FEATURE

ECB Launches Mammoth, Open-Ended Bond-Buying Package. Here's Why It Might Work.

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Christine Lagarde, President of the European Central Bank
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The European Central Bank announced on Wednesday night an extraordinary 750 billion euro asset-buying program to help the eurozone fight the consequences of the coronavirus outbreak and support "all citizens of the euro area through this extremely challenging time."

After a late-night videoconference call, the ECB's governing council made it clear that its new "pandemic emergency purchase programme" (PEPP) wouldn't be constrained by the self-imposed limits of its previous and current quantitative easing policies.

The massive ECB effort, coming less than a week after President Christine Lagarde had detailed the central bank's first line of response to the outbreak, was triggered by the widening of Italian government bond spreads in recent days, which indicated that investors were beginning to worry about the country's ability to finance itself.

They need worry no more. The new ECB package is massive — amounting to around 6% of the eurozone's GDP. And it comes on top of the two existing quantitative easing programs — the regular monthly €20 billion purchase of assets, and a new virus-focused tranche of €120 billion announced last week, to be spent before the summer.

Since the extra €750 billion will all be spent by the end of the year, this means that the ECB will altogether buy €1.11 trillion worth of assets on the markets this year. This year alone, the central bank will increase the size of the portfolio of assets it has acquired since 2014 by more than 40%.

Whereas the ECB had been careful in the past to set itself limits on the amount and nature of the bonds it would acquire, it took pain this time to emphasize that its PEPP would be "conducted in a flexible manner." This, it added, "allows for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions."

In other words, the central bank this time has decided to keep the freedom to focus on the securities of a particular country — such as Italy, the country most affected by coronavirus in Europe. As a sign of how far it could go, the ECB also decided to resume buying Greek government bonds, which it hadn't done up till now due to its own eligibility requirements.

The ECB also broadened the type of assets it will buy. It currently includes mostly government bonds, and a little corporate debt. It has now been extended to commercial paper "of sufficient credit quality." This is important, said Gilles Moec, chief economist at AXA, the European insurer, because "this market is under pressure and it's key to the funding of crucial European corporates which don't need that extra concern at the moment."

The package was enough to impress markets, and yields on Italian 10-year bonds shrank from the nearly 3% they had reached on Wednesday to 1.6% on Thursday in morning trading.

But the most important part of the central bank's statement may have been the promise of open-ended action, if the coronavirus consequences prove more severe than currently envisioned.

First, the ECB warns it will "consider revising" the remaining limits to its action (notably on the geographic allocation of the bonds it acquires, and the 30% limit on any given bond) "to the extent necessary to make its action proportionate to the risks that we face."

Second, the central bank warns that it is "fully prepared to increase the size of its asset purchase programmes and adjust their composition, by as much as necessary and for as long as needed." In other words, the $750 million isn't a ceiling.

And finally, in a cryptic sentence, the ECB also seemed to open the way to new forms of action, yet to be determined, that would benefit all economic agents and not only governments or banks. It promises to "ensure that all sectors of the economy can benefit from supportive financing conditions that enable them to absorb this shock. This applies equally to families, firms, banks and governments."

So, from now on, "nothing can be ruled out in the future to support all economic agents using existing tools or new ones, summed up Frederik Ducrozet, global macro strategist at Pictet Asset Management.

The ECB’s massive program now puts the onus on eurozone governments to come up with a credible and coordinated fiscal plan to fight the pandemic’s consequences. Wednesday’s decision shows “that the ECB is still the primary (only) game in town and the eurozone remains highly vulnerable,” tweeted Oliver Rakau, chief German economist at Oxford Economics.

Marcel Fratzscher , the head of the DIW economic institute in Berlin, concurred: “Fiscal policy in Europe now needs to step up urgently. The ECB cannot prevent insolvencies, only governments can,” he tweeted.