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Deutscher Bundestag

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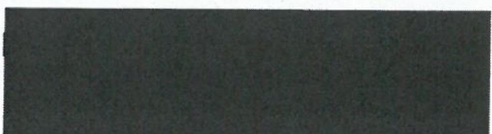

21 November 2014

EXPANDED EURO AREA ASSET PURCHASE PROGRAMME: MONETARY POLICY CONSIDERATIONS[1]

1. Introduction

This note is a follow up to the request from the Governing Council meeting on 6 November 2014 for ECB staff and relevant Eurosystem committees to ensure the timely preparation of further measures to be implemented, should it become necessary to further address risks of a too prolonged period of low inflation. It presents outstanding volumes across asset classes and discusses monetary policy and implementation aspects of an expanded euro area asset purchase programme. Purchases of ABS mezzanine-guaranteed tranches have already been agreed and would fall under the ABSPP, while acceptance of such tranches as collateral would concern the existing collateral framework.

2. Monetary policy considerations of programme design

2.1. Principles

With policy interest rates at their lower bound, asset purchases are one of the main non-standard monetary policy instruments available to the ECB to provide further monetary accommodation if

[1] Section 2, 3 and 5.1 prepared by [redacted], Section 4, 5.2 and 5.3 by [redacted], Section 6 by [redacted] and [redacted] Section 7 by [redacted] Section 8 by [redacted], Section 9 prepared by [redacted]. Comments by [redacted]. A previous version has received comments and approval from [redacted] [redacted].

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needed.[2] Indeed, the Governing Council has underlined that its monetary policy measures – lending operations and asset purchases - will have a sizeable impact on its balance sheet. This reflects the commitment to scale the magnitude of the measures to a size that can deliver the intended macroeconomic impact, namely to bring inflation rates closer to 2%. Should current monetary policy measures fall short of that commitment or should further risks to the inflation outlook materialise, further monetary policy measures, most notably in the form of asset purchases might be warranted.

A possible expanded asset purchase programme should adhere to the following principles. First, this programme should be instrumental in the ECB delivering on its area-wide price stability mandate and – in this view – in promoting a return of inflation to levels closer to 2% over a meaningful definition of medium term. This suggests that purchases should be as effective as possible in further easing the financing conditions faced by households and private firms, as an intermediate step toward influencing aggregate spending and, ultimately, inflation trends. Measures with the highest potential on this score can also impact on the price stability outlook by boosting confidence, encouraging a further correction in the external value of the euro to levels consistent with differences in the monetary policy cycles across large currency areas, and contributing to a firm anchoring of inflation expectations. Second, purchases should as much as possible adhere to the singleness of monetary policy and be executed under selection criteria that are consistent with those adopted under the collateral framework and the other two outright programmes (ABSPP and CBPP), so as to minimise allocative distortions. Third, and relatedly, purchases should minimise the ECB's exposure to risk.

The present note mainly focuses on the second and third criteria, leaving aside the issue of transmission and effectiveness in easing financing conditions and steering inflation toward the aim of "below but close to 2%".[3]

2.2. Considerations regarding the duration of the programme

When deciding on the modalities for asset purchases, an essential choice is between a closed-end and an open-ended programme. One option would be to announce a fixed envelope of total purchases ("closed-end" or "stock" intervention), to be achieved over a certain period of time – along the lines of the Fed's QE1 and QE2, the Bank of Japan's and the Bank of England's programmes. The other would be to entertain a monthly volume of purchases – possibly as an upper limit rather than a hard target, or alternatively as a range – to be continued until some criterion is fulfilled ("open-ended" or "flow" intervention). The criterion for cessation of purchases could, for example, be the inflation

[3] The transmission and effectiveness of a broad euro area asset purchase programme are discussed in a separate note entitled "Large-scale asset purchases: Strategies, effectiveness and channels".

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outlook coming in line with our aim of "below, but close to, 2%". This approach would be similar to the Fed's QE3 and the Bank of Japan's more recent QQE.[4]

Absent operational constraints, the key difference between the two approaches is with respect to the certainty – and thus commitment – provided about the overall magnitude of purchases and thus, by first approximation, about the central bank's balance sheet expansion. While the closed-end programme provides this commitment to the programme size, the open-ended set-up could be seen as providing more directly a commitment towards a relevant metric that is closely linked to the ultimate objective – price stability. Open-ended purchases allow more flexibility in adjusting purchase volumes to the evolving assessment of the economic situation and ensure that the size of the programme is appropriately scaled to the required need of monetary accommodation. As the experience of other central banks has shown, the effectiveness of such an approach depends crucially on the quality of the chosen metric. The advantage of announcing a large overall envelope for an asset purchase in the context of a closed-end programme could be that it comes with more potent signalling effects. Of course, any volume announcement comes with the risk that the announced envelope may in the end be either too large or too small. In the former case it leads to time inconsistency problems while in the latter it may undermine effectiveness to the extent that the programme subsequently, and possibly repeatedly, has to be sized up. While the latter problem may indeed be considered serious, it should not be over-emphasised. Unconventional monetary policy unavoidably involves some degree of experimentation, as transmission of quantitative interventions works through channels that are known still relatively imprecisely. The experience of the Fed, sequentially revising envelopes and modes of interventions as it was gathering evidence and new data, is instructive in this respect. Intermediate options exist, such as the announcement of an envelope of "up to" a certain (large enough) amount, and possibly conditional on progress towards the policy objective.

3. Overview of different options for an expanded euro area asset purchase programme

Abstracting from relative effectiveness consideration which may argue in favour or against interventions in certain asset classes, the universe of securities to consider for the design of a broader euro area asset purchase programme APP should, in principle, be:

- denominated in euro;
- originated and issued by private and public entities resident in the euro area;

[4] For purchase programmes involving government bonds, an open-ended intervention scheme that does not specify any upper ceiling for the overall volume of purchases faces certain implementation risks originating from the ongoing review of OMT by the European Court of Justice (ECJ). In its referral of the case to the ECJ, the German Constitutional Court asked the ECJ to address whether the fact that OMT does not provide for quantitative limits for purchase volumes jeopardises its compatibility with Art. 123. The view of the ECJ on this issue will probably not be known before Q1/Q2 2015.

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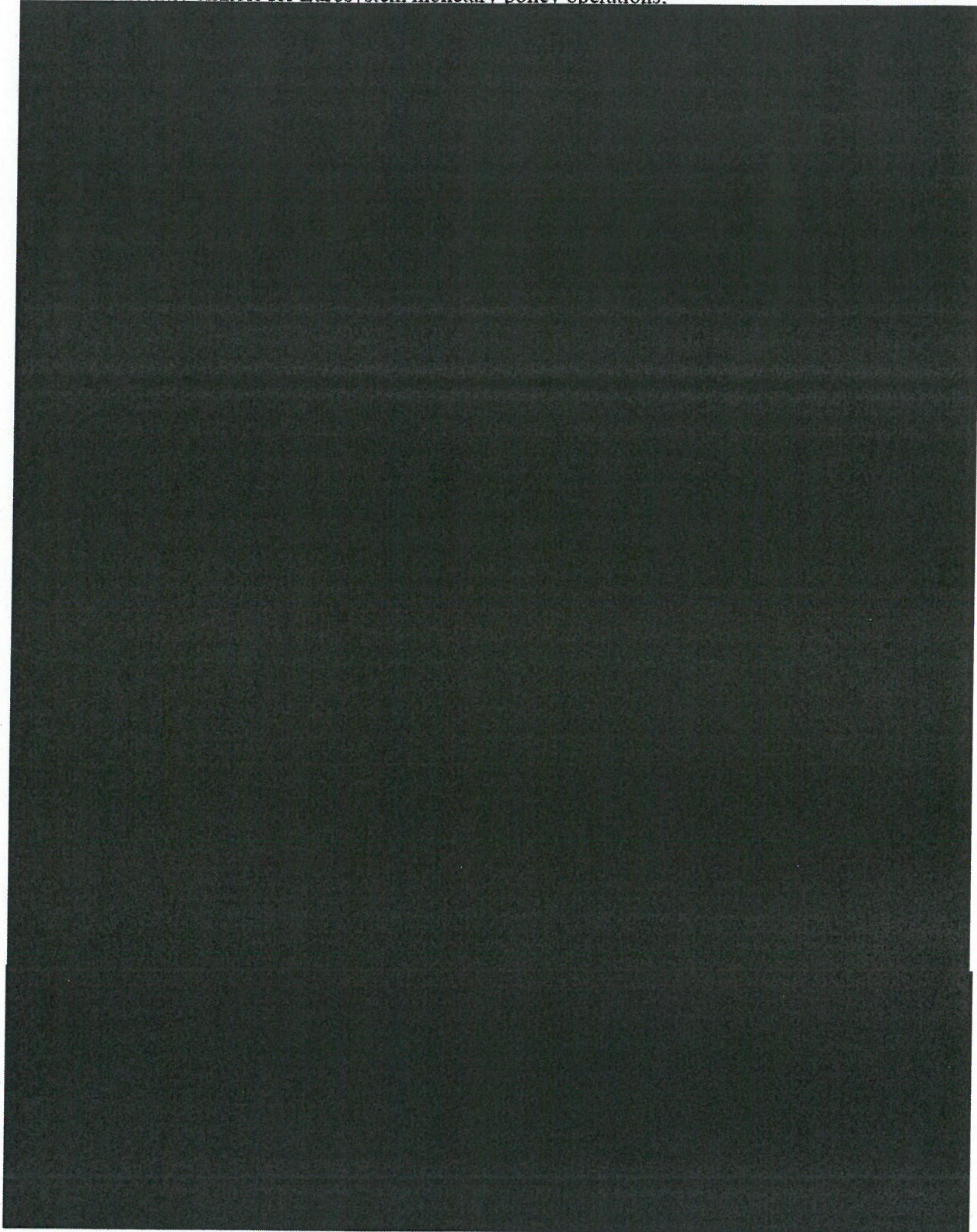
- currently eligible for Eurosystem monetary policy operations;



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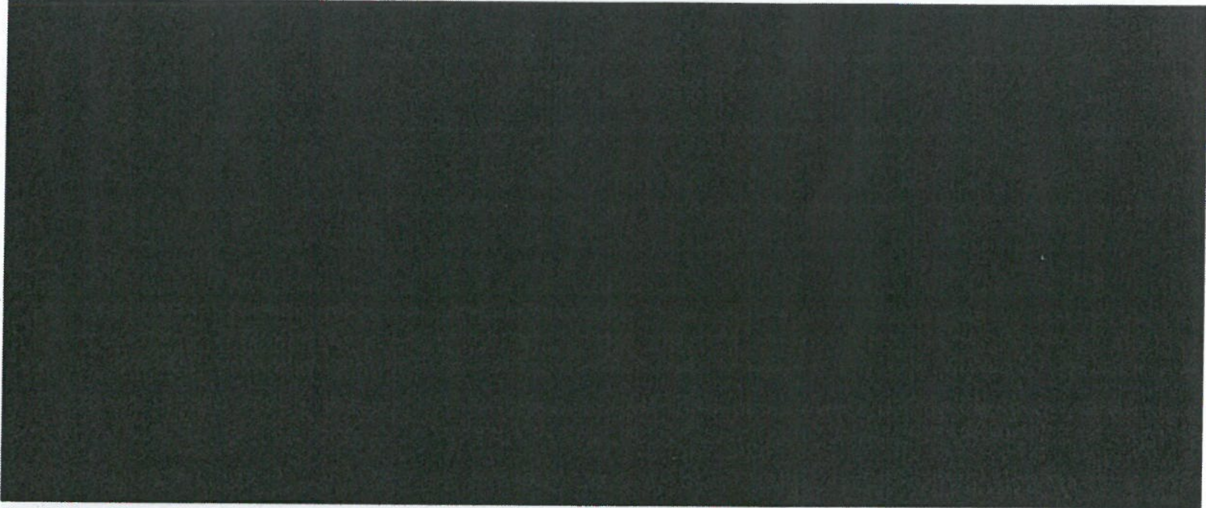

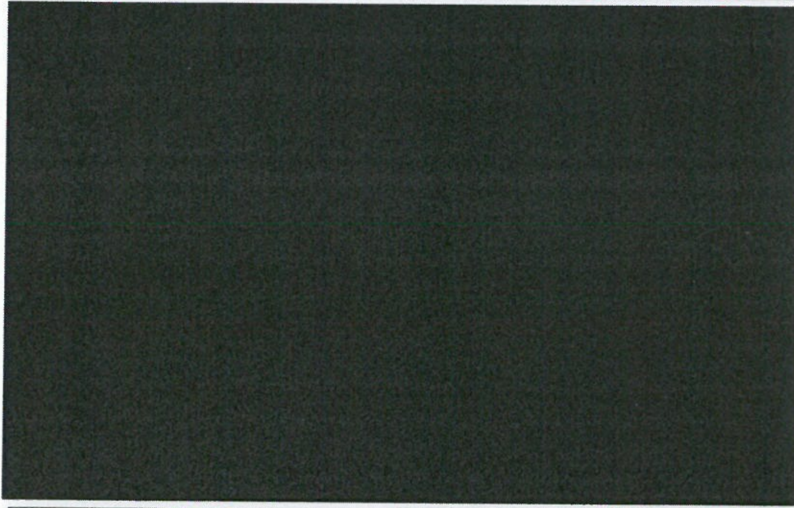

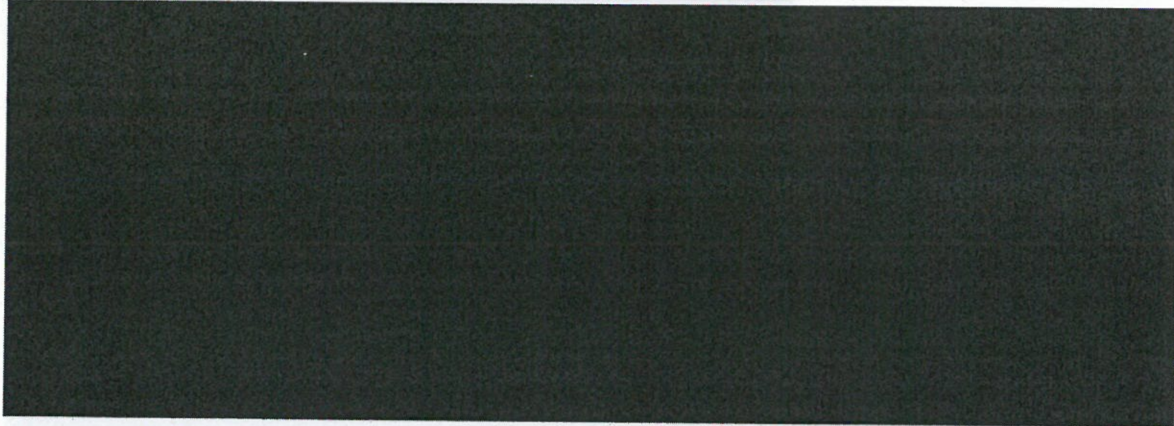

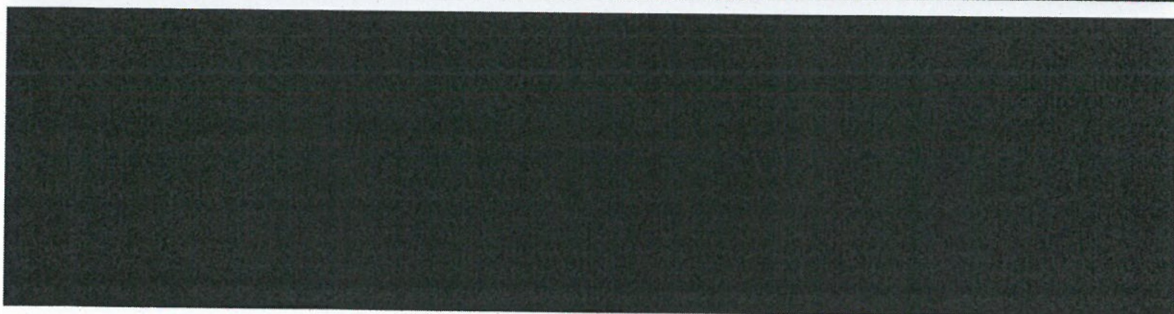

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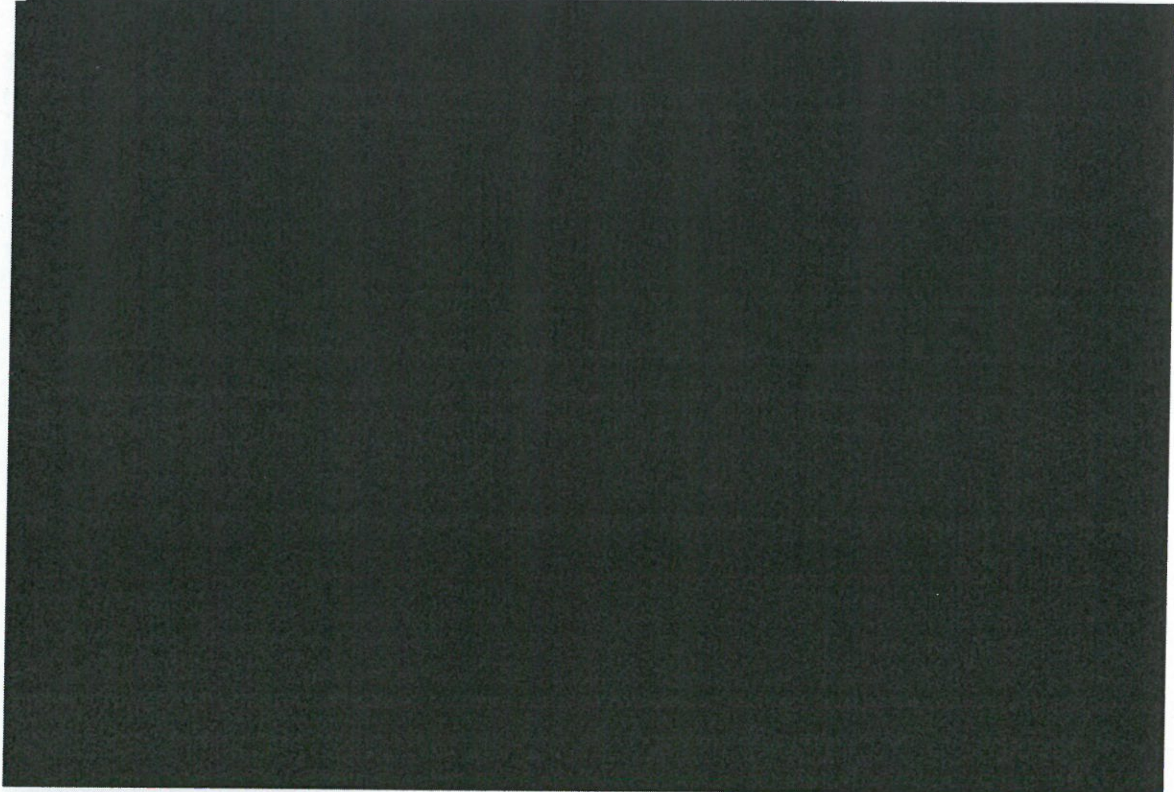

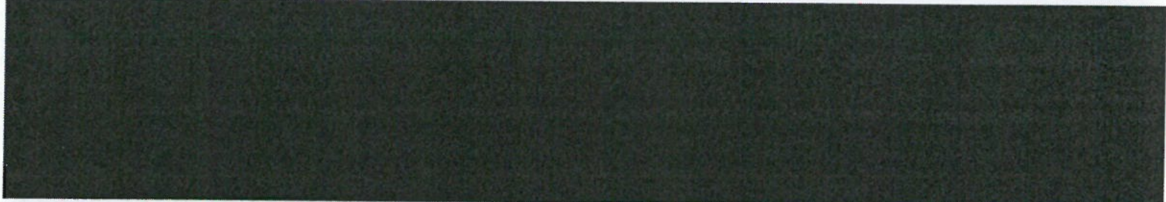

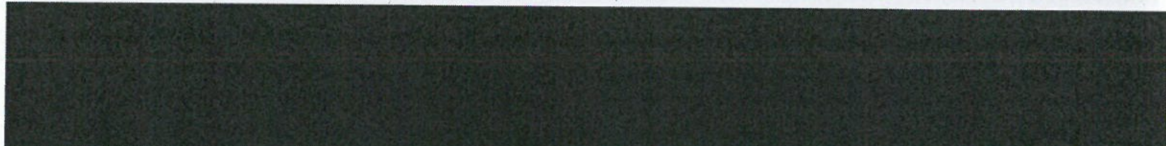

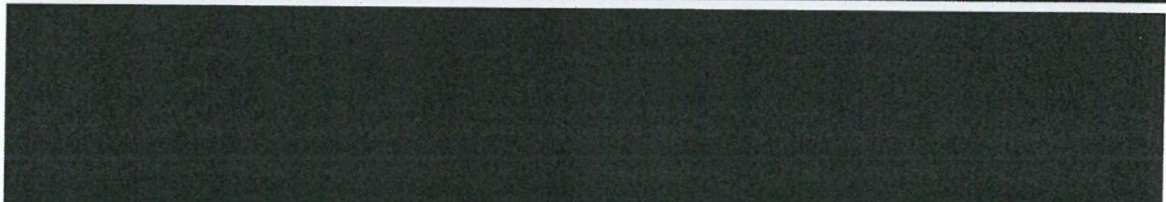

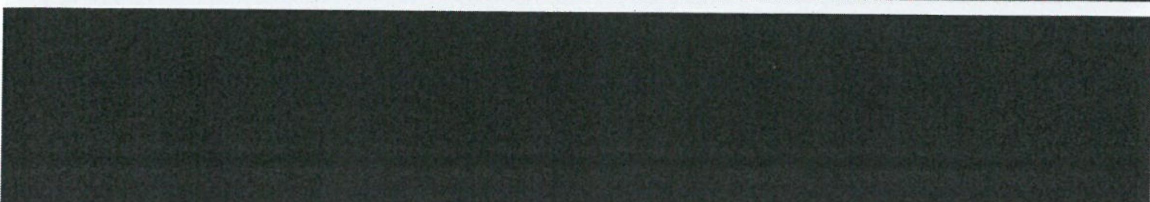

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5. Government bond purchase programme (including SSAs)

5.1. Monetary policy considerations related to government bond purchases

The eligible universe of government bonds is EUR 8.3 tn. For the larger jurisdictions, the market is liquid. A government bond purchase programme would permit buying the largest volumes and be subject to the shortest implementation lag (about 2 weeks), as the Eurosystem is familiar with this asset class.

5.1.1. Monetary policy challenges in designing a purchase programme for sovereign bonds

As a matter of principle, a clear monetary policy justification of any elements of the programme is of fundamental importance from a legal point of view. In the context of government bond purchases, the absence of a single, well-defined risk-free yield curve in the euro area suggests two considerations in addition to those mentioned in Section 2: purchases would need to comply with the prohibition on monetary financing enshrined in Article 123 of the Treaty; and, purchases should as much as possible preserve incentives for prudent fiscal policies and reduce moral hazard.

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These requirements imply that designing a sovereign bond purchase programme involves particular challenges. On the one hand, an intended broad-based easing of the monetary policy stance – which may be required by the pursuit of the ECB's price stability mandate – and the principle of singleness of euro area monetary policy suggest purchases of as broad a portfolio of sovereign bonds as possible. On the other hand, protecting the Eurosystem balance sheet and preserving incentives for sound fiscal policies would be arguments in favour of potentially placing restrictions on the eligible universe, contingent on the soundness of the issuing countries' economic fundamentals.

The above principles also carry an important corollary: large-scale sovereign purchases with the aim to provide a broad-based easing should not directly target a reduction in sovereign bond credit spreads. Put differently, these central bank interventions should focus on reducing overall financing costs in the area as a whole by compressing the premia related to the uncertainty about future policy rate hikes and to unspecific duration risk. Hence, while credit spread compression might be an unavoidable ex-post outcome of candidate purchase programmes through portfolio rebalancing and confidence effects, it would not be the ex-ante objective of central bank interventions.

The following two subsections elaborate on issues related to the monetary financing prohibition and conditionality.

5.1.2. Monetary financing prohibition (Article 123 TFEU)

According to the monetary financing prohibition referred to in Article 123 of the Treaty for the Functioning of the European Union (TFEU) and Council Regulation (EC) No 3603/93,[5] the Eurosystem may purchase public sector debt instruments only in the secondary market and not in the primary market.[6] Secondary market purchases should not be seen as a way to circumvent the objective of the monetary financing prohibition but solely as a way to ensure the delivery of the monetary policy objective – price stability – and be fully consistent with the ECB's independence.[7]

First, currently the purchase of sovereign bonds in the secondary market would be clearly motivated by the price stability mandate, given the very subdued inflation outlook and the fact that the main monetary policy interest rates have reached their effective lower bound. However, compliance with the mandate is a necessary but not a sufficient condition.

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[5] See Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Treaty, OJ L 332 of 31.12.1993, p. 1, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.1993.332.01.0001.01.ENG
Articles 104 and 104b(1) of the Treaty establishing the European Community (TEC) are now Articles 123 and 125(1) of the Treaty on the Functioning of the European Union (TFEU).

[6] With respect to compliance with the prohibition of privileged access referred to in Article 124 of the Treaty, the Eurosystem must ensure, in principle, equal treatment of private and public issuers in a purchase programme. Hence, the design of a purchase programme needs to ensure a priori purchases of both private and public debt instruments subject to the effectiveness of such purchases regarding the achievement of the monetary policy objective.

[7] Recital 7 of Council Regulation (EC) No 3603/93.

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Second, functional (or instrument) independence and financial independence of the ECB and the national central banks (NCBs) are of particular relevance in the context of an asset purchase programme. Article 18.1 of the Statute of the ESCB allows the Eurosystem to transact in financial markets by buying and selling assets outright. Quantities, prices and many technical features related to outright purchases would fall within the discretion of the Governing Council so that functional independence is warranted. To ensure financial independence, the necessary precautionary measures in the design of a purchase programme would have to be worked out by D-RM.

Third, purchases of government debt instruments in the secondary market could constitute a circumvention of the prohibition if the purchases undermine the financial discipline of the public sector. A loosening of fiscal discipline could be the case, among other things, if such purchases (i) help to ensure or regain market access, (ii) alleviate the burden of an EU/IMF adjustment programme or Post-Programme Surveillance (PPS) and/or (iii) induce a monetary-financed fiscal expansion.

In particular, the monetary financing prohibition rules out raising inflation via stimulating aggregate demand on the basis of a monetary-financed fiscal expansion. The Eurosystem must not pursue its price stability mandate by violating the monetary financing prohibition.

5.1.3. Conditionality

Sovereign bond purchases and the concomitant reduction in sovereign borrowing costs may undermine incentives for reform and prudent fiscal policies. These weakened incentives may, in turn, undermine the effectiveness of the monetary policy measures in ensuring price stability und cause more severe problems further in the future. For example, a lack of reform efforts could lead to deteriorating long-term growth prospects. The associated decline in the natural real rate of interest may defeat the very purpose of the monetary policy intervention, which is closing the gap between the market rate and its natural level. To mitigate these potential adverse incentive effects, sovereign bond purchases could be made conditional on a country's economic fundamentals. Specifically, the ECB could consider purchasing bonds of a country only if its economic fundamentals can be judged as sound according to some concrete and robust criteria; and, if the country fails to meet these criteria, the ECB might either choose to altogether refrain from purchasing bonds of that country or only conduct purchases if the government commits to a serious and implementable reform agenda.

There are three options for devising the criteria to distinguish between countries falling in the respective category.

- The first option would be to rely on country ratings from credit rating agencies. These ratings provide a relatively transparent and easily interpretable metric of economic fundamentals. However, they would make the ECB's monetary policy dependent on the judgement of a small group of private sector rating agencies. Furthermore, relying on country ratings might lead to a pro-cyclical and discontinuous implementation of asset purchases, e.g. if purchases were suddenly stopped or markedly slowed down for securities issued by a

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country facing a rating downgrade related to a perceived deterioration of economic conditions.

- A second option would be to rely on key yardsticks under the EU structural and fiscal surveillance frameworks so that, for instance, only countries outside an excessive deficit procedure (EDP) and the excessive imbalances procedure (EIP) would be eligible for purchases without further policy adjustments. While this option would have the benefit of being anchored on an established monitoring framework, it would probably further increase the political pressure to water down the implementation of these rules. These two options may imply meaningful differences in the set of countries included in the purchase programme since ratings depend to an important extent on stocks of debt, while the EDP focuses on deficits. Thus, countries that are subject to an EDP procedure but have moderate debt levels would be included in the purchase universe under a ratings-based approach, but not under a surveillance framework-based approach, and vice versa.
- As a third option, the ECB could prepare its own assessment of each country's economic fundamentals. While, in this option, the decisions on eligibility would remain subject solely to the independent assessment of the ECB, any approach or methodology would be likely to come under significant challenge.

In any case, the ECB would face a trade-off when determining the stringency of the criteria used to distinguish between the different types of bonds. Stricter criteria would lower the adverse incentive effects of sovereign bond purchases; but they also raise the risk that fewer countries are eligible and the policy intervention itself would be more fragmented and less consistent with the aim to adopt a general monetary policy measure for the euro area as a whole. Further aggravating this problem, including bonds from some Member States on the basis of their economic fundamentals, the Governing Council risks cementing perceptions of a two-tier sovereign bond market and sends a signal to financial markets that it might be concerned with the sustainability of the debt of these countries. Such a perception – irrespective of whether it is justified or not – can lead to a rapid and self-enforcing widening of spreads with serious political and economic repercussions that would run counter the initial objective.

If, nonetheless, such criteria were to be adopted, countries failing to present sound economic fundamentals could be provided with a further avenue towards eligibility, namely via an ESM programme. This option would benefit from an established framework by which countries can commit themselves to their economic reform agenda and by which the European Commission, in liaison with the ECB and possibly the IMF can monitor reform process.

However, the link to conditionality might expose the programme to different sources of uncertainty: in the context of the case on OMT, the European Court of Justice has yet to issue its ruling and the link of a monetary policy measure to conditionality under an ESM programme is one of the elements that the Court has been asked to assess by the German Constitutional Court. Hence, it is uncertain

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whether this design feature would be feasible. Further adding to this uncertainty, the link to conditionality, if adopted, implies that activation of large-scale bond purchases for all countries falling under this eligibility criterion would be contingent on political (and in some countries formal parliamentary) approval of the concomitant ESM programme.

As to the type of ESM programme that could be envisaged as a complement to the asset purchases, an Enhanced Conditions Credit Line appears most suitable. Most other ESM instruments are probably unsuitable to complement a large-scale bond purchase programme by the ECB in current conditions since the Guidelines for most instruments (including the ESM Loans or Secondary Market Purchases) have the explicit aim to counteract acute financial market crisis situations. But the large-scale bond purchases, as a means to inject additional accommodation, could be warranted even in the absence of such crisis symptoms. An exception are the precautionary programmes (comprising the Precautionary Conditioned Credit Line (PCCL) and the Enhanced Conditions Credit Line (ECCL)) whose stated aim is to: "prevent crisis situations by allowing ESM Members to secure the possibility to access ESM assistance before they face major difficulties raising funds in the capital markets" (ESM guideline on Precautionary Financial Assistance Article 1). Among the types of precautionary programmes, the ECCL appears preferable from an incentive perspective as it requires the respective ESM Member to be subject to enhanced surveillance.

Short of conditionality, moral hazard problems could also be mitigated by exempting sovereign debt purchases from the normal loss-sharing arrangement. If losses are shared, incentives to pursue fiscal and other economic policies to ensure debt sustainability may be weakened as any potential losses in the case of non-sustainability would be spread across the Eurosystem. At the same time, profit- and loss sharing – as is customary for the vast majority of our monetary policy instruments – may be more conducive to the singleness and overall effectiveness of monetary policy.

5.2. Universe and benchmark design

A key impediment to euro area government bond purchase programme is that there is no unique credit risk-free yield curve for the euro area, but 17 individual issuers with a potentially large dispersion of yields. On one hand purchasing a broad portfolio of bonds offers a way to approximate "buying the euro area", but on the other hand would involve buying bonds that can neither be seen as credit risk-free nor in many cases very liquid. Table 4 provides an overview of the rating distribution by country of issuance, indicating that somewhat more than half the euro area central government securities, EUR 3.8 tn out of a total of EUR 6.8 tn, is rated in the highest credit quality step.

In addition to central government securities, it could be considered to also include regional governments or national agencies such as KfW and ICO in the programme, thereby enlarging the universe by around EUR 0.9 tn. These institutions fulfil important functions in developing and supporting the local economy or to introduce governmental programmes to foster new lending. As a consequence, they might constitute a further potential conduit of the intended monetary policy

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impulse to inflation. Secondary market liquidity also deteriorated in line with all the other markets but, at least for the big agencies like ICO and KfW, there is decent liquidity in secondary markets.

An alternative to approximate the euro area would be to focus purchases on European Institutions securities. Currently a volume of EUR 0.5 tn is outstanding, albeit all rated in the highest credit quality step.

Table 4: Euro denominated securities issued by the government sector according to credit quality steps

(market value)

in EUR bn	Rating	AT	BE	CY	DE	EE	ES	FI	FR	GR	IE	IT	LU	LV	MT	NL	PT	SI	SK	EU	Total by instrument
Government securities		**219**	**389**	**6**	**1900**		**910**	**86**	**1696**	**65**	**136**	**1820**	**7**	**4**	**6**	**359**	**111**	**16**	**33**		**7763**
- central government		*219*	*380*	*6*	*1230*		*802*	*85*	*1562*	*65*	*136*	*1808*	*7*	*4*	*6*	*359*	*111*	*16*	*33*		*6829*
	AAA to AA-	*219*	*367*		*1230*			*85*	*1562*				*7*			*359*					*3828*
	A+ to A-		*13*				*802*				*136*	*1808*		*4*	*6*			*16*	*33*		*2819*
	BBB+ to BBB-																*111*				*111*
	BB+ and below			*2*						*63*											*65*
	Not rated			*4*						*2*											*6*
- regional government			*9*		*319*		*58*		*8*			*12*									*408*
	AAA to AA-		*6*		*302*				*8*												*316*
	A+ to A-		*2*				*7*					*2*									*10*
	BBB+ to BBB-						*36*					*10*									*47*
	BB+ and below																				
	Not rated		*1*		*17*		*15*														*34*
- agency					*351*		*50*		*126*												*526*
	AAA to AA-				*351*				*125*												*476*
	A+ to A-						*50*														*50*
	BBB+ to BBB-																				
	BB+ and below																				
	Not rated																				
European institutions debt securities																				**530**	**530**
	AAA to AA-																			*530*	*530*
	A+ to A-																				
	BBB+ to BBB-																				
	BB+ and below																				
	Not rated																				
Total by country		**219**	**389**	**6**	**1900**	**0**	**910**	**86**	**1696**	**65**	**136**	**1820**	**7**	**4**	**6**	**359**	**111**	**16**	**33**	**530**	**8293**
	AAA to AA-	*219*	*373*	*0*	*1882*	*0*	*0*	*85*	*1695*	*0*	*0*	*0*	*7*	*0*	*0*	*359*	*0*	*0*	*0*	*530*	*4620*
	A+ to A-	*0*	*15*	*0*	*0*	*0*	*859*	*0*	*1*	*0*	*136*	*1810*	*0*	*4*	*6*	*0*	*0*	*16*	*33*	*0*	*2879*
	BBB+ to BBB-	*0*	*0*	*0*	*0*	*0*	*36*	*0*	*0*	*0*	*0*	*10*	*0*	*0*	*0*	*0*	*111*	*0*	*0*	*0*	*158*
	BB+ and below	*0*	*0*	*2*	*0*	*0*	*0*	*0*	*0*	*63*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*65*
	Not rated	*0*	*1*	*4*	*17*	*0*	*15*	*0*	*0*	*2*	*0*	*1*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*41*
Share of total		26	47	01	229	00	110	10	205	08	16	220	01	00	01	43	13	02	04	64	100
ECB capital key in %		28	35	02	257	03	126	18	203	29	17	176	04	03	01	57	25	05	11	00	100

Source EADB/UCDB – 25 September 2014.

Notes The table excludes securities maturing before 31/01/2015. Amounts below EUR 1 billion not shown for ease of visibility.

In addition, policy-related constraints relating to the residual maturity of the securities may be devised in order to leverage the signalling effect with regard to the intended monetary policy accommodation. For instance, exclusive purchases of shorter-term debt securities, below 3 years, owing to their more rapid redemption may have more limited temporal expansionary monetary effects. Moreover, it may be considered to exclude securities with performance linked to inflation (around 0.5 tn), as this market segment is only present in a few euro area countries and is largely populated by specialised investors using inflation-linked bonds overwhelmingly for inflation-hedging purposes. Including such bonds would presumably result only in limited portfolio rebalancing effects and. would be easily prone to being squeezed by central bank asset purchases, owing to the lack of substitutes.[8]

[8] While the Federal Reserve included Treasury Index Protected Securities in its LSAP, the Bank of England excluded purchases of index-linked gilts from its asset purchase programme, despite the important share of these bonds in UK government bond market.

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The following sections provide some preliminary views with regard to rating and risk considerations. A more comprehensive and systematic risk analysis of the options shall be conducted by Directorate Risk Management and the RMC.

5.2.1. Exigent rating threshold

A possible delimitation of the universe is to approximate a risk-free sovereign yield curve for the euro area by focusing the purchases on the highest-quality assets only, i.e. bonds rated AAA down to AA-. This represents a considerably more stringent credit standard than applied in the Eurosystem collateral framework or ABSPP and CBPP. As indicated in Table 4, a significant share of the government securities universe would still be addressable by such purchases. At the same time, it excludes 7 sovereign issuers from the programme.

Purchases of this subset of euro area government bonds would provide further easing of the monetary policy stance by lowering the natural euro area pricing benchmark. The absorption of high-quality assets would target the expected path of future short-term rates and the term-premium component of market interest rates. Depending on the volume of purchases, this would also activate portfolio rebalancing and signalling channels, which in turn may lead to lower yields even for member states not directly benefiting from ECB interventions. In affecting directly the (synthetic) risk-free yield curve in the euro area, the effects of purchasing the safest government bonds in the euro area will be similar to the effects resulting from interventions in the interest rate swap market that would have the ECB receive a fixed interest rate and pay floating (e.g. three-month or six-month EURIBOR). Of course, this presupposes that cross-country arbitrage in risk-free assets functions properly. Limiting interventions to high-quality bonds would also provide some insurance against unduly compressing credit spreads, in case this was not called for from a monetary policy perspective. At the same time, purchases of high-quality bonds would both inject central bank liquidity and take out term risk. Therefore, they would go significantly beyond the option of IRS which would only take out term risk and do nothing on liquidity. Massive liquidity injection could have a particular strong effect in the current context of negative rates.

This demanding rating based definition is supported by general risk management considerations as, at the time of purchase, it provides maximum protection to the Eurosystem balance sheet. However, this must not necessarily apply over the life-time of the holdings. The euro area sovereign debt crisis provides examples for rapid rating migration over a time horizon relevant for a purchase programme. In addition, the possibility of rating migration also needs to be considered with regard to the time of purchase, as rating actions could be disruptive to the implementation by the Eurosystem by reducing the addressable universe.

While stringent rating-based criteria offer protection for the Eurosystem balance sheet, it also suffers from significant drawbacks. First, by limiting the scope of possible interventions it may fail to produce a substantial enough easing of the monetary policy stance in the euro area, for example if

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portfolio balance effects prove insufficient to ease financial conditions in stressed countries. Second, it would run counter to the principle of monetary policy singleness in the case that cross-country arbitrage is ineffective in ensuring that the reduction in the risk-free curve is transmitted across the entire euro area. In such as case, this approach is likely to induce significant redistributive effects by benefitting only a few countries, including their government sector, that already enjoy a strong credit profile. In addition, following the introduction of liquidity coverage ratio, a purchase programme focussing on highest-rated bonds could interfere with the implementation of the liquidity regulation by reducing the supply of assets available to banks. Therefore, setting a high rating threshold seems self-defeating also from a monetary policy perspective.

5.2.2. Investment grade jurisdictions

A broader delimitation of the universe consists in including all investment grade jurisdictions in the scope of the purchase programme. This would make the overwhelming share of government bonds eligible for Eurosystem purchases, EUR 7.6 tn. Such a broad approach would be consistent with the Eurosystem minimum credit quality threshold in the Eurosystem collateral framework and can therefore be seen a providing sufficient protection for the Eurosystem balance sheet. The approach would, however, not guarantee the inclusiveness for the euro area as Greek and Cypriot securities would not be eligible.

5.2.3. Including sub-investment grade jurisdictions

An inclusive programme covering the whole of the euro area is an important element in order to signal that the programme is a monetary policy programme providing monetary accommodation to all euro area countries, thereby avoiding contributing to financial fragmentation. At the same time, it must be acknowledged that all euro area sovereign issuers do not enjoy identical financial soundness. This would necessitate that the credit quality threshold waivers applied to sovereign bonds in regular Eurosystem monetary policy operations would extend the purchase universe in some cases to below investment grade. Sub-investment grade government bonds should only be included in the purchase universe as long as the country is subject to an EU/IMF programme. Such an approach would be consistent with the design of the CBPP3 and ABSPP.

5.2.4. Asset allocation: capital key and variants

In principle, there are many ways to allocate a euro of purchases across eligible sovereigns. The most straightforward allocation keys are the country weights in the ECB's capital share, and the country proportions in total outstanding stocks of debt, respectively (see Chart 2). The principle of not interfering with relative prices (see section 5.1.1) could suggest buying in proportion to the outstanding amounts of debt: this strategy may be considered to have a more limited effect on relative

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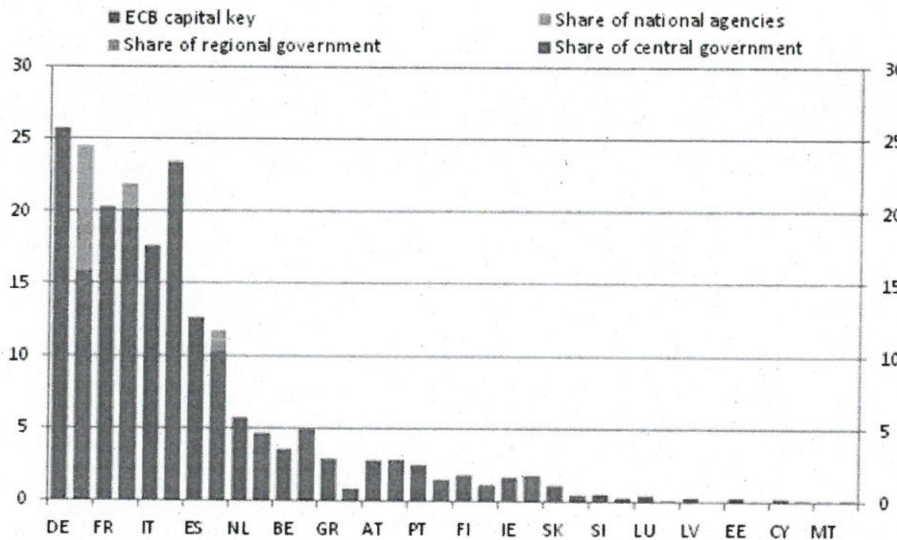
sovereign spreads, as the same share of a market is purchased in all jurisdictions. At the same time, it could be argued that buying in proportion to outstanding amounts is not consistent with "spread neutrality": to the extent that there is a positive correlation between the stock of bonds and sovereign credit risk, this rule for apportioning purchases would take more credit risk out of the market, possibly resulting in spread tightening. Further, weighting purchases according to outstanding amounts of debt could be seen as "rewarding" the more heavily indebted countries – with possible adverse effects on fiscal incentives. An example of an allocation key that takes such considerations into account could be to use ratings to adjust the weights, with the better-rated sovereigns receiving a proportionally higher weight. However, this scheme would still retain the dependence of purchases on ratings, while also being difficult to communicate due to its complexity. To conclude, the simplest and most transparent solution would likely be the capital key criterion.

Chart 2: Share according to ECB capital key and outstanding amounts of government securities *(in %)*



Sources: ECB, ECB calculations.

5.2.5. Specific considerations on European supranational debt securities purchases

A proposal to address the lack of risk-free euro area sovereign yield curve could be to approximate the euro area by focussing purchases on European supranational debt securities. Beside government bonds and covered bonds, European institutions debt securities are an important part of the liquid segment of the euro area fixed income market, with an outstanding amount of close to EUR 530 bn. Table 5 provides the outstanding volumes of securities from respective institutions, indicating that such a programme would effectively focus on two issuers, the European Financial Stability Facility (EFSF) and the European Investment Bank (EIB).

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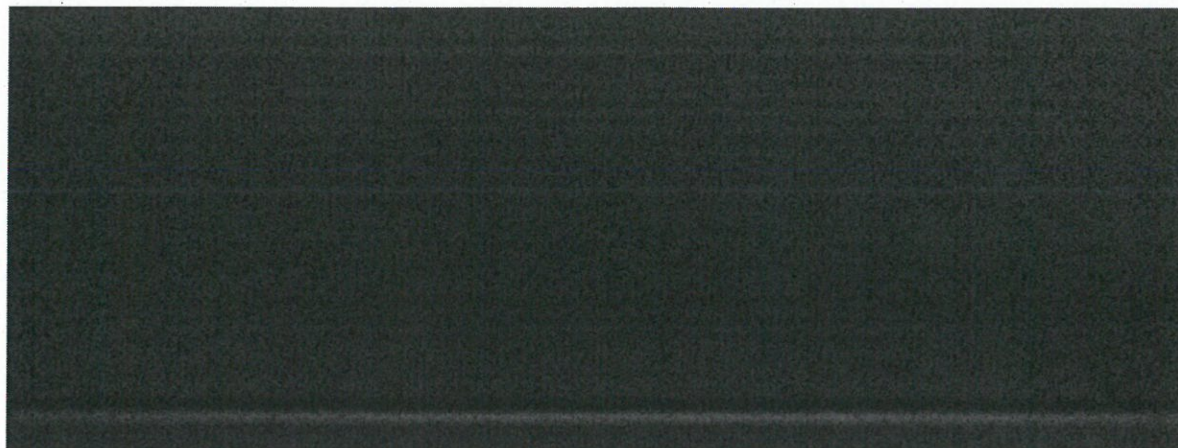
Table 5: Euro denominated debt securities issued by European Institutions

Issuer	in EUR bn
Council of Europe Development Bank	*5.3*
Eurofima (European Company for the Financing of Railroad Rolling Stock)	*3.1*
European Atomic Energy Community	*0.2*
European Bank for Reconstruction and Development	*0.8*
European Financial Stability Facility	*203.3*
European Investment Bank	*218.6*
European Stability Mechanism	*38.9*
European Union	*60.0*

Source EADB/UCDB – 25 September 2014.
Notes The table excludes securities maturing before 31/01/2015.

All securities are rated in the AAA to AA- credit quality. Many market participants investing in such securities are hold-to maturity investors, such as official institutions and conservative asset managers. Secondary market liquidity has deteriorated somewhat but, at least for the big agencies such as EIB and EFSF, there is decent liquidity in secondary markets.

Given that this option does not involve direct euro area sovereign bond purchases by the ECB, it reduces somewhat the Eurosystem's credibility and reputation risks associated with a broader delimitation of the universe. However, targeting a portfolio of bonds issued by supranational institutions would not ex-ante guarantee that sovereign yields decline across euro area jurisdictions, which could increase heterogeneity within the euro area and result in distributional effects. In case it is difficult to build up a large portfolio of EFSF/ESM bonds (given the currently small amount outstanding) or if the approach leads to stronger yield divergence within the euro area, the option - a portfolio of bonds weighted according to the ECB capital - could be preferred. It should be noted that legal considerations with regard to the prohibition of monetary financing apply to European Institutions to the same extent as to central governments. Moreover, it should be recalled that the institutions involved have a remit that extends beyond the euro area, and in some cases beyond the EU.



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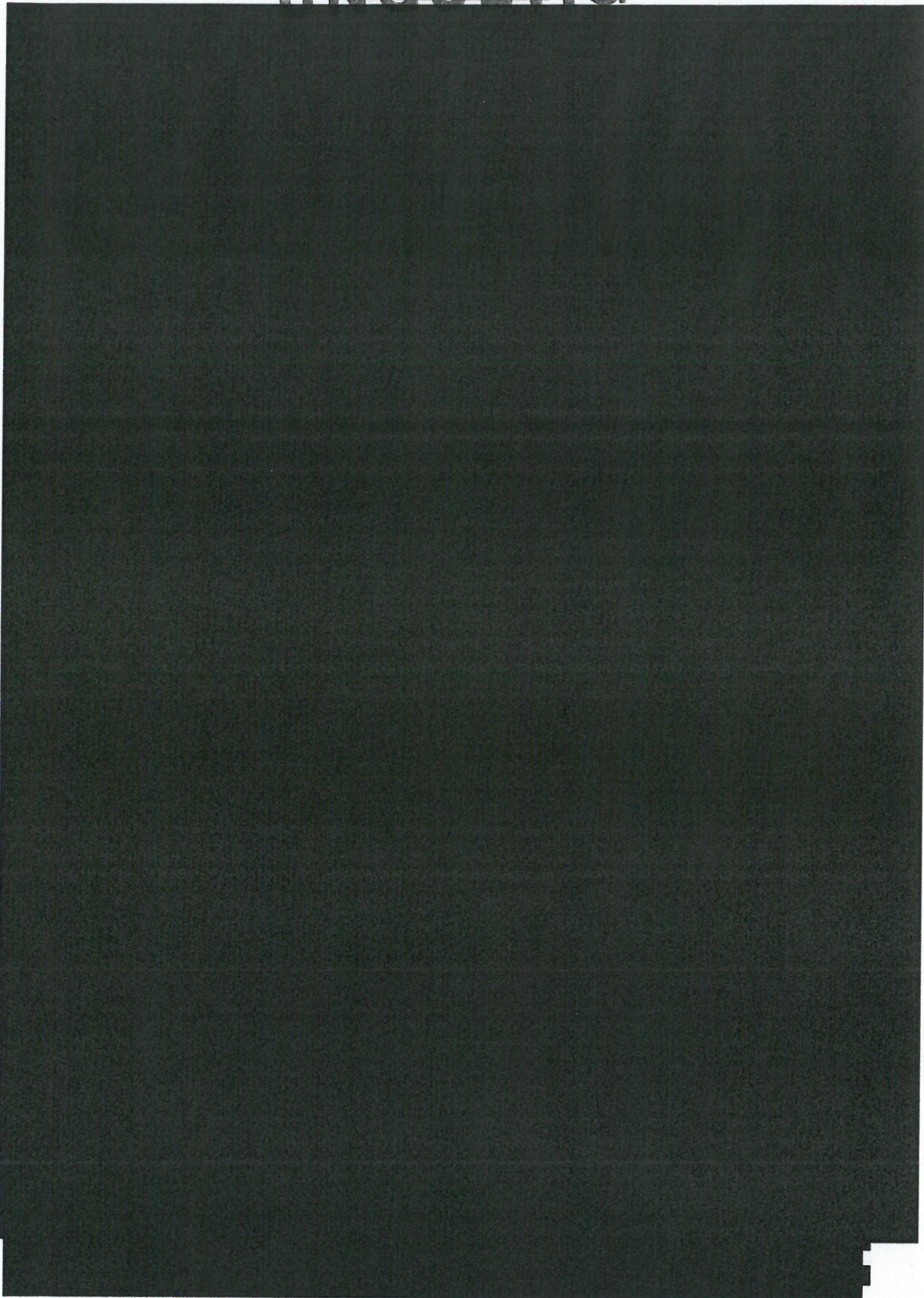

[9] Eurosystem Taskforce of Portfolio Managers, Specifications of a large scale asset purchase programme.

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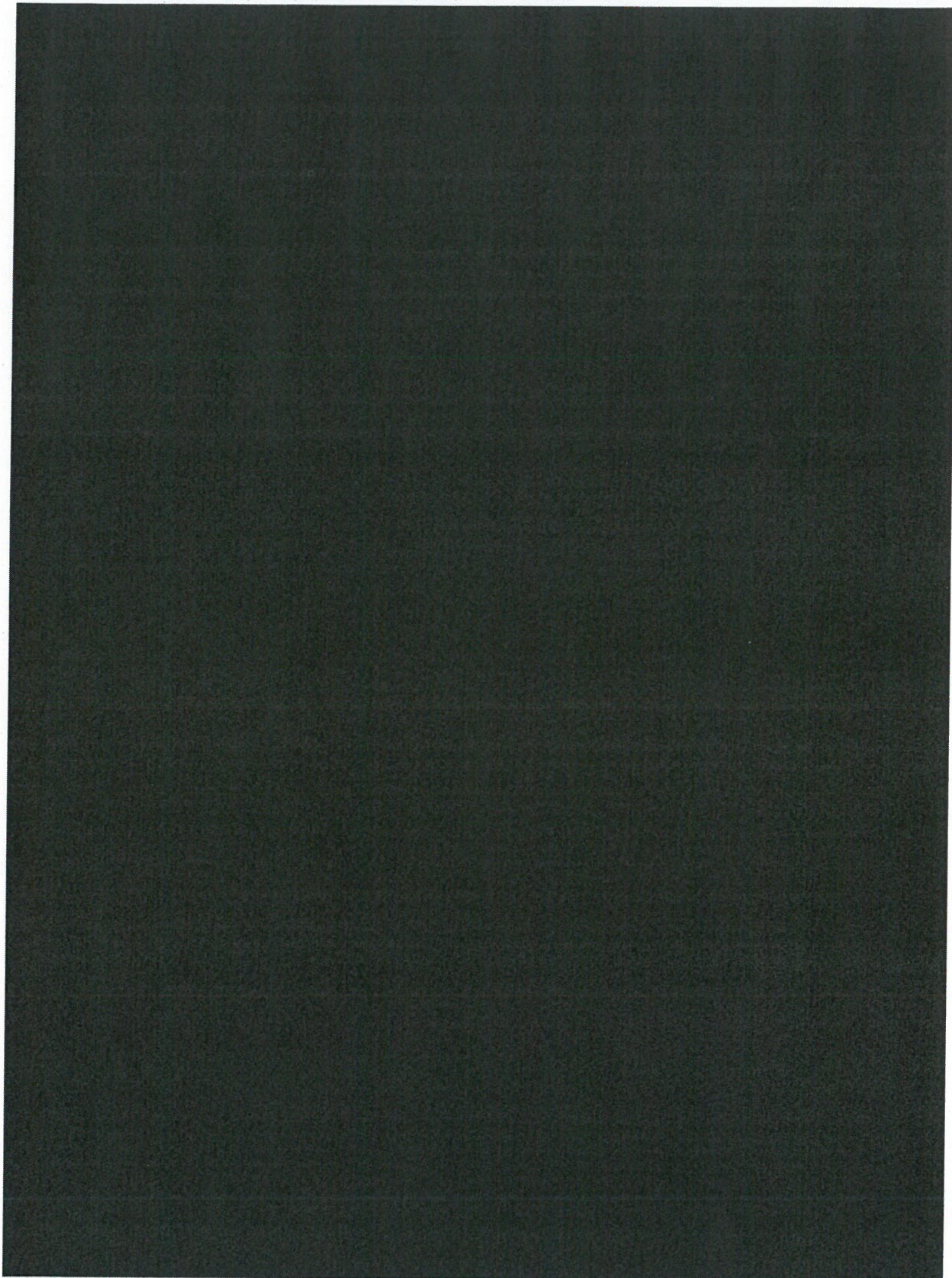

[10] See 6 November 2014 Governing Council decision point (y) on ABSPP (SEC/GovC/XXX/14).

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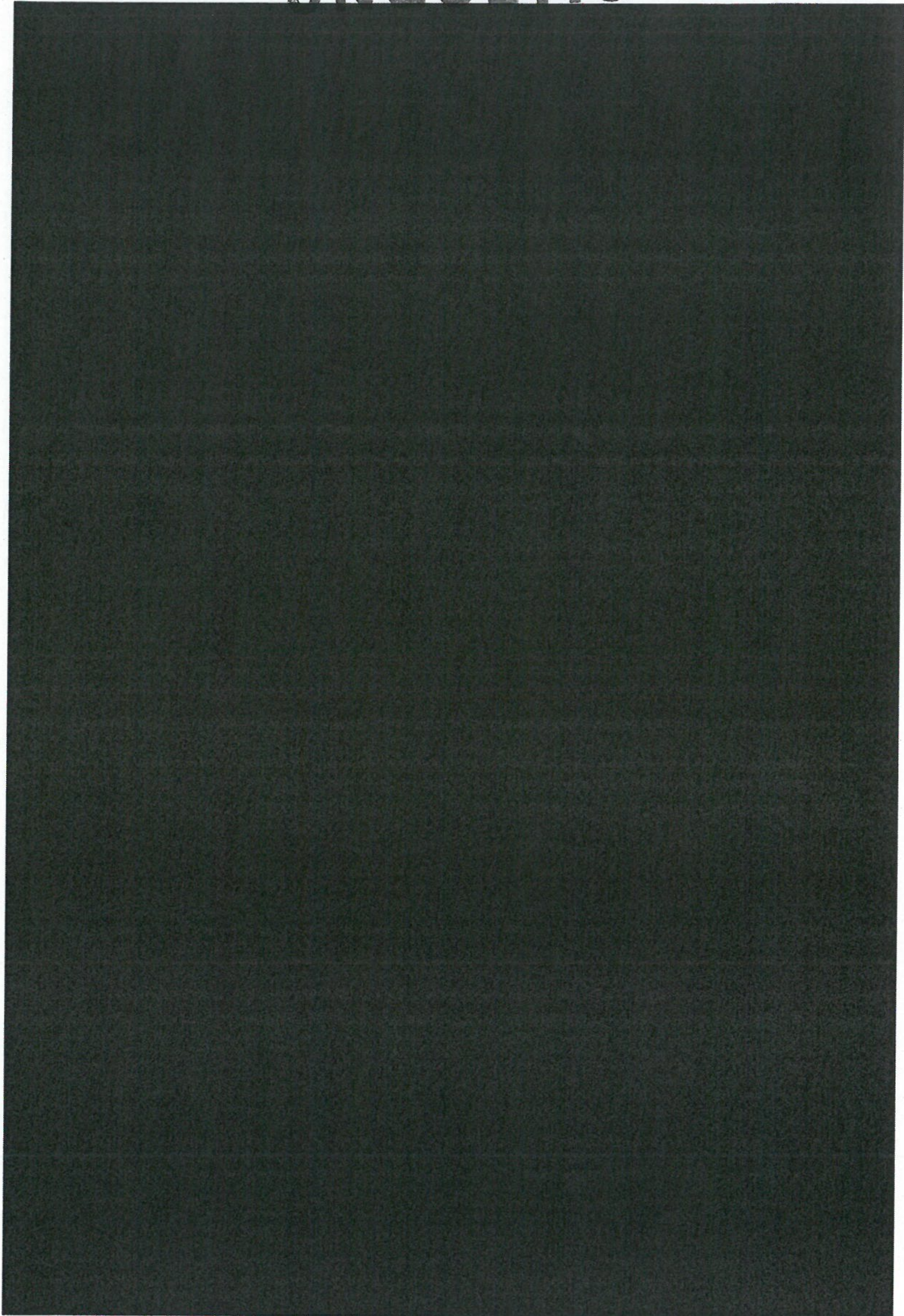

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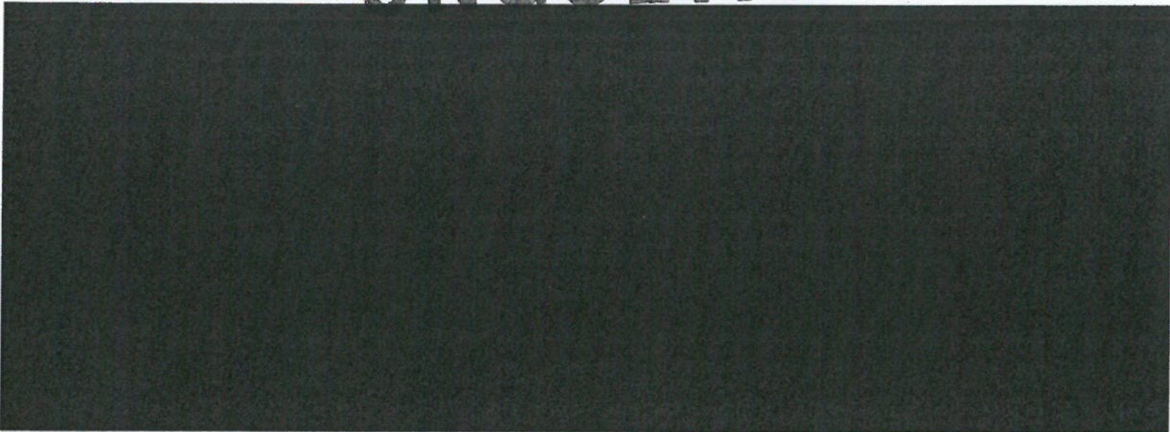

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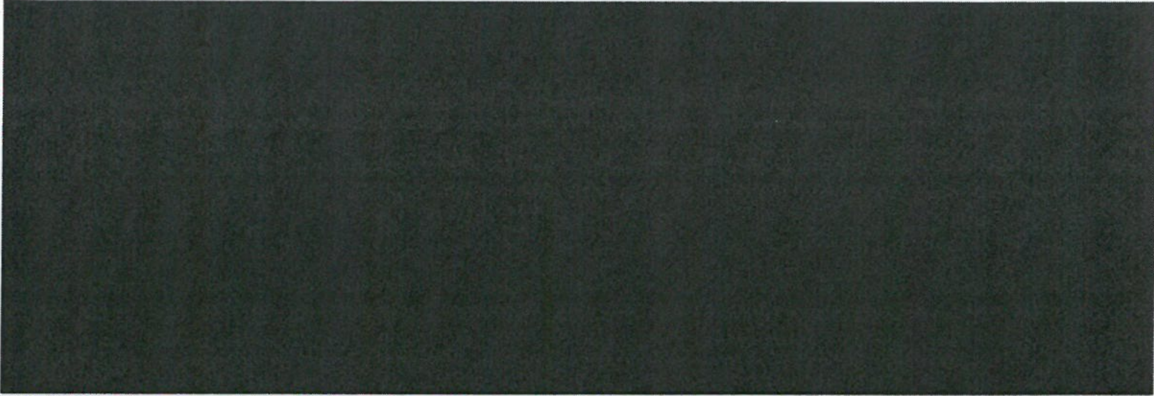

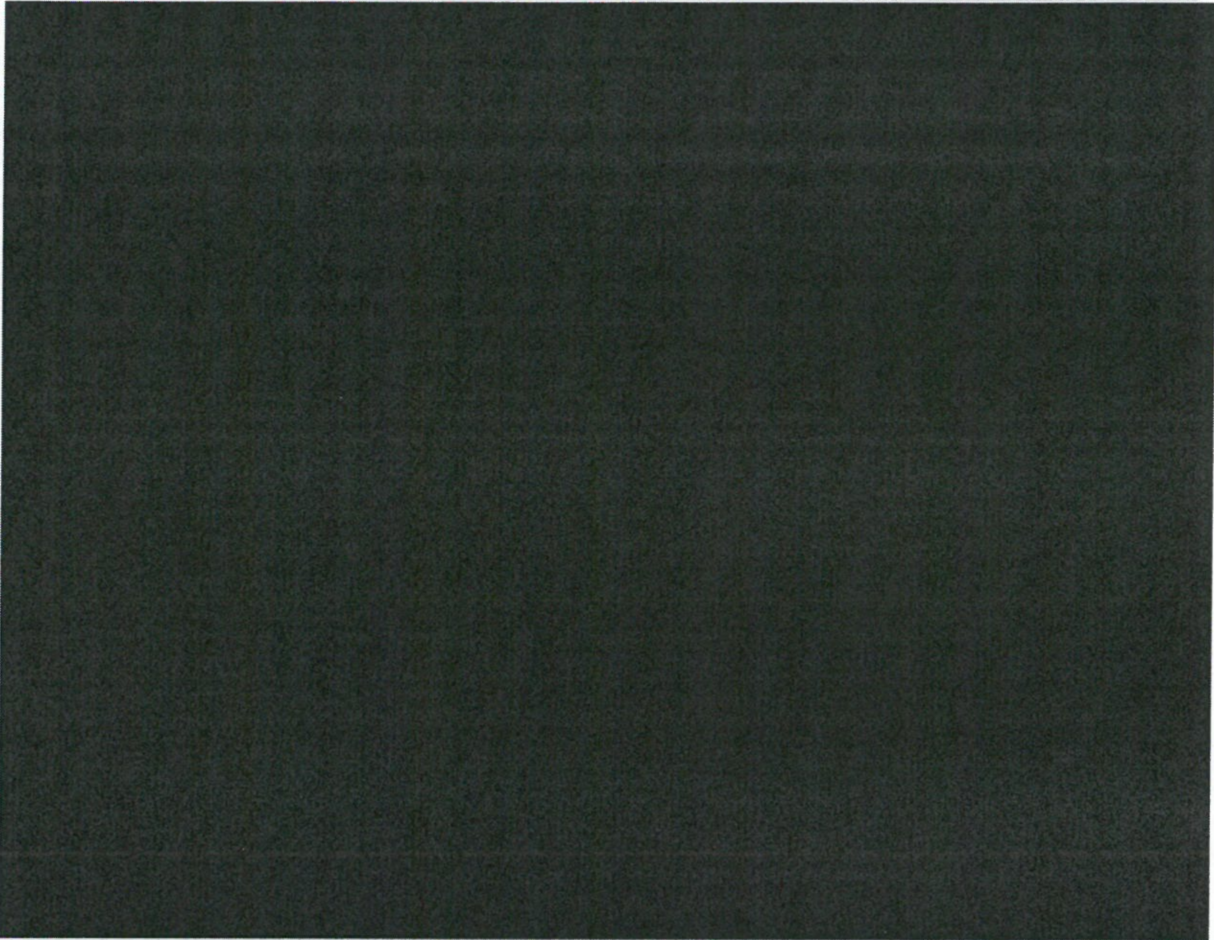

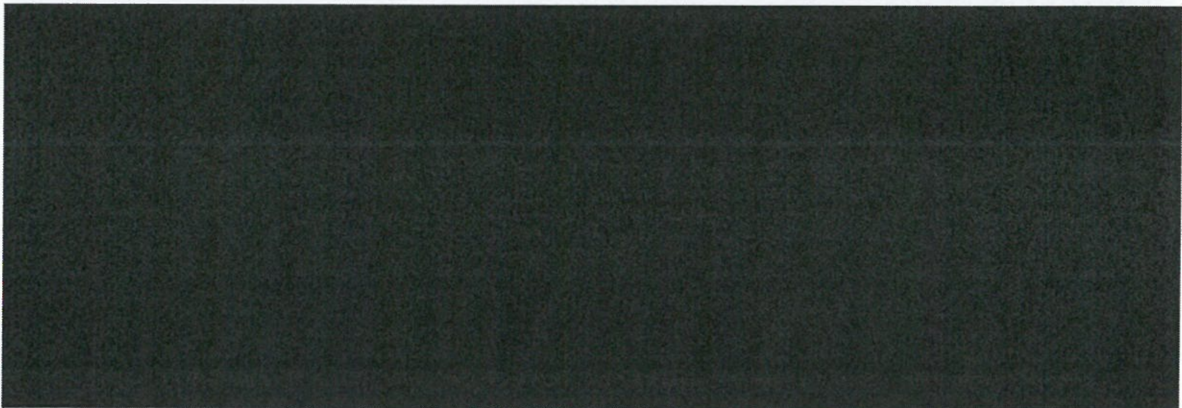

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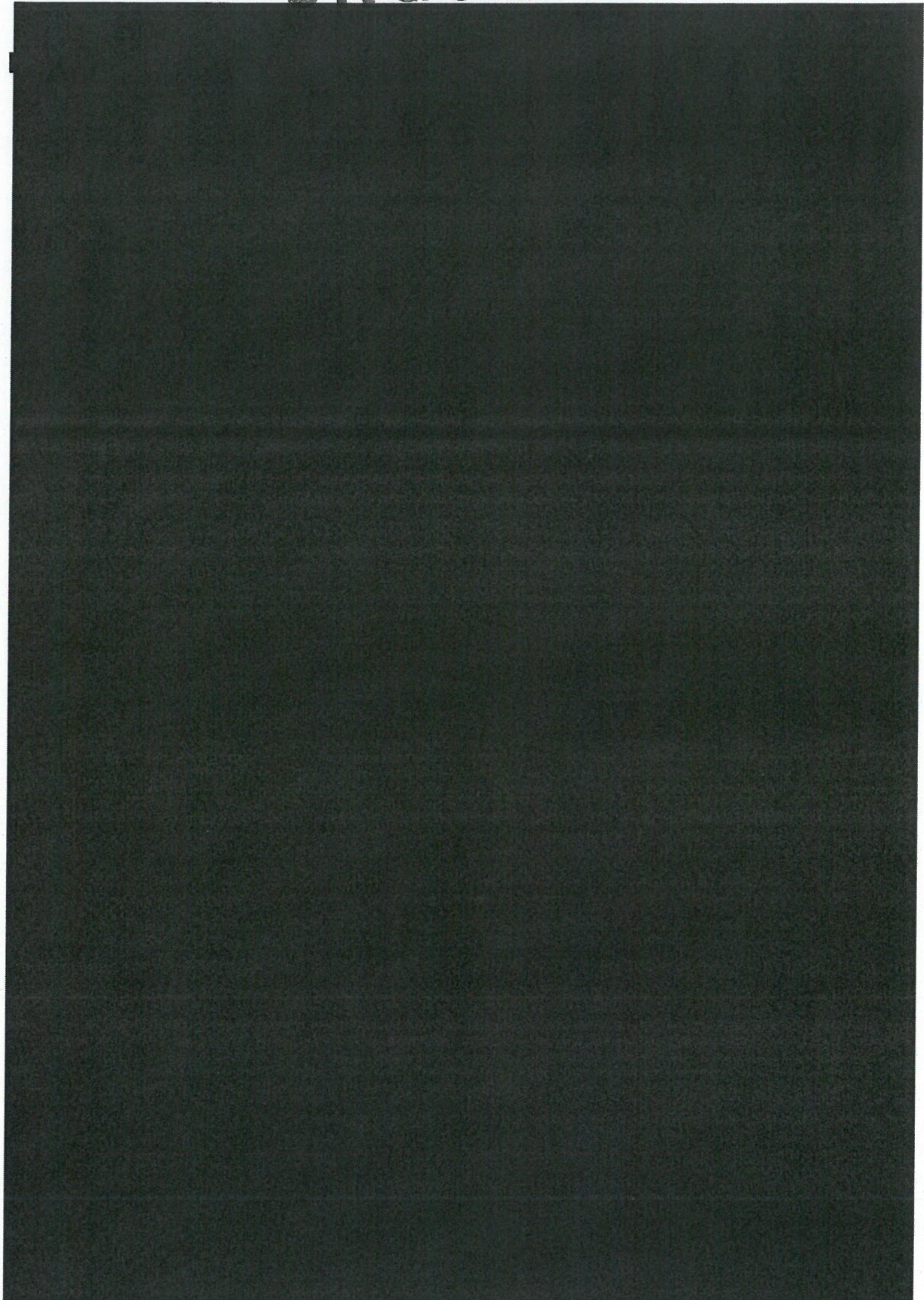

[11] As for ETFs, the asset management companies normally exercise proxy voting rights independently and solely in the interests of their clients and beneficiaries in accordance with their Stewardship Codes.

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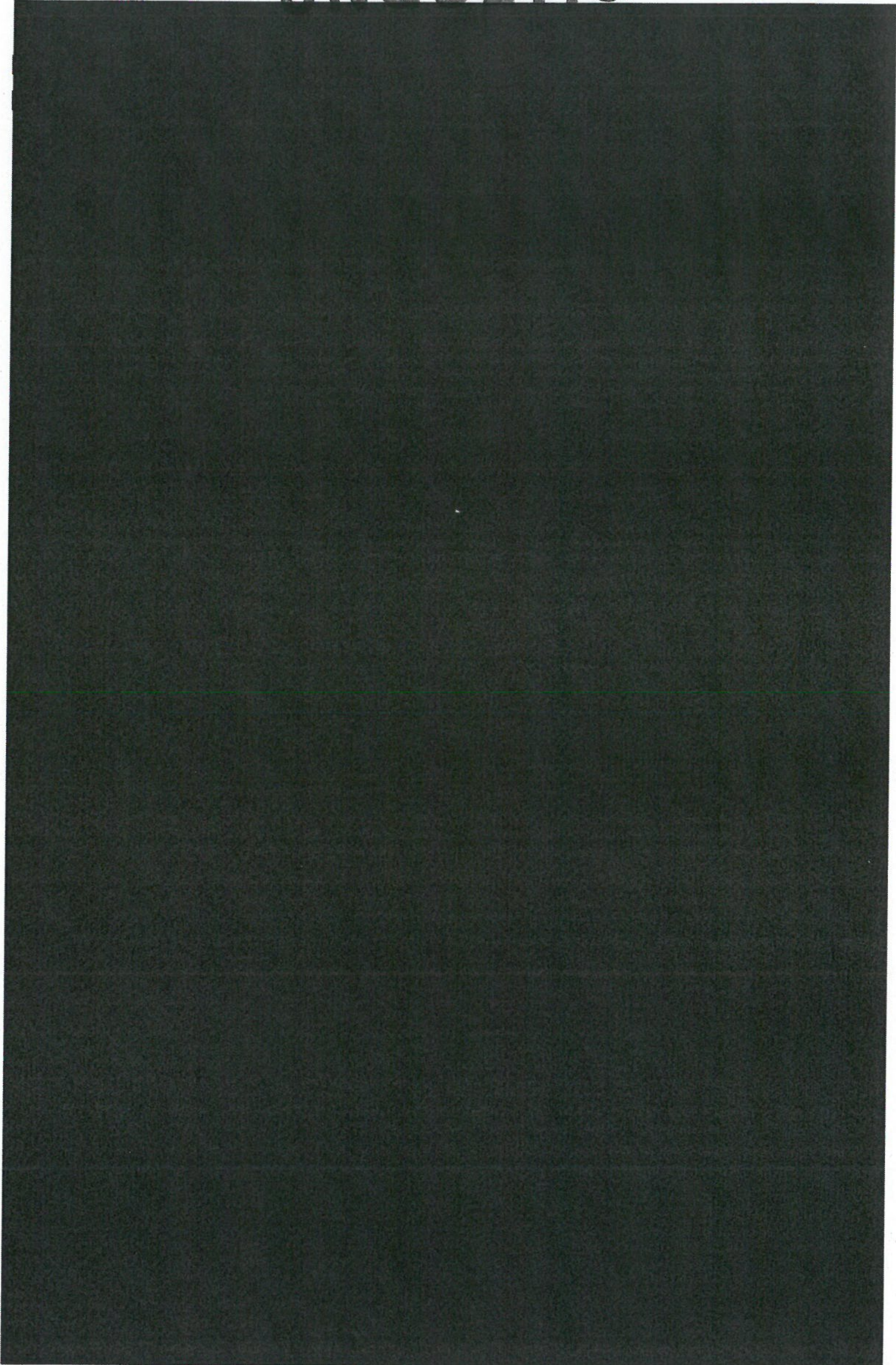

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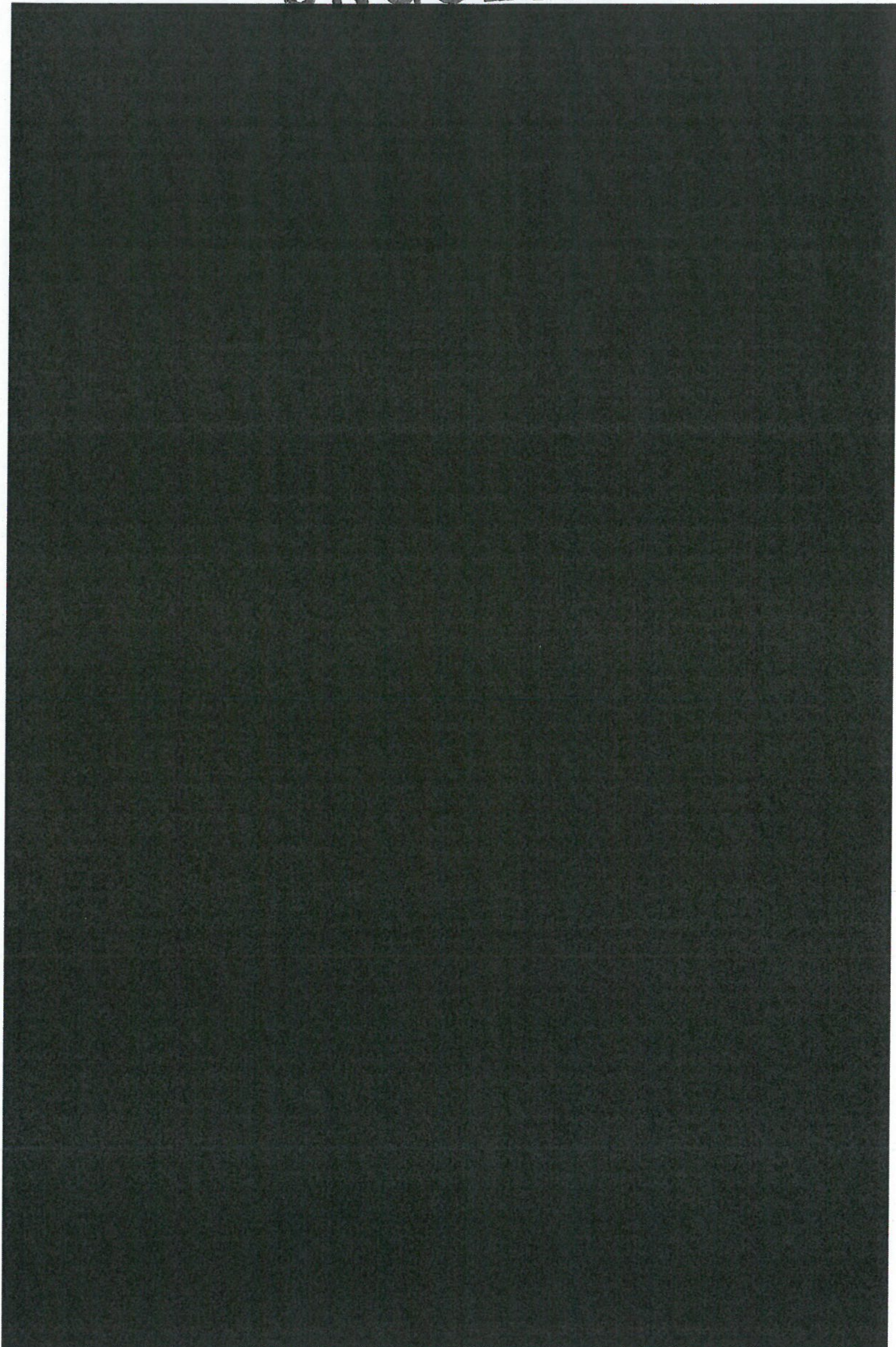

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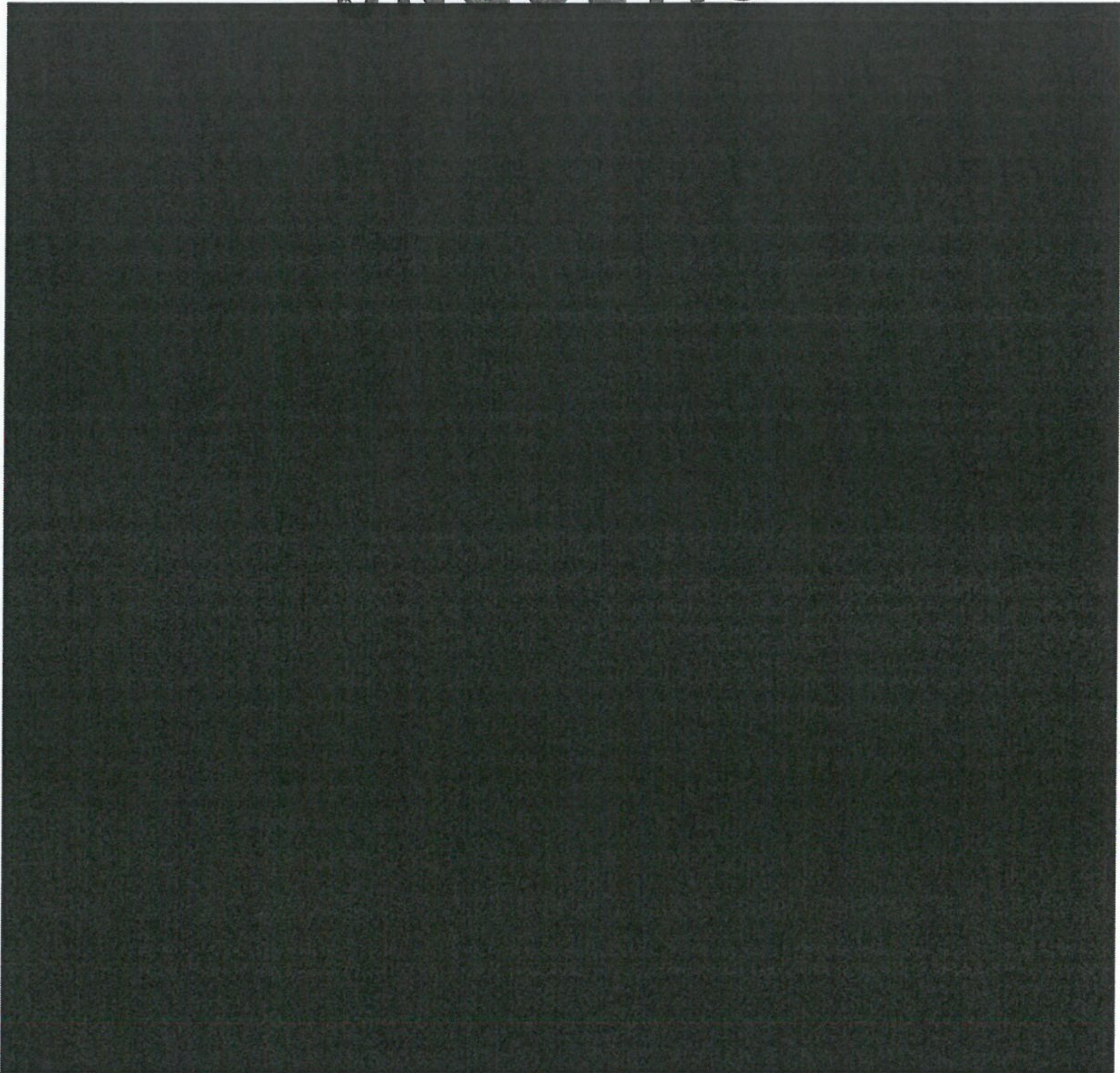

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[12] *The Bank of Japan may not conduct any business other than that specified by this Act as the business of the Bank; provided, however, that this shall not apply to the case where such business is necessary to achieve the Bank's purpose specified by this Act and the Bank has obtained authorization from the Minister of Finance and the Prime Minister.*

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