CEPS COMMENTARY

Thinking ahead for Europe

A silver bullet for the ECB

The European Quantitative Easing Intermediated Programme (EQUIP)

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The ECB's dilemma

The European Central Bank has recently acknowledged the dangers attendant a prolonged period of excessively low inflation in the euro area. ECB board members are adamant that the dangers of low inflation will adversely affect the overall stability of the euro area. Lower-than-expected inflation rates "would increase the real value of debt, slowing down the deleveraging process of borrowers, both public and private. The increase of the debt overhang burden would also be detrimental to debt sustainability and to growth."[1]

Against this backdrop of a persistently weak inflation outlook, a slowing growth momentum, and subdued monetary and credit dynamics, the ECB decided to implement a package of measures between June and October to provide further monetary policy accommodation and to support lending to the real economy. However, doubts have grown about the efficacy of conventional monetary policy instruments (LTROs, VLTROs and TLTROs), which rely on demand for credit by the banks and the real economy, in the face of continuously sluggish money and credit dynamics.

Given the weakness of conventional measures, the size of the Eurosystem balance sheet has attracted the attention of ECB observers. In order to expand its balance, the ECB decided that the liquidity injections through the TLTROs need to be accompanied and reinforced by the ABS (asset-backed securities) and covered bond purchases. The purchase of covered bonds has already started. However the capital market segments targeted by the ECB purchases are not as deep and liquid as their equivalents in other leading economies. In this context, it is possible that the ECB finds it necessary to expand its purchases to the wide market of euro-area public securities, resorting to sovereign quantitative easing (QE), i.e. large-scale central bank purchases of government debt.

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[1] Speech by Vítor Constâncio, Vice-President of the ECB, at the 18th Annual Central Bank and Investment Authority Seminar organised by Commerzbank, Berlin, 16 October 2014 (www.ecb.europa.eu/press/key/date/2014/html/sp141016.en.html).

The EQUIP proposal

Our proposal is intended as a contribution to the current analysis of sovereign QE that the ECB has already initiated through its internal working groups. We see a specific opportunity in sovereign QE that could provide for a game-changer in the course of the European crisis.

The eurozone has the peculiarity of not being able to rely on the existence of a single liquid and public security representing the whole area. On the contrary, the euro area is characterised by the existence of different public securities representing each single member state. Against this backdrop, it is likely that the ECB will decide to purchase public securities of all countries in distinct quantities approximately replicating a pre-fixed key as close as possible to the ECB capital key representing each state's contribution to the ECB capital.

The ECB intervention would be less distortive and more effective if it could leverage on the existence of a liquid market for a public security representing the eurozone as a whole, based on the securitisation of the different underlying national public securities. It would consist of an asset-backed security (ABS) of the existing euro-area public securities composed according to the pre-defined key. The creation of such a security would be a private initiative of financial intermediaries, under the condition that the ABS respects the pre-defined qualifications provided for by the ECB. The ECB itself could announce that it would consider such a security - mirroring the key of its sovereign bonds purchases in a fixed proportion that should be clearly announced at the beginning of the programme and would de facto create a basket of sovereign bonds – eligible in its purchase programmes both in the context of QE and outside of it, supporting a European quantitative-easing intermediated programme, or EQUIP.

The new asset-backed security would not only be an attractive innovation for the ECB, but it would greatly benefit private investors, both European and non-Europeans, who are longing for a European liquid and safe asset. Market makers engaged in the EQUIP would provide liquidity for an important segment of financial markets, also reducing the transaction costs for the basket of national public securities.

If the total amount of QE is estimated at €1trillion, the market behind the new security would amount to one of the largest in global finance. A group of financial intermediaries, mainly the largest government bond market makers, would be called upon to set up the market for the new security. Private actors might find it attractive to create and trade a security that finds an ultimate purchaser in the ECB in the context of the QE programme. In other words, liquidity of the new asset would be assured. Since its outset, and even since its announcement, the gradual programme of purchases – the FED purchased a monthly amount for several years – would motivate the private economy to develop immediately a large supply of the new security amounting to a large share of the total QE programme.

EQUIP would by no means imply a burden-sharing of public debts between states or between debtors, since ABS would carry the same risk-yield of its underlying components, taking into account the yield correlations.

The Consequences of EQUIP

The consequences of the EQUIP programme might be highly beneficial:

- The signalling effect of the new common European security would engage the private economy and spur a close scrutiny by private investors of the financial conditions of the euro area as a whole, while preventing the formation of 'bad equilibria'; therefore, it would align the authorities' commitment to saving the euro with "whatever it takes" with private sector interests and engagement.

- The new EQUIP security would represent a new European safe asset coveted by global investors lamenting the absence of such European assets. It would create a market of size comparable to the US Treasury bonds.
- Since it would mirror the weighted risks of its single underlying components, the new ABS safe asset would carry a higher – or more normal - yield than the safest among national public securities in the euro area, whose low level is a cause of concern in those countries; in particular, it would allow for improved investment opportunities for pension funds and insurance companies in the core countries.
- If largely held in the portfolios of euro-area banks, it would contribute to the decoupling of the risk rating of individual banks from that of the sovereign debt of their home countries.

Clearly these arguments are valid to the extent that the euro ABS would become widely used by the private sector and indeed over time would become the benchmark safe security for euro investors. This outcome would be directly fostered by the QE securities purchase programme of the ECB, which would provide from the start the required liquidity underpinning for the development of this market.