The Investment Institute
by UniCredit

Coffee Break

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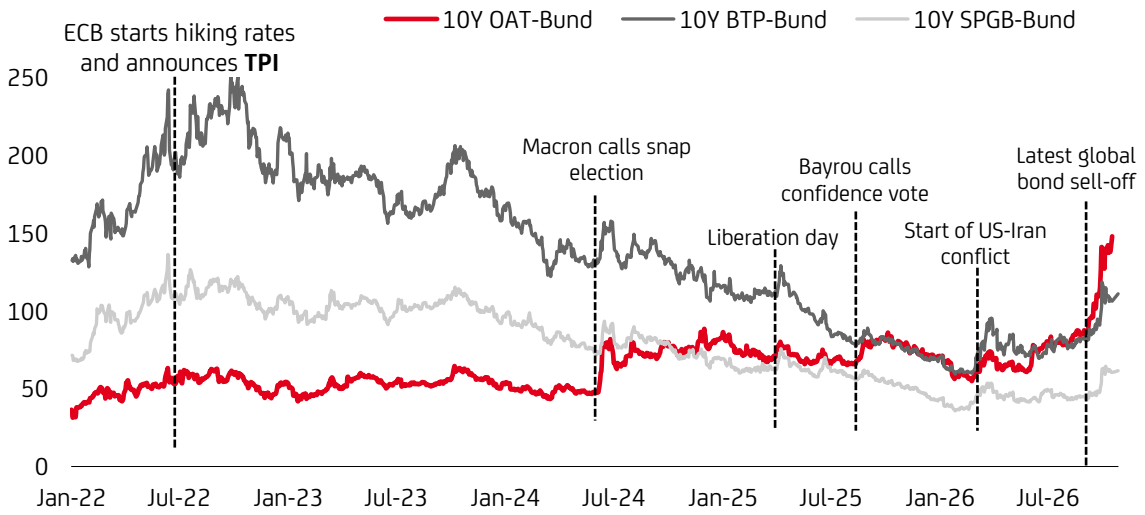
What are the ECB's options if sovereign tensions intensify?

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The current widening of sovereign spreads warrants careful monitoring but remains far from levels that prompted ECB concerns in the past. We look at what could trigger ECB action and what tools could be deployed.

PRESSURE ON FRENCH SOVEREIGN DEBT BUILDS

BASIS POINTS



Source: Bloomberg, The Investment Institute by UniCredit

THE CONTEXT

The recent strong increase in EGB yields and a widening in sovereign spreads has raised questions about a possible ECB response. To understand if, and how, such response might materialise, we deem it important to provide a framework of how we think the ECB assesses current market conditions, what could potentially trigger action, and what tools might be deployed.

As a general remark, the ECB cannot prevent a repricing of credit risk that is fundamentally justified. In the current environment characterised by a global rising trend in yields and reduced appetite for carry trades, it is normal to see

spreads widening in countries with weaker credit metrics. Therefore, this is not something the ECB should fight. Nor, of course, should the ECB counter spread widening triggered by persistently unsustainable fiscal policy. However, the ECB can and should act against sovereign market tensions if they become disorderly and not fundamentally warranted, thereby threatening the transmission mechanism of monetary policy.

The ECB has two tools at its disposal to counter unwarranted and disorderly moves in EGB markets: Outright Monetary Transactions (OMT, announced in September 2012) and the Transmission Protection Instrument (TPI, announced in July 2022). Both programs require conditionality, and neither has ever been implemented.

Activating **OMT** requires that the beneficiary country is under a European Stability Mechanism (ESM) program; such harsh conditionality makes this instrument unsuited to the current context. Therefore, at this juncture, the relevant instrument for the ECB would be the TPI. Under the **TPI**, the ECB could carry out potentially unlimited purchases of govies of jurisdictions experiencing unwarranted deterioration in financing conditions and disruption to the transmission mechanism of monetary policy. A key aspect of the TPI is the large degree of discretion granted to the ECB's Governing Council (GC), which will "consider" various criteria, conduct a "comprehensive assessment" of market conditions and judge whether intervention is proportionate. Eligibility criteria are not restrictive; a budget deficit above 3% of GDP and excessive macroeconomic imbalances are not impediments to a deployment of the TPI as long as the country beneficiary of ECB purchases undertakes credible corrective action in line with EC recommendations, and its public debt is deemed to be sustainable. It is not a member state that requests TPI support. The decision on whether to act, when to act, and how aggressively to act rests entirely with the ECB's GC.



THE DATA

Current market developments warrant careful monitoring, but they remain far from levels that prompted ECB concerns in the past. When the TPI was launched, the 10Y BTP-Bund spread fluctuated around 200-250bp, well above the current level of OAT and BTP spreads to Bund. That said, there is no predefined spread level that automatically triggers ECB intervention. Along with the fulfilment of eligibility criteria, the GC will assess a broad set of financial indicators.

The level of spreads matters, but so does the absolute level of sovereign yields relative to nominal GDP growth, the speed of market moves and the shape of the yield curve. From the perspective of a central bank that wants to preserve the singleness of its monetary policy, a quick build-up of sovereign tensions that extend to the short end of the curve should be deemed as particularly dangerous. The GC would also closely monitor spillover to other asset classes, including equities and corporate credit, as well as signs of contagion across jurisdictions. Ultimately, the ECB will have to assess whether market dynamics risk becoming self-fulfilling and spiralling out of control. In such circumstances, the central bank is likely to consider intervention as a circuit breaker.



OUR VIEW

What does all this mean for the future? If sovereign tensions intensify, the ECB has at least two lines of defence. The first is **communication**. Faced with a resurgence of sovereign stress, ECB policymakers would argue that higher sovereign yields and rising risk aversion are adding to the tightening of financial conditions, thereby reducing the need for additional rate increases. If this is not enough and stress mounts, the ECB would need to become more vocal and explicitly **put TPI activation on the table**, hoping that this would discourage speculative positioning and stabilise markets. Indeed, and similarly to the OMT, a key purpose of the TPI is deterrence rather than actual use.

Only if these measures fail would the ECB likely proceed towards active purchases. Should the TPI ultimately be deployed, we would expect intervention to be large and front-loaded. The objective would be to restore orderly market functioning quickly. In this sense, the ECB's approach could resemble the emergency gilt purchases conducted by the BoE in 2022.

In our view, a slowdown in quantitative tightening (QT) would not prove effective at calming sovereign stress. The ECB has consistently argued that, in a world where risks to price stability are no longer predominantly to the downside, the large QE-related bond portfolio should gradually decline to zero. Reversing or suspending this strategy in response to sovereign tensions at a time of heightened inflation risk would appear inconsistent with previous guidance, signalling ECB reluctance to deploy the TPI. This would pose a major issue. The ECB and financial markets would be better off if the central bank preserves the credibility of the TPI as a targeted anti-fragmentation tool instead of altering balance-sheet normalisation that has long been presented as operating largely on autopilot.

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