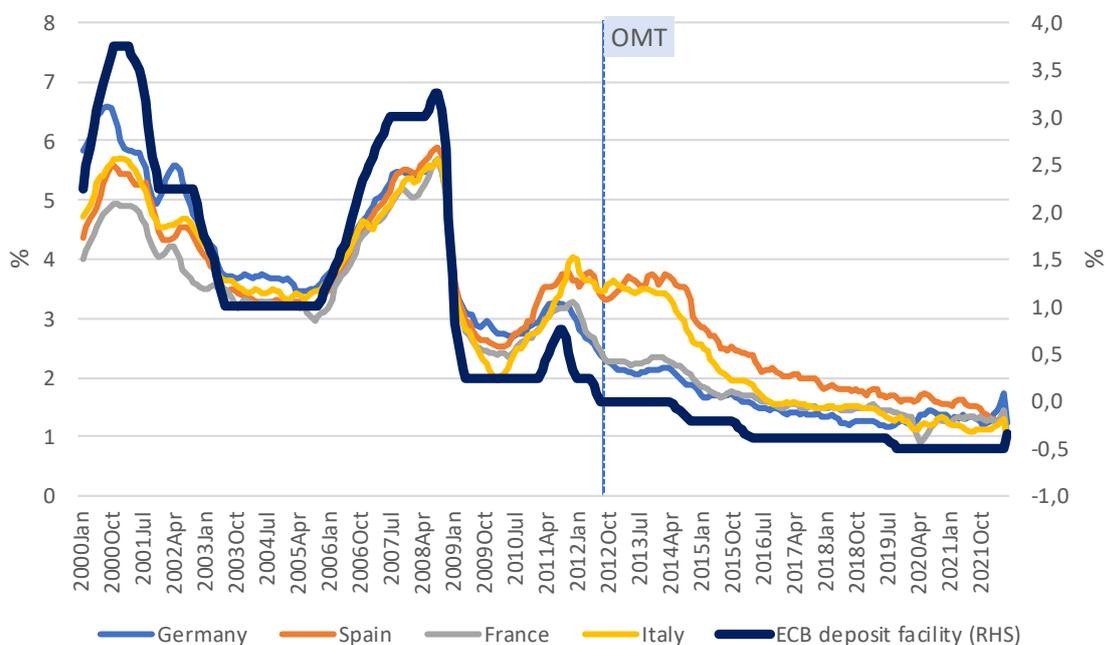
The proper administration of the TPI requires, in our view, that the ECB sets up a new MTM cross-border monitoring system covering all steps in transmission: from central bank policy actions to money markets, and from money markets to banking markets. The ECB’s quarterly Bank Lending Survey and the supervisory information housed in the central bank can both provide useful elements for such monitoring.

2.3. The MTM in action

Figure 1 below shows the key ECB policy rate, namely the deposit facility rate and the rate at which banks were lending to their corporate customers for the four largest euro area countries. It is apparent that until about the end of 2011 lending rates tended to track the policy rate of the ECB, as one would expect from a well-functioning MTM when interest rates are not constrained by the zero lower bound. However, starting around that date, lending rates in Italy and Spain remained higher, whereas those of France and Germany followed the downward movement of the policy rate. This illustrates the way in which the MTM was impacted by the crisis, and the problems the OMT was meant to address.

However, the figure also shows that the differences in lending rates between the core (Germany and France) and the periphery (Italy and Spain) remained high for some time, even after the announcement of the OMT (and after sovereign spreads had fallen). This is an indication that not all the differences in lending rates were due to the tensions in the sovereign debt markets. Banks are likely to charge higher rates when they perceive a higher risk, because the economy is in recession. The high rates charged to German corporations during the early 2000s were not considered a sign of malfunctioning of the MTM, but of a weak German economy. High sovereign spreads thus do not constitute a necessary or sufficient condition to warrant the conclusion that the MTM is impaired. Also, comparing the left- to the right-hand scale shows that lending rates were on average two percentage points higher than the ECB rate, as one would expect since banks have to be compensated for their risks and other costs.

Figure 1: Bank lending rates to non-financial corporations, new business



Source: Authors’ calculations based on ECB data.

3. THE MTM AND LONG- VERSUS SHORT-TERM RATES

The key role of short-term rates in the MTM suggests that a distinction should be made between long- and short-term rates. The hasty decision process on the TPI was entirely driven by concerns about long-term spreads, but the MTM argument calls, instead, for a predominant focus on short-term ones. The fact that spreads on the short-term rates central to the MTM have not moved at all during the last months has not been properly considered so far.

The motivation for the TPI offered by the ECB speaks only, en passant, of “comprehensive assessment of market and transmission indicators” During the July press conference, ECB President Lagarde mentioned fragmentation risks or “disorderly market dynamics” only in general⁶.

3.1. Flattening the risk curve as a key danger signal

A key warning signal in 2011-2012 was the fact that short-term rates had also increased in higher-risk countries. When asked what signal had convinced the ECB that strong intervention was needed, Draghi responded in August 2012:

“I would not point to one single episode but certainly one thing, if one really wants to, was the sudden increase in the shorter part of the yield curve for several countries in the euro area, which for people who know the markets is usually ominous”⁷.

Other ECB sources confirm that short-term rates provided the key signal for the need to intervene (e.g. Cœuré, 2013). In early 2012, the ECB still had the possibility to buy peripheral bonds under its SMP, which had been announced in May 2010, allowing the ECB to purchase unspecified amounts of peripheral bonds to “to ensure depth and liquidity in those market segments which are dysfunctional”.

The ECB did not specify the purchase amounts under the SMP; the argument was that “speculators” should be kept in the dark about its firepower. The amounts bought under the SMP were published only later, when the programme had ceased (several hundred billion Greece, Italy, Portugal and Spain [GIPS] bonds).

The SMP had obviously not been adequate to reduce market turbulences, which in fact surged in 2011 and 2012 so that at one point, Italy’s yield curve was almost completely flat. A flat yield curve (at a high risk premium) signals that investors fear an imminent debt restructuring, because in most restructurings the residual maturity does not matter as all bonds in default are treated as one mass. This is the reason why Draghi called a sudden increase in short-term rates “ominous”.

The OMT trigger was thus a pervasive fear that the euro area would break up, reflected in high risk premia on short-term rates. This is why the ECB wanted to signal a commitment to making sure the euro area would not break up, even if this might require unlimited intervention. ECB research by Altavilla et al. (2016) suggests that the OMT lowered short-term rates by about 200 bps for Italy and Spain in the shorter-term two-year segment, compared to just under half as much (80-100 bps) for the 10-year rate.

⁶ See Lagarde, C. (2022).

⁷ Draghi (2012) added, however, that the sudden increase in shorter term rates “was one sign, but I would not point only to that symptom, since there were other symptoms of market fragmentation which tend to worsen the situation”. He added that “[a]s to the second question on why we are focusing on the short end of the yield curve, the main reason is that this falls squarely within the range of classical monetary policy instruments. The shorter the spectrum, the closer it is to money market operations ... the first point is very important because we want to repair monetary policy transmission channels and we clearly see a risk, and I mean the convertibility premium in some interest rates”.

3.2. Long- versus short-term debt and the cost of public debt

It is often argued that government debt in the euro area is “fragile” because a buyer’s strike could drive any euro area government into default (De Grauwe and Ji, 2012), whereas this is not possible in countries with their own central bank. All of the contributions for the June 2022 meeting of the Monetary Dialogue provide examples of this point of view and the corollary that the ECB should be ready to protect countries against speculative attacks (European Parliament, 2022).

Speculative attacks can arise only if the government has to refinance large amounts of government debt. This implies that a government with very long-term debt should be relatively immune to speculative attacks. The higher the proportion of long-term debt, the lower the potential should be for self-fulfilling attacks (Calvo, 1999). Governments can thus reduce the risk of speculative attacks by issuing more long-term debt (Giavazzi and Pagano, 1989).

This remains true today. But the issue at hand is not what maturity structure would be best for a euro area country with high debt, but how to manage the problems of countries with a given maturity structure. Most large euro area countries have an average (weighted) maturity of their (bonded) public debt of around seven years.

Much of the attention of policymakers over the last months has been on the “spread”, which is the difference between the yield on a 10-year Italian government bond (BTP) and a 10-year German bond (Bund). At first sight this seems justified by the fact that the average maturity of Italian government debt is seven years. However, it takes a long time before the increase in the spread translates into higher interest costs for the Italian government. This is different for short-term rates. It takes over 10 years of high rates to translate into higher interest costs if the 10-year rate increases, which gives the government ample time to enact the reforms needed to regain the confidence of markets. An increase in the 10-year rate thus does not represent a “speculative attack”. This is different for shorter-term rates. For example, an increase in two-year rates requires just two years to be fully reflected in higher interest costs. For very short-term rates, e.g. three months, this goes even more quickly. Only an increase in short-term rates can thus qualify as a speculative attack (and short-term rates did not move over the last months – see below). Moreover, the government can avoid issuing long-term debt if the premium is too high, thus keeping interest service costs low even if the spread increases. As documented by Angeloni and Gros (2022), this could be observed in 2018/2019, when the formation of a government with eurosceptic members led to a sharp increase in the spread (up to 200-300 bps) but the interest cost for all new government debt remained very low (1.07%).

4. RECENT DEVELOPMENTS (JUNE/JULY 2022)

During the July press conference, ECB President Lagarde referred several times to the flexibility in reinvestment of the PEPP as one remaining anti-fragmentation instrument. It is thus useful to consider why the ECB added flexibility of purchases across issuers under the PEPP. The two reasons given were the need to keep inflation down and the need to safeguard the MTM:

“... purchases will be conducted in a flexible manner on the basis of market conditions and with a view to preventing a tightening of financing conditions that is inconsistent with countering the downward impact of the pandemic on the projected path of inflation. The flexibility of purchases over time, across asset classes and among jurisdictions will continue to support the smooth transmission of monetary policy”.

We first document market conditions during the last months (since the surprise ECB pivot towards a more hawkish policy, and then the ECB’s reaction in terms of the flexibility of PEPP reinvestment.

4.1. June 2022: false alarm?

The reason why an additional anti-fragmentation instrument suddenly appeared on the agenda was that Italy’s 10-year spread had widened to 220-250 bps in early June. This amount was lower than the levels observed during 2018, when the ECB did not react in any way, but this seemed to have no impact on the discussions. The spread fell after the 15 June meeting (which de facto constituted an announcement that a new anti-fragmentation instrument would be forthcoming), but then rose again until the 21 July meeting when the TPI was unveiled. Unfortunately, the Italian government fell the same day, making it impossible to disentangle the impact of the TPI announcement.

Table 1: The term-structure of risk spreads, Italy

	1 June 2022	13 June 2022	22 July 2022	22 August 2022
3 months	-0.05	0.06	0.05	-0.04
2 years	0.54	0.85	0.93	0.92
10 years	2.00	2.47	2.40	2.28

Source: authors’ compilation based on data from Investing.com.

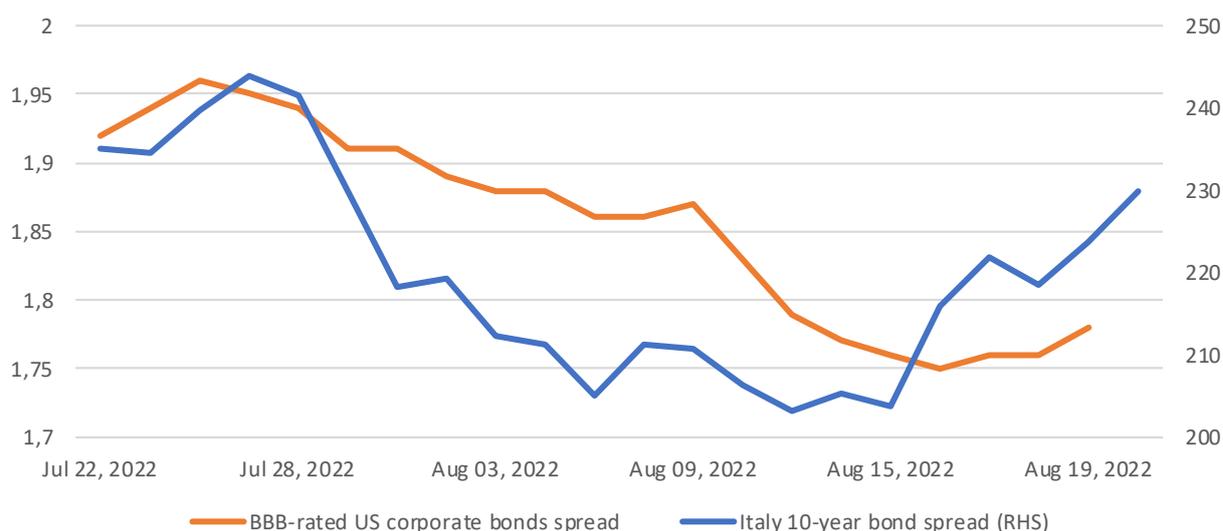
Table 1 shows Italian (versus German) yield spreads on government bonds of different maturities during this period. The spreads on Spanish and Portuguese bonds are highly correlated with those of Italy, but in general move much less than 1:1. The Spanish 10-year spread has hovered between 1.0 and 1.2 percentage points during the same period.

The first row shows that the spread on the three-month rate has remained extremely low (less than 10 bps), indicating the absence of any concerns about pending default or redenomination and suggesting that the MTM is not impaired. This was very different in 2012 as mentioned above.

The two-year bond yield spread between Italy and Germany has increased slightly but remains at only 40% of the 10-year yield spread. This implies that any pass-through from higher rates to higher borrowing costs would have taken a long time to materialise.

We note that the reassessment of financial markets over the first half of this year has led to an increase in risk premia for many risky assets, not only peripheral sovereign debt. As Figure 2 below shows, Italy’s spread has closely followed the spread of BBB-rated corporate bonds in the United States over US Treasuries. This comparison seems adequate since Italy is also rated BBB.

Figure 2: Spread on risky assets versus Italy's 10-year bond spread (vs Germany)



Source: authors' calculations based on data from Investing.com, FRED.

This tight correlation suggests that the widening of peripheral spreads might be less of a consequence of ECB action and more of heightened risk aversion at the global level.

4.2. Extreme flexibility in PEPP reinvestment June/July 2022

In June and July 2022, the Eurosystem holdings under the PEPP of core government bonds (Germany, Netherlands and France) declined by a total of almost EUR 19 billion, whereas those of peripheral governments increased by a similar amount. During this two-month period, the net purchases of Italian and Spanish securities amounted to over 3% of the previous total. The deviation from the previous pattern was unprecedented. The purchases made by these two countries increased their shares over two months by an amount equivalent to about three to seven times the variations in average purchases (over March 2020 to May 2022). Taking into account the previous two-month period (April to May), when net purchases had already fallen to zero, would not change this conclusion materially.

Table 2: June/July PEPP 2022 reinvestments: extreme flexibility

	Net purchases June/July under PEPP as % of initial holdings	Changes compared to variance of purchases March 2020 – May 2022
NL	-4.1	-2.7
DE	-3.6	-7.3
FR	-0.4	-0.2
IT	3.4	3.3
ES	3.0	6.8
EL	2.7	4.0

Source: Authors' calculations based on ECB data.

It is difficult to reconcile this extreme imbalance in reinvestment with the official justification given above. The first motivation, keeping inflation down, is no longer applicable. There is also no indication

that the increase in 10-year spreads in June/July has threatened the MTM in any country. The ECB should provide the reason why it saw it necessary to concentrate reinvestments to such an extreme on Spain and Italy.

We also note that the fact that in June/July of this year holdings of core government bonds under the PEPP decreased by about EUR 19 billion means that under the PEPP, large amounts of rather short-dated bonds were bought. Since the PEPP started only in March 2020, any redemptions this year can only be due to bonds with a remaining maturity of about 2 to 2.5 years. It is difficult to understand why the ECB thought it necessary to buy considerable amounts of such relatively short-dated bonds of core governments. Bond purchases by central banks are supposed to work by compressing long-term premia.

5. CONCLUSION

Our analysis suggests that if the TPI is really about protecting the MTM, it should refocus from long-term spreads to short-term rates. This has at least five aspects:

- Away from the zero lower bound, the MTM works via short-term rates.
- Spreads on long-term securities carry little information on the state of the MTM; they are much more affected by political developments and concerns about long-term debt sustainability.
- Concerns about the doom loop between banks and sovereigns are now reduced because the safety and soundness of banks have improved.
- Purchasing long-term securities (up to 10 years is foreseen) would not be effective, and risks leading the ECB away from its core field, namely monetary policy.
- When fixing the details of the TPI, the ECB should follow the arguments emphasised by Draghi when he introduced the OMT in 2012: *“As to the second question on why we are focusing on the short end of the yield curve, the main reason is that this falls squarely within the range of classical monetary policy instruments. The shorter the spectrum, the closer it is to money market operations”*.

Given the purported aim of the TPI, the ECB should create a Transmission Observatory to detect threats and to document the need for intervention when needed. So far, the ECB has only stated that a decision to “activate the TPI will be based on a comprehensive assessment of market and transmission indicators”. It should explain which indicators it will use and pay due regard to the conditions of bank credit markets. Its quarterly Bank Lending Survey and the wealth of supervisory information at its disposal should be used systematically. A mere observation that long-term interest rates on government securities diverge would not be enough evidence of the need to use the TPI.

A corollary of this analysis is that the concern about the widening of long-term spreads for Italy in June was overblown, and the extreme concentration of PEPP reinvestments on Italy and Spain was not justified by any danger to the MTM. Moreover, going forward, it seems increasingly difficult to justify enhanced use of the flexibility of PEPP reinvestments with reference to the pandemic.

REFERENCES

- Altavilla, C., Giannone, D. and Lenza, M. (2016). "The Financial and Macroeconomic Effects of the OMT Announcements", *International Journal of Central Banking*, Vol. 12, No 3, pp. 29-57, September, <http://www.ijcb.org/journal/ijcb16q3a1.pdf>
- Angeloni, I. and Ehrmann, M. (2003). "Monetary policy transmission in the euro area: any changes after EMU?", ECB Working Paper series 240.
- Angeloni, I. and Gros, D. (2022). "How can the ECB deal with the risk of fragmentation?", CEPS Policy Insights, July, <https://www.ceps.eu/ceps-publications/how-can-the-ecb-deal-with-fragmentation-risk/>
- Angeloni, I., Kashyap, A. and Mojon, B. (2003). "Monetary Policy Transmission in the Euro Area", Cambridge University Press.
- Calvo, S. (1999). "Reducing vulnerability to speculative attacks", PREM Notes, No 16, World Bank, Washington DC, <https://openknowledge.worldbank.org/handle/10986/11497>
- Cœuré, B. (2013). "Outright Monetary Transactions, one year on", speech at the conference "The ECB and its OMT programme", organised by Centre for Economic Policy Research, German Institute for Economic Research and KfW Bankengruppe Berlin, 2 September. <https://www.ecb.europa.eu/press/key/date/2013/html/sp130902.en.html>
- De Carpentier, J. R. (2022). "Single Resolution Fund on track for €80 billion by end 2023", The SRB blog, 2 May. <https://www.srb.europa.eu/en/content/single-resolution-fund-track-eu80-billion-end-2023>
- De Grauwe, P. and Ji, Y. (2012). "Mispricing of Sovereign Risk and Multiple Equilibria in the Eurozone", CEPS Policy Brief, January, <https://www.ceps.eu/ceps-publications/mispricing-sovereign-risk-and-multiple-equilibria-eurozone/>
- Draghi, M. (2012). Introductory statement to the press conference (with Q&A), 2 August. <https://www.ecb.europa.eu/press/pressconf/2012/html/is120802.en.html>
- Draghi, M. (2017). "The interdependence of research and policymaking", speech at the Lindau Nobel Laureate Meeting, Lindau, 23 August. <https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp170823.en.html>
- European Parliament (2022). "10 years after 'whatever it takes': fragmentation risk in the current context", Compilation of papers, publication for the Committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg. [https://www.europarl.europa.eu/RegData/etudes/STUD/2022/703367/IPOL_STU\(2022\)703367_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2022/703367/IPOL_STU(2022)703367_EN.pdf)
- Fabo, B., Jančoková, M., Kempf, E. and Pástor, L. (2020). *Fifty Shades of QE: Comparing Findings of Central Bankers and Academics*, NBER Working Paper No 27849, September, <https://www.nber.org/papers/w27849>
- Giavazzi, F. and Pagano, M. (1989). "Confidence Crises and Public Debt Management", NBER Working Paper No 2926, April, <https://www.nber.org/papers/w2926>
- Greene, M. (2022). "Crisis looms if the ECB's new tool comes up short", Financial Times, 28 June 2022. <https://www.ft.com/content/bb7634bf-f449-4850-a043-9dde6d7fe926>
- Lagarde, C. (2022). Monetary policy statement, 21 July, press conference. <https://www.ecb.europa.eu/press/pressconf/2012/html/is120802.en.html>

- Trichet, J.-C. (2011a). "The ECB's response to the crisis", speech at the WDR Europa-Forum, Berlin, 26 May. <https://www.ecb.europa.eu/press/key/date/2011/html/sp110526.en.html>
- Trichet, J.-C. (2011b). "The monetary policy of the ECB during the financial crisis", speech, Montreal, 6 June. https://www.ecb.europa.eu/press/key/date/2011/html/sp110606_1.en.html
- Weisbrot, M. and Montecino, J.A. (2012). "More Pain, No Gain for Greece: Is the Euro Worth the Costs of Pro? Cyclical Fiscal Policy and Internal Devaluation?", CEPR Report, <https://cepr.net/report/more-pain-no-gain-for-greece/>

The European Central Bank has announced a new facility, the Transmission Protection Instrument (TPI), to safeguard the monetary policy transmission mechanism (MTM). The euro area is more robust and resilient today than in past euro crises. The TPI should therefore focus on short-term instruments in which threats for the MTM may reside. The recent increase in Italian long-term spreads did not signal such threat. The ECB should create a Transmission Observatory, with data and analyses on the pass-through from the money market to bank credit conditions, to detect possible threats to the MTM and document the possible need for intervention.

This paper was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the Committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 26 September 2022.
