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Devil is in the Details: ECB Still Needs to Clarify Backstop Goals and Mechanisms

Highlights:

- *The ECB has made strides towards purchasing significant quantities of sovereign debt. However, the specific goals, mechanisms, and other details have not been fully clarified as yet.*
- *Will the ECB subject itself to haircuts in any future debt restructuring? If not, by placing the burden solely on private investors, ECB actions may inadvertently raise yields in specific markets.*
- *While the ECB will seemingly focus on the front-end of the yield curve, the question is exactly how short a maturity will be under consideration for purchase. Whether the purchases will be sterilized or unsterilized is still unknown.*
- *Countries will have to agree to fiscal reforms when requesting bailout funds. Will these reforms reiterate previous austerity commitments or will they be more stringent?*
- *Finally, will the ECB cap periphery yields or spreads? The ECB may continue to be vague on this issue for fear that markets will test the central bank's resolve.*

President Draghi seemingly made a significant step forward last month towards his central bank buying potentially significant quantities of sovereign debt. However, many questions remain as to how exactly and when this would occur. The following analysis addresses what major issues need to be clarified.

Seniority. This is an issue clearly that the ECB has realized has become more and more important, with President Draghi having accepted that the concerns of private investors about seniority will need to be addressed. These concerns intensified following the Greek PSI deal earlier this year when the likes of the ECB refused to be subject to the haircuts which were suffered by private sector bond holders. As a result, the risk is that yields in certain markets could actually rise as a result of ECB debt purchases if private sector bond holders perceived their holdings would be subject to bigger haircuts. As a result, *the ECB may have little alternative but to accept openly that it will definitely participate in any future sovereign debt restructuring*, something it is being pressured into already.

Front-End Purchases Only? It was emphasized at the press conference that the ECB will focus its purchases on the short-end of the curve in order that it more closely follows classical monetary policy than the SMP did. The question is exactly *how short a maturity will be under consideration* for purchase, ie up to a year, or more likely double that. More implicit is that while the focus on short-end purchases has been justified by the ECB as this is where it sees the greatest divergence from 'fundamentals' in terms of heightened risk premia, is the ECB also being over-protective; purchasing short-term bonds carries less risks than buying longer-term.

Sterilization. President Draghi last time around made it clear that it was not yet decided whether any new sovereign bond purchases would be sterilized or unsterilized. It should be remembered that the SMP program that was run previously was sterilized by conducting a weekly liquidity absorbing operation. *More likely than not, the major countries will demand some form of sterilization.* In the short to medium term this should not prove difficult. Indeed, given the current deposit interest rate level of 0%, offering banks even a few basis points of interest, it should not prove difficult to get banks to place the amount required for sterilization on deposit for seven days. However, in the longer term (and especially if vast purchases are implemented) the ECB may have to be more pragmatic in regard to sterilization.

EFSF/ESM Relationship. The ECB has been most insistent that any potential sovereign debt purchases must be associated with the relevant sovereign entering an EFSF/ESM bailout program as this effectively ties the requesting country into implementing economic reforms and fiscal adjustments which the ECB does not have the authority to enforce itself. However, *it is uncertain whether the required reforms and fiscal adjustments will simply reiterate what countries have already committed or will they entail deeper cuts and larger reform programs.*

This is a crucial question as the threat of further measures and the associated additional loss of sovereignty would make governments significantly more reluctant to request help from the EFSF/ESM unless forced to by financial

market pressures. In addition, it will be interesting to see how the ECB will monitor the extent to which countries are adhering to the reform programs and, if not, what sanction may be applied. Indeed, this issue of enforcing reforms is perhaps the most contentious within the ECB, with the central bank fully aware that once it starts bond purchases, it may be locked in regardless.

A second pertinent question is whether the EFSF/ESM would buy bonds in conjunction with the ECB? Given the restrictions the ECB has about only intervening in the secondary market, it is possible that the ECB could purchase at the front end in the secondary market while the EFSF/ESM focuses on the primary market at longer maturities. However, given that the bailout funds have a combined remaining lending capacity of no more than € 500 bln, the most likely scenario is that the only role of the EFSF and ESM will be to enforce conditionality and that they will play very little role in the actual purchase of sovereign debt.

Yield Caps. Perhaps the most blaring omission from the ECB statement in early August was the lack of indication what its objective actually would be. However, in this regard, there has already been ample media speculation in the last few weeks. One option (and one most worrying to the likes of the Bundesbank) would be to bring yields down below a specific publicized capped level and hold them there, ie draw a line in the sand. Another (inter-related) option would be to target spreads, albeit the problems with this course of action being any rise in German yields that may occur on markets sensing a large-scale bond purchase program was in the offing.

More likely, *the ECB could remain deliberately more vague about its aspirations*, the problem being that markets may very well be much more likely to test the mettle of the ECB regularly and so the central bank may very well have to purchase a larger volume of debt than under the former option. Regardless, it will be interesting to see if the ECB promises to be as open about any purchases as it was in regard to SMP where weekly updates were given in regard to size, albeit with little in regard to which bonds.