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The ECB’s options in dealing with France’s fiscal woes

The bar for activating the ECB's bond-buying programme remains high. However, a further deterioration in France's situation could eventually force the ECB to demonstrate whether its 'whatever it takes' commitment still holds



ECB President Christine Lagarde

The ECB’s most powerful tools are the ones it has never used. They are the tools that the ECB developed after Mario Draghi’s ‘whatever it takes’ speech. Tools that showed ‘whatever it takes’ was something markets could believe in. The Outright Monetary Transactions programme during the euro crisis and the Transmission Protection Instrument (TPI) after the pandemic both shared the same objective: to enable potentially unlimited purchases of government bonds if needed.

Political and fiscal woes in France and the widening of the French spread have now raised the question of whether the ECB could intervene through TPI, which allows it to purchase securities issued by member states whose financing conditions have deteriorated for reasons not justified by country-specific fundamentals. However, before activating it, the Governing Council considers a cumulative set of criteria to determine whether the countries concerned are pursuing sound and sustainable fiscal and macroeconomic policies. In practice, this includes

compliance with the EU fiscal framework, which would, at a minimum, require the proposed French budget to be fully adopted.

The ECB has nevertheless left itself some discretion, stating that the intervention criteria “will be dynamically adjusted to the unfolding risks and conditions to be addressed”. This brings back memories of the famous “because it’s France” by former European Commission President Jean-Claude Juncker. Generally speaking, the ECB will be in a difficult position: intervening too quickly in support of France may be viewed unfavourably by other member states and interpreted as monetary financing of the debt of a country unwilling to follow the rules. That argues strongly against early intervention. Also, don’t forget that the leadership changes at the ECB over the next months (Schnabel, Lane, Lagarde) could also affect how the ECB views TPI.

Given the challenges of justifying the activation of TPI at present, we expect the ECB to adopt a three-pronged approach to address the French crisis.

The first line of defence is a more dovish approach to policy rates. As bond markets are currently taking over the ECB’s job of inserting a more restrictive monetary stance on the economy, there is less need for the ECB to hike rates aggressively, or to hike rates at all. In fact, the ECB has already started to prepare this option, as ECB president Christine Lagarde recently noted that “while growth has been resilient, since our last meeting long-term interest rates have risen notably, which will slow growth and reduce pass-through by more than projected in our September exercise".

The second line of defence would be a covert return to bond purchases. The ECB could instead pause quantitative tightening temporarily and reinvest maturing bonds in its portfolio “flexibly”, sending a positive signal to bond markets. This had already happened during the Covid period.

Last but not least, and in our view, the ultimate option in the case of more contagion in eurozone bond markets, the ECB would eventually trigger TPI. As long as France remains non-compliant with the European fiscal rules, the ECB might even consider purchasing bonds from almost all eurozone countries, except for France.

All in all, the current French situation is simply not enough for the ECB to trigger TPI. There are other ways to tackle any unwarranted impact from higher bond yields on the broader eurozone economy. However, a further escalation could eventually force the ECB to prove whether its 'whatever it takes' commitment still holds.

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