GENERALI INSURANCE ASSET MANAGEMENT

Focal Point

The ECB's anti-fragmentation tool: just a paper tiger?

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Our Focal Point series explores topical issues on macro, markets, and investment

- Recently the ECB presented its tool to prevent fragmentation in financing conditions. Under the Transmission Protection Instrument (TPI) it can potentially buy unlimitedly sovereign (and eventually private) 1Y to 10Y debt with pari passu treatment.
- Eligibility formally requires compliance with the EU fiscal framework, no severe macroeconomic imbalances, fiscal sustainability and sticking to EC recommendations. Presently Italy, Cyprus, Greece do not fulfil these criteria. However, the final decision is fully in the hands of the Governing Council (GC) so that these criteria are only one input for the final decision.
- We think that the GC remained vague and indefinite to protect itself against lawsuits. Also, it was not revealed which indicators will be used to detect fragmentation. Uncertainty surrounding the TPI remains huge.
- Markets will in the end need to test whether the TPI is more than a paper tiger.

It is again testing time for the ECB. The sudden swing from low inflation at the outset of 2021 to unprecedentedly strong price dynamics - 8.9% yoy in July - has put the ECB under pressure to act. It terminated the Pandemic Emergency Purchase Program (PEPP) in April, the Asset Purchase Program (APP) in July and also lifted its key rates by 50 bps at the July meeting. And it made perfectly clear that further rate hikes are ahead.

The flipside of this policy turn is that finance ministers will be confronted with higher yields. Markets have started to scrutinize the sustainability of public finances again, putting especially the high indebted Southern European countries into the focus. Augmented by political woes markets took a negative stance on Italy pushing the 10-year BTP-Bund spread above 200 bps in June. After President Lagarde played down the issue at the June 9 meeting this spread came close to 250 bps prompting the ECB to an ad hoc meeting and the announcement of a new anti-fragmentation tool just about one week later and its presentation at the July meeting.

In the past an extremely accommodative monetary policy (incl. bond purchases) greatly reduced fragmentation risk. But, with policy normalisation ahead it might gain prominence. The new mechanism hence is meant to complement the ECB's policy toolbox. But will it be effective? There remains ample uncertainty about key details.

The new anti-fragmentation mechanism

The new anti-fragmentation mechanism is a two-step procedure. The "***first line of defence*" will be PEPP reinvestment flexibility**. Stocks of PEPP purchases amount to € 2744 bn currently and the GC pledged to leave it unchanged until at least year-end 2024. Until then PEPP reinvestments will enable the ECB to buy bonds at close to € 20 bn per month. However, this may not be enough in times of serious stress. When the ECB launched the PEPP in early 2020 it bought by more than € 100 bn per month and most of it was obviously used to fight fragmentation. Indeed, data for June/July imply that this first line of defense was already activated.

The **second stage will be the activation of the newly created Transmission Protection Instrument** (TPI). It has potentially unlimited resources for asset purchases to be made in the 1Y to 10Y segment. That said, the details available (see box below) so far are vague about key issues like the triggers and the importance of the eligibility criteria. What exactly is meant by fragmentation? And will the GC judge in any case that the Outright Monetary Transactions (OMT) Program should be used in the case the eligibility criteria are not met?

Box: Key features of the TPI

- **Trigger**: deterioration in financing conditions not warranted by country-specific fundamentals
- **Volume**: potentially unlimited purchases depending on the severity of risks
- **Purchases**: public sector securities in the 1Y to 10Y segment, private sector securities could also be considered
- **Eligibility**: criteria the GC considers are 1) compliance with EU fiscal framework, 2) absence of severe macroeconomic imbalances, 3) fiscal sustainability, 4) sound and sustainable macroeconomic policies
- **Activation**: *"a comprehensive assessment of market and transmission indicators, an evaluation of the eligibility criteria and a judgement that the activation of purchases under the TPI is proportionate to the achievement of the ECB's primary objective*."
- **Termination**: *"a durable improvement in transmission, or based on an assessment that persistent tensions are due to country fundamentals."*
- **Creditor treatment:** same (pari passu) treatment as private or other creditors.
- **Monetary policy stance:** no persistent impact on the overall Eurosystem balance sheet

What is fragmentation?

The ECB officially defines fragmentation as "***unwarranted, disorderly market dynamics*** *that pose a* ***serious threat to the transmission of monetary policy*** *across the euro area*". In a recent speech GC member Schnabel pointed out that differences in government bond yields leading to **heterogenous financing conditions** were a feature of EMU complicating monetary policy but that eliminating them "*lies firmly in the hands of governments*". From a monetary policy perspective there is need to act when "…*fragmentation reflects a sudden break in the relationship between sovereign yields and fundamentals, giving rise to non-linear and destabilising dynamics.*" Key reasons provided are:

- Factors related to market liquidity or speculative market behaviour in the form of **self-fulfilling market dynamics**.
- Markets find it difficult to price risk – because uncertainty is so high that **risk premia become indeterminate**.
- In the euro area as a currency union with sovereign states the **redenomination risk** and **financial contagion** potentially leading to a systemic shock are also to be considered.

Fragmentation and financing conditions are linked

To get an idea about how much fragmentation hinders the working of monetary policy we find it useful to take a closer look at the above-mentioned **financing conditions**. Chief Economist Lane and President Lagarde specified financing conditions as a combination of upstream (risk-free yield curve, sovereign yield curve) and downstream (loan supply, credit standards, bank lending rates, credit demand, corporate yields) factors. Based on these indicators we built a financing conditions dashboard derived summarized these indicators in the table below.

The ECB's Financing Conditions Dashboard

z-scores of respective variables with values > 0 indicating better than average financial conditions, < 0 the reverse; own calculations, latest data on lending rate estimated, BLS data monthly interpolated

	2021	Q1 2022	Q2 2022	May-22	Jun-22	Jul-22
Gov. bond spread (GDP weighted)	1.45	0.22	-1.26	-1.01	-2.62	-1.66
Term premium (10Y-1Y OIS)	1.01	0.14	-0.46	-0.46	-0.46	-0.46
BLS credit standards	-0.52	-0.01	-0.66	-0.91	-0.59	-0.26
BLS credit demand	-0.30	0.01	-0.45	-0.42	-0.62	-0.82
High Yield spread	1.02	0.13	-0.90	-1.06	-1.45	-2.56
Lending rate	1.39	0.20	0.21	0.11	0.11	0.11
unweighted mean	**0.67**	**0.12**	**-0.59**	**-0.63**	**-0.94**	**-0.94**
~ ex Lending rate	0.53	0.10	-0.75	-0.77	-1.15	-1.15

last update: 26/07/2022, lending rate: June/July assumed constant at May level

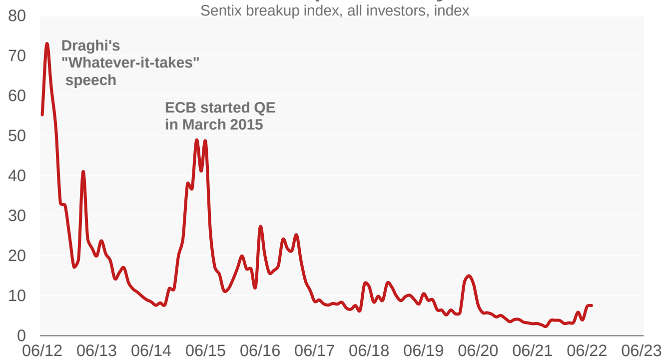
Source: Datastream, GIAM calculations

It is obvious that a government bond spread widening leads to a deterioration of euro area's aggregate financing conditions and so do higher High Yield spreads. However, for a single economy financing conditions might be considerably worse. The reason is the still huge importance of national sovereign bond holdings for the respective banks and the fact that consumers and firms to large degree still rely on their respective national financial intermediaries. In the end lending rates and bank lending standards will also be impacted by fragmentation. However, the **cornerstone remains the sovereign bond spread**.

Current fragmentation unrelated to redenomination risk

The most outstanding period of fragmentation in EMU's history was clearly 2012. Following sharply widening peripheral government bond spreads markets started questioning the existence of EMU. In contrast, the **current fragmentation concerns are obviously not related to the redenomination risk**. For instance, the Sentix breakup index (chart below) remained at low levels and increased not much. Unlike to the past there are now better tools available to tackle systemic risk. Following the 2012 woes and Draghi's famous "Whatever-it-takes" pledge, the Securities Market Program (SMP) which was later substituted by the OMT was invented. And in December 2014 the ECB announced QE which started in March 2015.

Euro breakup fears stay low
Sentix breakup index, all investors, index



Source: Datastream

The intra-EMU sovereign spreads increased sharply over the course of 2022 suggesting that **no EMU-wide concerns but rather idiosyncratic factors are at work**.

Bond spread rise indicates fragmentation
GDP weighted 10Y government bond yield of EMU economies minus 10Y OIS yield, pp, monthly average

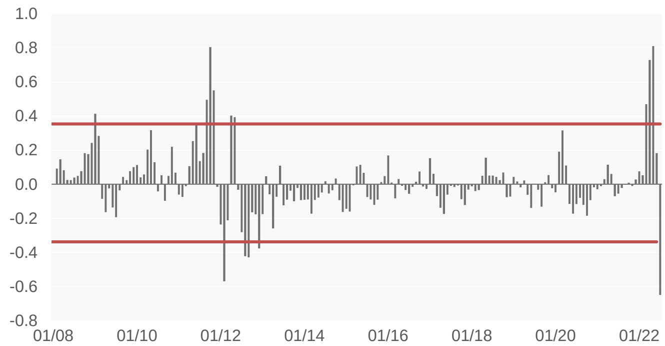
Source: Datastream, GIAM calculations

The nearing end of QE and the start of the rate hike cycle put debt sustainability concerns into the focus again and brought peripheral debt under pressure. In June, sovereign bond spreads widened to the highest level since the start of 2013 as the Italian Prime Minister Draghi was finally ousted and snap elections for September 25 announced (see graph above).

What is the ECB's threshold of alertness?

The genesis of the TPI as well as ECB communication suggest that the **fragmentation momentum is far more important than its level**. Indeed, the GC's focus and willingness to actively tackle fragmentation occurred in an environment of quickly widening government bond spreads. For three consecutive months (April to June), the widening of this spread (the 2-month change of the weighted EMU monthly average yield) was above the 2-standard deviations threshold. This situation occurred before only during the euro crisis in 2011/12. That said, more ingredients will likely be needed. The ECB embarked on a tightening trajectory so that it could not expect any relief from its interest rate policy later. And while President Lagarde still played down the issue at the June 9 meeting, the widening of the 10-year BTP-Bund spread by 20 bps to 248 bps just five days after probably was also of importance. But consecutive and significant (beyond the 2-standard deviation range) increases of the government bond spreads obviously are a necessary condition for thinking about activation of the TPI.

Strong fragmentation momentum
change in GDP weighted EMU 10Y-10Y OIS yield, 2-month change of monthly average, bps, and 2-sigma bands



Source: Datastream, GIAM calculations

In the end it will be a very case-specific decision as President Lagarde point out that "*to assess whether you have unwarranted, disorderly market dynamics, the **Governing Council will take into account multiple indicators** to determine the warranted versus unwarranted, and to determine the orderly versus disorderly, and multiple indicators have been discussed and will be taken into account by the Governing Council.*"

Not all countries fulfil eligibility criteria

To assess the eligibility of a country for the TPI, compliance with the standards of sound fiscal and macroeconomic policy set on the European level is the starting point. As it stands now, the only obstacle for being supported by the TPI in case of need arises from the existence of **severe**

macroeconomic imbalances in the case of Cyprus, Greece, and Italy (see table below).

Looking ahead, the European Commission postponed the enforcement of the fiscal rules under Stability and Growth Pact (SGP) by another year to 2024. Nevertheless, the EC will reassess Member States' budgetary situation in the autumn of 2022. In spring 2023, it will assess the relevance of proposing to open excessive deficit procedures based on the compliance with the fiscal country-specific recommendations. They concentrate on reducing the dependency on fossil fuels through reforms and investments, in line with the REPowerEU priorities and the European Green Deal. A risk, however, in our view could be the case that some member states do not manage to comply with their commitments made under Recovery and Resilience Facility (RRF) due to internal political struggle or poor performing public administration.

The TPI eligibility criteria

Criterion	*Definition*	*Assessment*
Compliance with EU fiscal framework	not being subject to an EDP or not complying with the deficit reduction targets made by the EU Council	all (SGP suspended until 2023)
Absence of severe macroeconomic imbalances	not being subject to an excessive imbalance procedure (EIP) or not being assessed as having failed to take the recommended corrective action related to	Cyprus, Greece, Italy
Fiscal sustainability	debt sustainability analyses by the EC, the ESM, the IMF, other institution and the ECB's internal analysis	according to the latest EC Fiscal Debt Sustainability report debt is not unsustainable in any EMU country
Sound and sustainable macroeconomic policies	complying with the commitments submitted for the RRF and with the EC's CSRs in the fiscal sphere under the European Semester	no non-compliance so far

source: EU,ECB, GIAM

In the end it's up the GC's discretion

That said, the eligibility criteria are only one important ingredient for the GC's decision making. Another one is whether the "***TPI is proportionate to the achievement of the ECB's primary objective***". In the Q&A of the July press conference President Lagarde added that *"… those of you who are familiar with the legal requirements and with the concept of proportionality will have understood what I mean by that…"*. We conjecture that she referred to the clash with the German Constitutional Court about the Public Sector Purchase Program (PSPP) that back in 2020 judged it as partly unlawful. A criticism was the lack of proportionality assessment. The German government and the parliament were obliged to ask the ECB for a proportionality assessment of the PSPP within three months. By explicitly referring to a proportionality assessment the ECB will have it easier to defend the TPI in future lawsuits. In the end the **proportionality assessment gives the ECB potential leeway for any decision**, a point also emphasized by Lagarde when stating – "*the Governing Council decides in sovereignty in respect to eligibility to the TPI*."

Seen from this angle the eligibility criteria may not always prevent the activation of the TPI. The GC will always carefully weigh pros and cons. In case of acute breakup fears resurging, we would not be surprised if the TPI was activated regardless of the full compliance to eligibility criteria. We could imagine that it could also be applied in a bridging period until the OMT becomes available.

Markets will need to test the TIP to learn more

In the end **there remains a huge degree of uncertainty surrounding the TPI**. This is intended. As Lagarde stated, "*There are certain components that are best kept unpublished, undisclosed, uncommented upon, and I am sure that you understand*." The ECB does not want to become hostage to the market by for instance publishing a more detailed set of fragmentation indicators the GC looks at. Markets now have a good idea about the purpose, the working and factors discussed before being activated. The mere existence of the TPI may already be priced by markets. But in the end **only times of stress will show how credible it is and under which real conditions it will be activated**.

When will markets test the ECB? The mere existence of the anti-fragmentation mechanism should increase the willingness of the GC to move ahead with rate hikes. That said, we expect the euro area to enter recessionary territory and Germany – the largest economy – to significantly underperform its peers. This could in the end slow the ECB's policy normalisation path. But with inflation still sky-rocketing the hurdle for doing so appears high. Therefore and given elevated uncertainty amid various political risks the **TPI's test on whether it is more than a paper tiger could come rather sooner than later**.

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