Alea iacta est

As Julius Caesar crossed the Rubicon in 49 BC, thereby plunging irrevocably into conflict with his own countrymen, he is supposed to have uttered the words “Alea iacta est” – “the die is cast”. The Governing Council of the European Central Bank (ECB) may have expressed similar sentiments as they announced open-ended purchases of government debt last week. Not that this is the first Rubicon that the ECB has crossed; just think of the initial tentative bond purchases in the Securities Market Programme (SMP) a year ago and the Long-Term Refinancing Operations (LTRO) a few months later.

The ECB crossed this last Rubicon far less decisively than Julius Caesar crossed his. The new Outright Monetary Transactions (OMT) are an impressive commitment but not a whole-hearted commitment. True, the ECB has not put a limit on its purchases but it is only willing to purchase debt with a maturity of three years or less. True, it is buying debt in riskier countries, but only if those countries sign up to a European Financial Stability Facility (EFSF) or European Stabilisation Mechanism (ESM) programme which come with strict conditionality. Despite this slight reluctance, the ECB has most definitely plunged into an irrevocable commitment to fight against the sovereign crisis.

The markets were suitably impressed. Sovereign yields in Italy and Spain fell substantially after the initial announcement last month that the ECB was considering a new programme to purchase government bonds. As more details were rumoured and then finally released on Thursday, the rally continued (see chart).

This kind of reaction to a policy announcement is familiar. There were similar movements in Spanish and Italian yields when the ECB announced the 3-year LTRO. Unfortunately, for the LTRO the reaction proved short-lived. It is plausible, then, to ask whether we can expect the most recent drop in yields to fade away as well. A good starting point would be to compare the potential of the OMT programme relative to other ECB programmes, and in particular to look at the main concerns of the market. On the face of it the OMT is promising on four key areas that concern the market.

Veni, vidi, vici

Spanish and Italian 3-year bond yields

Source: Bloomberg, UBS Global Asset Management
The first is the conditionality imposed on the sovereigns. In the short term, the market would probably have been happiest with no conditionality because the buying by the ECB would then be more certain. Politically, conditionality is a necessity for the ECB so that it is not writing a blank cheque. Longer-term, it is also better for the markets because it will help to deal with the underlying problems of debt sustainability. The drawback is that some countries, particularly Spain, are not keen on signing up to any additional conditionality.

With the OMT the ECB has managed to steer a decent middle course. Rather than impose its own conditionality, as many feared, the ECB has simply insisted that it will only buy bonds of countries that have signed up to the conditionality that goes with a bailout from the EFSF or the ESM. This works nicely for the ECB because it leaves the conditions to the politicians (which helps preserve ECB independence), and it also means that there is fiscal support from the EFSF or ESM to back up the monetary support.

The outstanding question is whether the ECB will be buying bonds from countries that are already in an EFSF/ESM programme. In the case of Ireland this is not much of an issue, but does it mean that the ECB should be buying Portuguese debt? And how about Greece? To avoid this rather unwelcome implication the ECB will only be providing support to countries that are attempting to issue new debt in the market. After all, what is the point of buying debt in the secondary market to get interest rates down if the sovereign is not issuing any new debt to take advantage of the lower interest rate? This way the ECB will only buy bonds that the market is also willing to consider buying.

The second concern for the markets was the maturity of the debt that would be purchased. There are really two problems with the monetary transmission mechanism in the bond market: the first is the transmission from the central bank rate at the short end into longer-term rates, and the second is the transmission from the central bank rate into the short end of different countries. Unlike the Federal Reserve and the Bank of England, who had the luxury of only having the first problem to deal with, the ECB is focusing on narrowing the spread between countries at the short end. Without the OMT the ECB effectively has lost control of monetary policy in the periphery economies. If the associated reforms are successful, and the market believes that the ECB action buys enough time for countries to reform, then longer-term rates should move as well.

Another concern amongst the markets was that the ECB would claim seniority for the bonds it purchases, but in the event it did not. To do so could have been self-defeating because it would have pushed prices lower for the remaining bonds as investors would need to price in a bigger loss in the event of a default. A demand for seniority would also have been a message that the ECB did not trust the countries to hold to their commitments. Just think what the message would have been to markets if the Fed had said that it was buying US Treasuries but was worried enough about default that it wanted seniority!

The last remaining concern is the yield at which the ECB would buy bonds. To put it another way, at what level would the ECB consider bonds to be fair value and stop buying them? On this matter the ECB is playing its cards close to its chest. In part this is to allow it enough flexibility. For example, if a country is falling behind on its EFSF/ESM programme the ECB could frighten it into compliance by letting bond yields drift higher. Another motive for keeping the target levels of yield hidden is that the uncertainty could encourage markets on their own to push yields even lower than the ECB would in fact be willing to push them through purchases.

It was a brave step that the ECB took this week. Despite protestations to the contrary, it is moving further and further away from the strict interpretation of its mandate. In just the same way, Julius Caesar insisted that he did not start a civil war to take control but only to preserve his “dignitas”. There are other similarities as well – Caesar faced dissension in the ranks and one of his inner circle, Marcus Junius Brutus, turned against him and became a dangerous opponent. Many might consider Jen Weidmann, the President of the German Bundesbank, in this role.