Global Macro Views – The Downside of ECB QE

June 2, 2022

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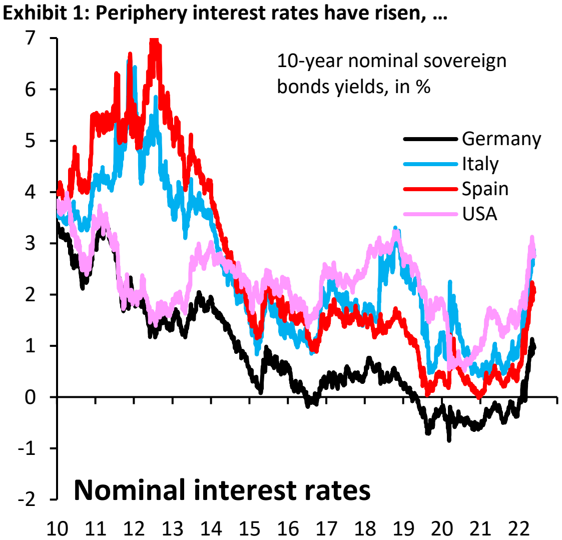
- ECB QE helped anchor Euro periphery yields during COVID, …
- a welcome step given turmoil in global bond markets at the time.
- But the stability that low periphery yields convey is a bit deceptive, …
- because low yields don't compensate investors for perceived risks, …
- so that those investors that can sell – foreigners – head for the exit.
- Dependency of periphery sovereigns on ECB QE has likely grown, …
- something that only higher yields and wider spreads will resolve.

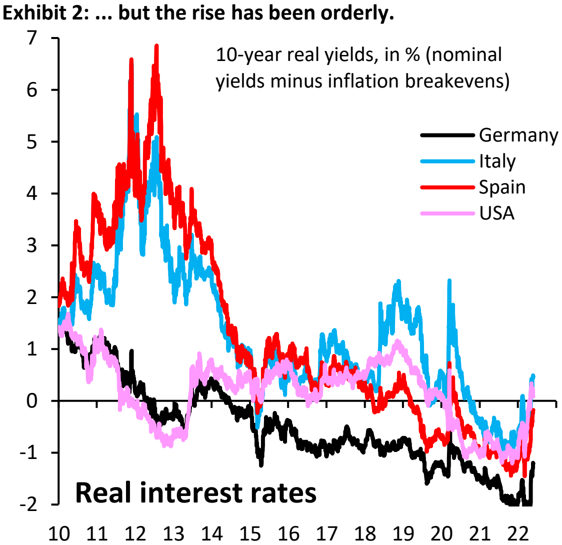
High inflation is pushing the ECB to normalize policy. We think this is a mistake, given that we expect the war in Ukraine to push the Euro zone into recession, which reduces the risk of supply shocks spilling over into broader inflation. It seems to us that inflation is therefore yesterday's problem, but the Governing Council does not seem to share this view, with rate hikes and an end to QE coming in the next few months. It is still the case that periphery yields have been quite well behaved, but this picture is deceptive. The era of low periphery yields that began with then ECB President Draghi's famous *"whatever it takes"* comment in July 2012 has taken yields below where private investors think they should be given the risks. As a result, the least encumbered private investors – foreigners – have been cutting their holdings of periphery debt, which has the unfortunate side-effect of making the periphery more and more dependent on the ECB. As the ECB moves to normalize policy, calls will grow that widening spreads signal *"financial fragmentation."* But wider spreads are the only way to lift the Euro periphery out of this ECB-dependent equilibrium.

Exhibit 1: Periphery interest rates have risen, …



Source: Haver, IIF

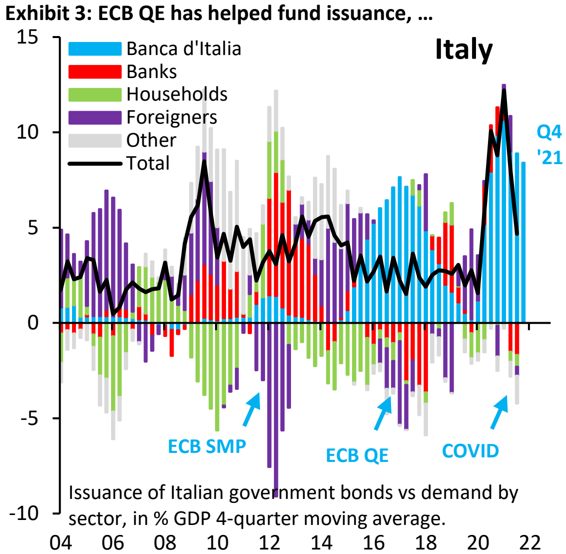
Exhibit 2: … but the rise has been orderly.



Source: Haver, IIF

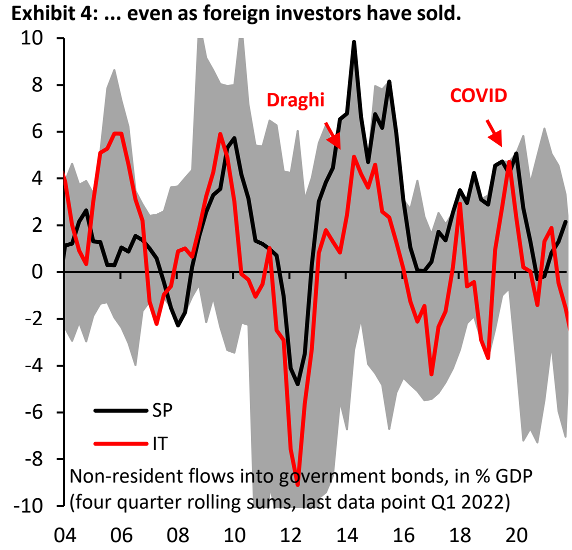
The global inflation scare has sent nominal bond yields up sharply (Exhibit 1), but the impact on the Euro periphery has so far been modest. One way to see this is to look at real longer-term interest rates, which in Italy remain only slightly above the US (Exhibit 1). However, this picture is deceptive, as the sheer scale of ECB QE since COVID has anchored periphery yields below where markets would set them (Exhibit 3), so that those investors that are the least encumbered – foreigners – have been cutting their holdings. This problem doesn't apply with equal severity across the Euro periphery. There appears to be more of an issue for Italy than Spain looking at non-resident flows into government bonds in recent years. Indeed, in the four quarters to Q1 2022, foreign selling of Italian government debt exceeded that during the chaotic early stages of COVID in 2020, while foreign interest in Spain looks to be rebounding (Exhibit 4).

Exhibit 3: ECB QE has helped fund issuance, ...



Source: Haver, IIF

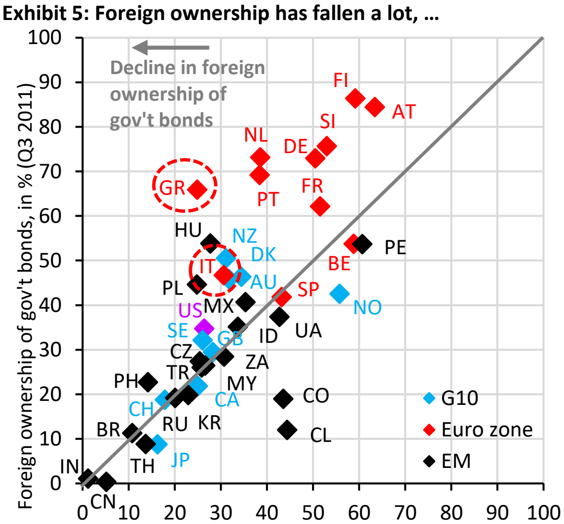
Exhibit 4: ... even as foreign investors have sold.



Source: Haver, IIF

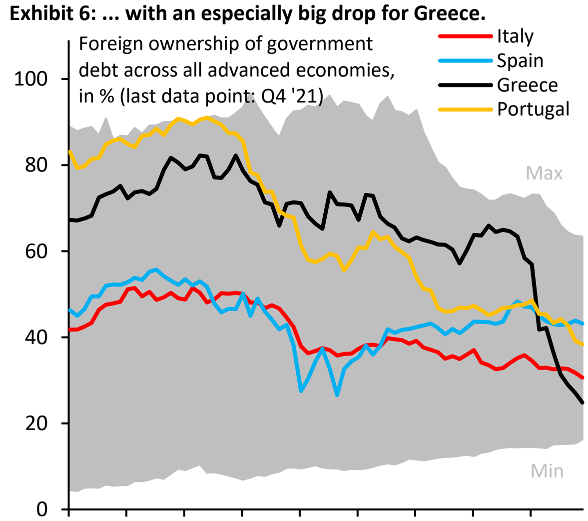
The era of low periphery yields, which began with then President Draghi's now famous *"whatever it takes"* remark in July 2012, has transformed who holds Euro periphery debt. Foreign holdings have fallen sharply across the board, most obviously so for Greece and Italy (Exhibit 5), perhaps because this is where yields are most out-of-sync with markets' perception of risk. After a sharp drop in foreign interest at the height of the sovereign debt crisis in 2011/12, foreign ownership of Italian sovereign debt has edged down only slightly, while for Greece it collapsed abruptly with the start of COVID (Exhibit 6). The void left by foreigners must be filled by the ECB, especially at a time when recession and the energy transition will boost deficits. Beneath the surface of well-behaved yields lies growing dependence of Italy and Greece on the ECB, which is something only higher yields – which will attract private investors back into periphery bonds – can fix. Unfortunately, wider periphery spreads are therefore something of a necessary evil.

Exhibit 5: Foreign ownership has fallen a lot, ...



Source: Haver, IIF

Exhibit 6: ... with an especially big drop for Greece.



Source: Haver, IIF