ECB reacts to recent bond spread widening

An ad hoc meeting less than a week after an official meeting is a strong sign of emergency at the European Central Bank. ECB members, however, were not able to agree on any tangible action but tasked the so-called committees to speed up the work on an anti-fragmentation tool

When the ECB goes into an ad hoc meeting less than a week after its last official rate-setting meeting, we know it must be an emergency. The widening in bond spreads but also the increase in funding costs has made monetary policy in the eurozone significantly more restrictive, even before the very first rate lift-off. The widening in bond spreads has immediately brought back bad memories of the euro crisis in 2010 and 2012. But we think concerns about a rerun are overdone. The eurozone is institutionally better prepared to face such a challenge; high inflation could actually benefit debt-to-GDP ratios and also bring windfall revenues, plus Italy had primary balance surpluses prior to the start of the pandemic.

Still, we also know from the past how fast market speculation and gossip can become a selffulfilling prophecy and that it is often more attractive to pre-empt the speculation than react too late. This is apparently why the ECB scheduled today's ad hoc meeting. The just-released press statement basically repeated the message from last week that the ECB will use the reinvestment of its Pandemic Emergency Purchase Programme purchases to tackle the unwarranted widening of spreads. More importantly, the ECB announced that it tasked the "relevant Eurosystem Committees together with the ECB services to accelerate the completion of the design of a new anti-fragmentation instrument for consideration by the Governing Council."

What such an instrument will eventually look like remains unclear. Experience from the past has shown that only asset purchases are really effective in controlling bond spreads. A very strong and convincing announcement could also do the trick. Remember that Mario Draghi's 'whatever it takes' speech, followed by the Outright Monetary Transactions programme, proved to be the most efficient means to control bond yields without spending a single euro. At the same time, however, the experience of March 2020 shows that actual purchases of bonds were needed to stabilise bond spreads. To make things even more complicated, it will be hard for the ECB to present new asset purchases so soon after it announced the actual ending of existing asset purchase programmes. Consequently, the only way out seems to be a programme that is tailor-made to tackle the unwarranted widening of spreads with certain conditions attached, as was the case with the OMT.

What the ECB didn't address today, however, is the issue of forward guidance. The current problem in financial markets is not only the widening of spreads but also the more general increase in rates. And the latter is also the result of the ECB's forward guidance from last week, opening the door to a series of rate hikes beyond the intended and expected normalisation of rates over the summer.

All in all, this is not the first time that the ECB has been overtaken by market developments. The March 2020 experience should have been more prominent in the ECB's institutional memory. Looking ahead, we still expect the ECB to hike interest rates by 25bp in July and 50bp in September with another 25bp hike in the winter. Also, the July meeting is now likely to bring more details on an anti-fragmentation programme.

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