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The TPI: a useful step, just a step

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The TPI: a useful step, just a step

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Abstract

The new Transmission Protection Instrument is well designed to cope with the risks of the monetary policy normalisation now under way. However, it is the third time that the ECB must craft an emergency instrument to cope with new risks. It is desirable to start work toward making the ECB a normal lender in last resort to governments.

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LIST OF ABBREVIATIONS

APP	Asset purchase programme
DSA	Debt Sustainability Assessement
ECB	European Central Bank
EP	European Parliament
EU	European Union
OMT	Outright Monetary Transactions
QE	Quantitative easing
QT	Quantitative tightening
PEPP	Pandemic emergency purchase programme
SGP	Stability and Growth Pact
TPI	Transmission Protection Instrument

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EXECUTIVE SUMMARY

- **The Transmission Protection Instrument is well crafted and stands to deliver on what the ECB needs**: normalise monetary policy and avoid deepening interest spreads across the euro area. It alleviates concerns that financial instability could derail the normalisation process that lies ahead.
- **Rising spreads in high-public-debt countries would not only prevent the transmission of monetary policy, it could also raise the prospect of a breakup of the euro area once again**. Higher interest rates stand to challenge the view that all public debts are sustainable. Public debt crises are inherently destabilising.
- **The Transmission Protection Instrument benefits from a first line of defence**. The ECB has started to use income from repayment of the maturing debts acquired during the Pandemic Emergency Purchase Programme to purchase debts issued by highly-indebted governments. If this line of defence is enough to keep market stability, the ECB may avoid having to actually use its new instrument, but there is no guarantee that this will be the case.
- **Beyond raising the interest rates, the ECB will also have to undertake quantitative tightening**. The current quantity of liquidity translates into vast amounts of excess reserves, which commercial banks could mobilise to expand credit and thus feed inflation pressure. Quantitative tightening stands to remove the cushion of liquidity that has long stabilised the financial markets and made it possible for governments to borrow heavily.
- During the debt crisis and at the outset of the COVID-19 pandemic, the ECB has put in place large-scale asset purchase programmes. **The Transmission Protection Instrument is the third programme of this kind.** Like its predecessors, it includes conditions that are closely tailored to the current situation.
- **In contrast to other central banks, the ECB does not feel that it can intervene as lender of last resort to member governments**. This is why it has to set a new programme whenever such interventions are needed, or may become indispensable. Not only is this step-by-step inefficient, but it also stands to raise suspicion on the ECB's ability to carry out the programmes.
- **The rapid response of the ECB and the quality of the new instrument should not hide that it is highly desirable that the central bank be equipped with a permanent instrument**. Such a step, however, is beyond the reach of the ECB alone. A permanent emergency asset purchase instrument – the ability to act as lender in last resort – requires that governments overcome mutual suspicions, adopt an effective fiscal discipline instrument (the Stability and Growth Pact has failed) and agree on what to do with current excessive public debts.

1. INTRODUCTION

On 21 July, the European Central Bank (ECB) formally announced the adoption of the Transmission Protection Instrument (TPI). This new instrument is officially designed to ensure that the key monetary policy instrument, the interest rate, applies throughout the euro area. The issue is much deeper, as explained in Section 2. At stake is the very existence of the euro as it faces recurrent market pressure on some national public debts. The TPI is judicious at this juncture, especially as it is complemented by a flexible exit from the Pandemic Emergency Purchase Programme (PEPP) adopted in 2020. Yet, as its predecessors, the Outright Monetary Transactions (OMT) programme and PEPP, it is a response to a specific situation, not to a structural flaw of the euro area's architecture.

A better "ideal" solution is possible, as sketched in Section 3. Unfortunately, this solution seems out of reach at this junction. As a result, the ECB is left with the need to proceed in a piecemeal fashion, putting down occasional flares. The TPI is likely to fulfil this task over the next couple of years (Sections 4 and 5), unless new threats materialise, which remains a distinct possibility in the current unstable geopolitical environment.

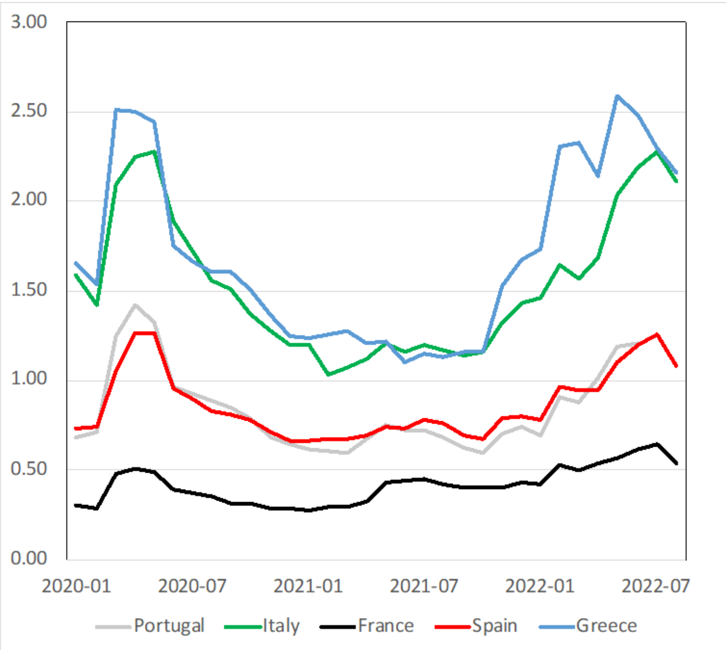
A more "permanent" solution, short of the ideal one, can be imagined. It would have to be entirely designed by the ECB but, of course, it must be acceptable to all Member States and recognised as legally compatible with the existing Treaty. Section 6 describe its key building blocks.

None of the above deals with the structural weakness that lies at the root of the problem, namely the fact that a number of member countries have accumulated very large public debts. Section 7 recalls that this risk was well understood when in the 1990s, the euro area was designed. Unfortunately, the solutions that were adopted then, mainly the Stability and Growth Pact (SGP) and the "no-bailout" clause, were ill-designed and predictably failed. Decades later, the problem has been recognised but partial reforms have, if anything made it more intractable. Even worse, public debts are now considerably larger and therefore more threatening.

2. THE PROBLEM: NOT JUST TRANSMISSION

Ever since the debt crisis of 2010-15, the ECB has been talking about the dangers of financial fragmentation. It is concerned that the markets may consider that financial risk differs across member countries, which would break the integration of financial markets. Markets are integrated when interest rates on assets with the same maturity and perceived riskiness are equal. Deviations from complete integration emerge for a host of reasons, including tax treatment, regulations, legal systems, liquidity and depth of the markets, and systemic riskiness. A key objective of the monetary union has always been to achieve full integration so that there is a single financial market. The now-familiar Figure 1 displays the spreads between interest rates on national public bonds of ten-year remaining maturities and the corresponding German rate since January 2020. These spreads are the usual gauge of market pressure and a measure of barriers to the transmission of the single monetary policy. Clearly, full integration has not been achieved in the public bond market.

Figure 1: Interest rate spreads on ten-year public bonds (relative to German bonds)

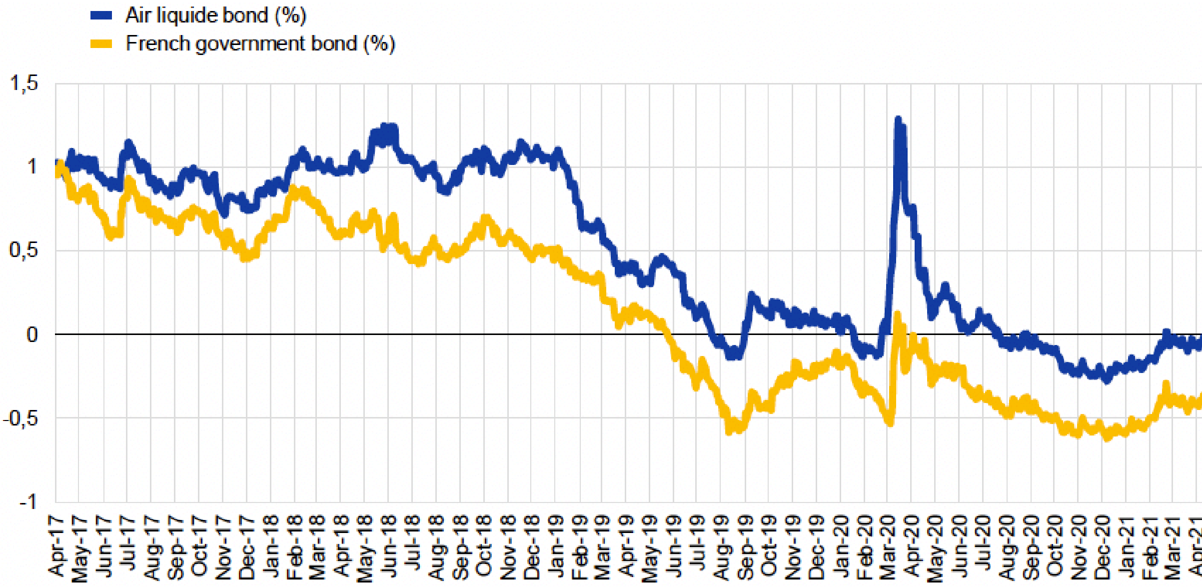


Source: OECD.

Still, integration could be achieved in the private bond markets if the interest rates that private firms pay on their borrowing were independent from the rates faced by their governments. It would seem logical that private investors should evaluate a firm's riskiness on the basis of its performance, past, present, and future, without paying attention to what its government does. In fact, the evidence is that corporations systematically borrow at higher rates than their own governments, at least in the developed countries. Figure 2 provides an example that compares the borrowing cost of the French Treasury with that of a highly-rated French corporation.

The dependence of private borrowing costs on public borrowing costs reflects the fact that a government is normally seen as the safest borrower in the land, because it has the power of taxation. When the financial markets start worrying about the sustainability of a country's public debt and require higher interest rates for further lending, we could imagine that the interest rates faced by highly-reputed corporations do not rise. This is not the case (see for example Graham et al., 2014), for several reasons. One of them is that investors shift out of corporate bonds to take advantage of rising returns available on Treasury bonds – the crowding-out effect. In troubled times, the most likely reason is that any run on a public debt is likely to adversely affect private corporations. First, the government may raise taxes on corporations, which would cut into profitability. Second, the attendant crisis is bound to harm growth, with a negative impact on the profitability and riskiness of local firms. Third, this effect is reinforced within the monetary union by the spectre that the country could have to abandon the common currency, which is bound to trigger deep economic and political turmoil.

Figure 2: Borrowing costs of the French Treasury and of Air Liquide



Source: Herbert et al. (2021).

Given that public and private bond markets underpin the financial market, the deviations reported so far imply that euro area financial markets are not fully integrated. Furthermore, the extent of these deviations can vary, quickly and sizeably, in response to variation of the spreads such as those visible in Figure 1. The upshot is that growing concerns about the sustainability of some countries' public debts can result in financial market disintegration. When this happens, the ECB can no longer establish identical, or fairly similar, interest rates among member countries. This is why it is rightly concerned about the transmission of its monetary policy decisions. In the current situation, now that it has embarked on a path of rising interest rates, it fears that the higher borrowing costs faced by some governments, which will lead to larger debt service, can considerably worsen the sustainability of large existing debts.

Transmission difficulties, however, are not the only concern, not even the main concern. Lurking in the background is the possibility that the required monetary policy normalisation may lead to a full-blown debt crisis reminiscent of the early 2010s (Wyplosz, 2022). At that time, the ECB talked about the risk of denomination, a shorthand for a country leaving the euro and adopting again its previous currency. The current language, which refers to the transmission of monetary policy, or the slightly more dramatic risk of financial fragmentation, should not hide the fundamental fear of a break of the euro area. This is really what is at stake and the key reason for adopting TPI (Gerlach, 2022).

3. THE IDEAL SOLUTION

In the developed countries outside the euro area, it is well understood that the central bank will always guarantee the sustainability of its government's debt. This guarantee is implicit and often not even acknowledged but quite obvious because the alternative is to let the government default on its debt. The economic and political consequences of the ensuing deep financial crisis are too unpredictable to brush aside. The guarantee can be exercised in a number of ways but, in the end, it will take the form of large-scale purchases of the public debt by the central bank, with no ex ante limit. Aware of this potential intervention, the financial markets will not fire-sell the public debt.

The guarantee does not come for free. It may result in large and growing inflation if the central bank actually needs to intervene and create large amounts of money to support the public debt. Still, even for a central bank, inflation is less dangerous than a debt default that will be inflationary anyhow. The pressure imposed on the central bank is usually referred to as fiscal dominance and it is the reason why central banks were made independent a few decades ago. Independence aims at monetary dominance, whereby governments manage their finances knowing that they will not be able to order their central banks to create money to help out with deficits and debts.

Monetary dominance, however, is a subtle concept. If the public debt becomes large, the risk that financial markets fret about unsustainability grows. A frequent situation is that markets react pre-emptively, if only because debt sustainability is nearly impossible to assess (Wyplosz, 2011). Fearing losses implied by a debt crisis, investors attempt to sell their holdings, which triggers a crisis even though the debt may not (yet) be unsustainable. Such self-fulfilling prophecies are symptomatic of the possibility of multiple equilibria: there may be a quiet – no crisis – equilibrium because the debt is sustainable, or a crisis equilibrium – the debt becomes unsustainable because of the crisis. Central banks have a strong incentive to eliminate the crisis equilibrium and intervene on their own free will. The distinction between fiscal and monetary dominance is not always clear-cut (Obstfeld, 1986).

The ideal solution, which is in place in developed countries outside the euro area, considerably reduces the odds of a self-fulfilling debt crisis. The ECB currently operates in an environment that leaves some doubts about its willingness to act as other independent central banks do. Even though the ECB is arguably more independent than most other central banks, it is hampered by the no-bailout clause spelled out in Article 125 of the Treaty on the Functioning of the European Union. Although the clause does not prevent large-scale purchases of public debt on the secondary market, OMT has been legally challenged in front of the German Constitutional Court and of the European Court of Justice. Their judgments have deemed OMT legal but with provisions that are a source of important ambiguity. Fully removing this ambiguity would make the ECB a "normal" central bank and help dispel the threat of self-fulfilling prophecies. Because this step probably would require an amendment of the Treaty, the ideal solution remains out of reach at this stage.

4. THE TPI FRAMEWORK

4.1. A powerful instrument

The TPI addresses the risks of self-fulfilling crises, by ticking all the relevant boxes:

- The net is cast appropriately wide since the ECB intends to purchase public securities of national and regional governments as well as public agencies. It even envisions purchases of private securities, presumably in anticipation that a public debt crisis affects private corporations because of the mechanism described in Section 2.
- There is no limit to the purchases. This is a critical requirement since it implies that private investors, whose resources are structurally limited, cannot "win the war" against unlimited interventions of the central bank, which can create as much money as necessary. The promise of unlimited interventions is a necessary condition to rule out self-fulfilling crises. It explains why the "whatever it takes" statement made the OMT announcement so powerful.
- As the holder of a significant share of government bonds, the ECB accepts the pari passu clause: in case of a partial or total default, it will claim no repayment priority relative to other bondholders. As the ECB takes the risk of sharing losses with private bondholders, market pressure is lessened. In practice, the risk for the ECB is minimal since the TPI stands to considerably reduce the likelihood of a self-fulfilling crisis.
- Finally, the ECB leaves open the possibility of using its previous debt crisis-preventing instruments. OMT can be invoked and, more importantly, it will twist its disengagement from PEPP by reinvesting previously purchased maturing bonds into the national debts under market pressure. This "first line of defence" sets the TPI as a last-resort intervention, which is consistent with other central banks' implicit commitments to back public debts.

4.2. Conditionality

Like in the cases of OMT and PEPP, the ECB ties its hands on the use of TPI. This is where the weight of the political and legal constraints makes the ECB stand apart from other central banks. TPI interventions are subject to four eligibility criteria:

- The country must be in good standing regarding the Stability and Growth Pact and related elements of the fiscal discipline apparatus, such as the Excessive Imbalance Procedure. This condition can be interpreted in two, not mutually exclusive, ways: 1) It provides some protection against fiscal dominance; 2) It serves as a cover against potential criticism that the ECB supports governments that are fiscally undisciplined. However, it also ties TPI to the current specific situation since the Stability and Growth Pact is suspended until the end of 2023. Beyond that, the ECB may not be able to protect all public debts with TPI.
- The public debt must be deemed sustainable. The ECB conducts its own Debt Sustainability Assessment (DSA) procedure, but it also intends to take into consideration DSAs from other institutions like the IMF, the European Commission, or the European Stability Mechanism. As noted in Section 3, DSAs are notoriously imprecise. They are also highly subjective since they rely on assumptions that are unverifiable. In practice, this condition leaves the ECB quite free to back its decision as it sees fit.
- The country must comply with its commitments under the Recovery and Resilience Facility. This condition is an insurance against the risk that a government backtracks on its intentions

to conduct important reforms. It also addresses the risk that a newly appointed government reneges on its predecessor's commitments. Not only does this condition ties the TPI to the current situation but it also transparently aims at the political evolution under way in Italy. Reneging on these commitments expose a government to lose both the promised grants and loans but also the protection of the ECB.

4.3. Limits

The TPI comes close to what is expected from single-country central banks. The difference is that other central banks do not have to build a specific instrument. They do not describe what they will do if the national public debt comes under market pressure but there is no doubt that they will conduct unlimited interventions, possibly extending purchases to private assets. They do not tie their hands with eligibility conditions because they know that a full-fledged debt crisis is catastrophic and may well lead to uncontrolled inflation. This constructive ambiguity may help with the risk of fiscal dominance but, in the end, the other central banks know that they have no protection against a government that is determined to be fiscally undisciplined. When national politics fail, central banks can only act as fire-fighters.

The ECB feels the need to set conditions and to explain in quite some detail what it will do because it serves several countries. Its interventions may result in significant transfers across countries, usually from the better disciplined to the less disciplined ones. Keen to eliminate such a risk, the founding fathers of the euro area adopted Treaty-based measures. Some of these measures target the member governments, others constrain the ECB. When member governments fail to live up to their commitments, for good or bad reasons, the ECB remains constrained.

The response has been the creation of new anti-crisis instruments: OMT, PEPP and now TPI. Each one is precisely tailored to the existing situation through a set of conditions. OMT ties central bank interventions to the presence of interventions by the European Stability Mechanism, PEPP concerns responses to the pandemic and TPI deals with the on-going process of interest rate normalisation. The TPI's two first conditions, compliance with the Stability and Growth Pact and the Macroeconomic Imbalance Procedure are moot until the end of 2023. The third condition is window-dressing designed to protect the ECB from criticism and litigation. The last condition, compliance with the Recovery and Resilience Facility is important to bind governments under the current circumstances. No matter how well-crafted they are, these conditions do not come for free.

They may reflect some degree of hesitancy, born out of underlying disagreements between fiscally disciplined and undisciplined governments. A possible consequence is that the financial markets may test the ECB's determination. OMT was never tested but, in the coming period, the ECB may have to conduct large-scale purchases to convince the markets of its determination. This may turn out to be dangerously controversial for the following reasons.

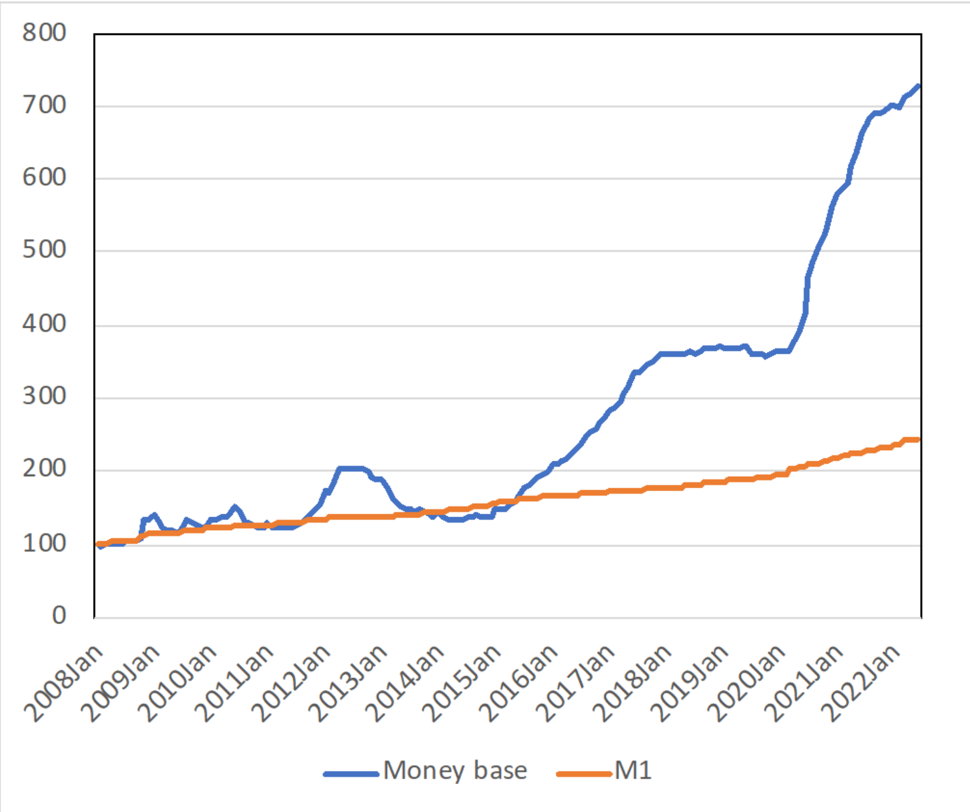
In its ruling accepting the legality of the OMT programme, the European Court of Justice noted that the purchases must be proportionate to the existing risk (Court of Justice of the European Union, 2015). While the TPI acknowledges the proportionality requirement, it also indicates that "the scale of TPI purchases would depend on the severity of the risks facing monetary policy transmission. Purchases are not restricted ex ante." This last sentence allows for unlimited purchases, a necessary condition for assured effectiveness. Obviously, the ECB must be hoping that it will be possible to avoid any escalation, and even any purchase at all. But should the markets test the ECB, an escalation cannot be ruled out. Assessing the risks and defining proportionality are murky undertakings, which could seriously impede the interventions.

Moreover, political considerations could interfere. Section 4.4 explains why TPI will be a requirement for bringing inflation down. Given the wide differences in size of national public debts, monetary policy normalisation stands to destabilise public debts in some countries, not in others. This could lead to divergent support for monetary policy normalisation, while interventions under TPI also stand to trigger deep disagreements.

4.4. TPI and inflation

The creation of the TPI is directly driven by concerns for debt instability now that the ECB has embarked on a new policy phase designed to bring inflation down to target. To that effect, it will have to raise its interest rates and reduce the monetary aggregates. Figure 3 shows that the money base has increased more than sevenfold since January 2008. This increase supported a rise of the narrow aggregate M1 by a factor of 2.4. The difference between the two aggregates and the fact that inflation remained low until 2021 indicate that the banking system has been transformed in the aftermath of the global financial crisis (Section 5.2 provides an explanation). The normalisation of monetary policy, including the end of negative interest rates, is likely to re-establish a long-run link between the monetary aggregates and inflation. It is far too early to even speculate how the link will operate in the future, but it is clear that the size of the monetary base will have to be reduced, possibly very significantly. To that effect, the ECB will have to reduce its holdings of national debts accumulated during the quantitative easing (QE) period. This is the process now known as quantitative tightening (QT).

Figure 3: The money base and M1 in the euro area (Index: 100 = Jan. 2008)



Source: Statistical Warehouse, ECB.

The combination of higher interest rates and the sale of public debts will profoundly affect debt sustainability. In its justification of TPI, the ECB correctly notes that the new instrument is needed to be able to pursue its policy normalisation. It is likely to be a precondition for bringing inflation down. This issue is further examined below in Section 5.2.

Another difficulty is how to simultaneously reduce the money base and purchase debts under the TPI. In will require the ECB to compensate its purchases by larger sales of the debts that it holds. This will require great care since large sales of debts from countries that do not benefit from TPI may threaten their acceptability by investors. There is clear border between large debts that require TPI support and slightly smaller debts that are safe. The risk of triggering contagion is not nil.

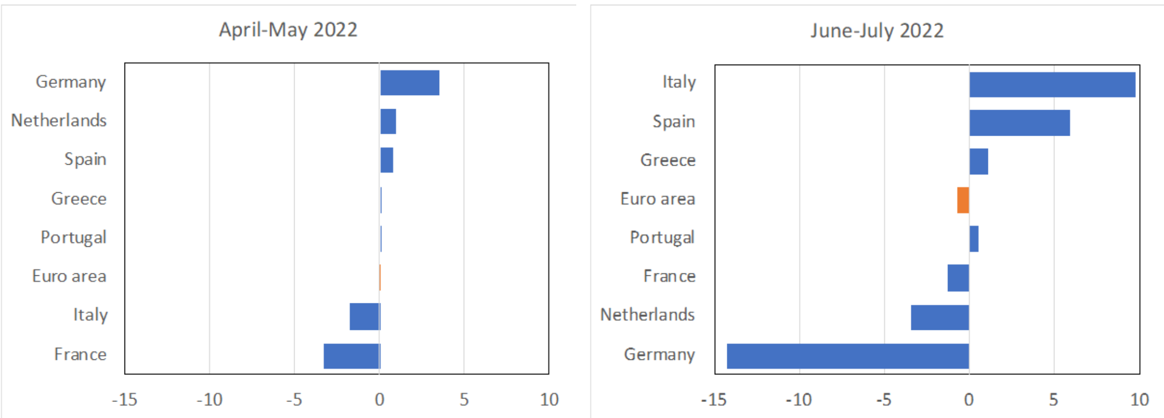
5. THE NEAR FUTURE

In short succession, the ECB has announced that net purchases under APP and PEPP would end, then raised its interest rates and put TPI in place on 21 July. It has also announced that it intends to continue raising the interest rates at forthcoming meetings of the Governing Council. The path of monetary policy is now clear.

5.1. PEPP in the forefront

As explained above, the TPI is the second line of defence after the use of PEPP maturing bonds to provide support to potentially fragile countries. The use of PEPP actually started before the announcement of TPI. The left-hand chart of Figure 4, which uses the same scale as the right-hand chart, shows how income from maturing bonds was reinvested into national bonds over April and May 2022, immediately after PEPP net purchases ended. The right-hand side chart indicates that the ECB began to target potentially fragile countries in June and July 2022 when interest spreads started to increase as documented in Figure 1. The net reinvestments are much larger than over the previous two months and exhibit a clear pattern. The ECB has purchased significant amounts of bonds issued by Italy, Spain, Greece and, to a lesser degree, Portugal. During this period, it has let its holdings of the less indebted countries, Germany and Netherlands, decline, with a small reduction of French bonds. It is likely that the ECB will continue to use income from sales of maturing assets to respond to the evolution of interest spreads as it continues to raise its interest rates.

Figure 4: Reinvestment of maturing bonds after the end of PEPP net purchases (EUR billion)

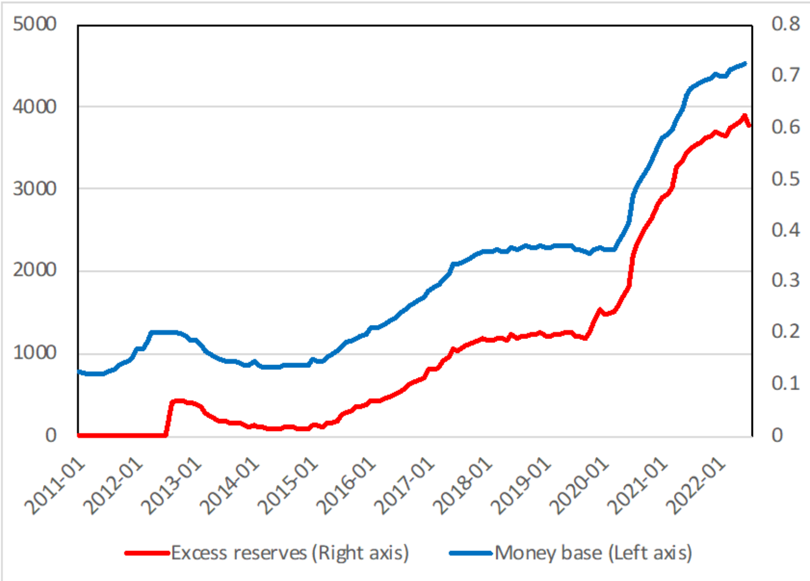


Source: Statistical Warehouse, ECB.

5.2. Quantitative tightening and TPI

So far, the ECB has not announced whether and when it plans to start QT. Section 4.4 argues that QT will be required to durably bring inflation down. Previously, following the large increase in the money base that resulted from QE after 2015, the ECB did not engage into QT, probably because M1 – and other monetary aggregates – did not increase commensurably (Figure 3). The main reason, however, was that the ECB was focused on trying to raise the inflation rate over the period 2015-19. Now that inflation has been ignited, a very large monetary base represents a major threat. Figure 5 explains why. It shows that the excess reserves of commercial banks have risen proportionately to the money base since 2015. Up until the euro area debt crisis, commercial banks held minimal amounts in deposits at their central banks, essentially what they were required to hold by the existing regulation, so excess reserves were about nil. With the advent of QE, they sold large quantities of bonds to their central banks against cash that they held at the ECB, well above the reserve requirements. This reflected a lack of more attractive use as they were loath to lend large amounts to their customers, because they had been fragilised by the crisis and because the unsettled situation made such loans risky.

Figure 5: The money base and commercial bank excess reserves (EUR billion)



Source: Statistical Warehouse, ECB.

However, excess reserves constitute a reservoir for lending, if and when the commercial banks feel ready. As such, they could support a rapid expansion of bank credit and of monetary aggregates. Such an evolution is quite likely once the economic situation stabilises. It could also be triggered if inflation remains lastingly above target for three main reasons: 1) If the interest rates remain low relative to the inflation rate, negative real interest rates provide an incentive to borrow; 2) Continuing inflation leads to higher demand for nominal money; 3) Positive interest rate imply that commercial banks find it more profitable to lend than to hold excess reserves.

What could the ECB do if bank credit starts accelerating sharply, thus threatening efforts to reduce inflation? One solution would be to raise the reserve requirements so that, mechanically, the amounts of excess reserves decline. The drawback is that this raises the operating costs of commercial banks. Another solution is to increase the interest rates. High interest rates are meant to discourage the demand for borrowing from banks, but the effect is known to be weak. Firms, in particular, are more concerned by expected profits – and therefore future growth – than by interest costs, which represent a modest fraction of investment costs. In such a situation, commercial banks occasionally entice their customers to increase borrowing through various schemes.

The ECB may believe that very large excess reserves do not represent an immediate threat and focus entirely on raising the interest rate. It can be encouraged to do so by the fact that over-abundant liquidity over the last decade has greatly reduced the odds of financial turmoil, while QT could trigger a debt crisis since it involves selling bonds back to investors who may not be prepared to absorb them. Highly-indebted governments then may face menacing interest rates increases, which would challenge the monetary policy transmission mechanism and threaten euro area membership. TPI stands to dissuade the ECB from giving up on QT.

5.3. Will TPI be ever utilised?

The early 2020 flare-up of interest rate spreads, visible in Figure 1, corresponds to the onset of the COVID-19 pandemic when most governments decided to quickly expand their fiscal policy support as they were mandating lockdowns. This was a promise of a rapid expansion of public debts and, quite naturally, the markets worried about highly indebted Greece and Italy, as well as about Spain and Portugal. Note that these spreads already existed beforehand, but their sudden increase opened the door to a potentially dangerous debt crisis. The ECB promptly responded with PEPP (and an expansion of APP). The ECB's readiness to purchase bonds according to perceived threats rather than in proportion of national ownership share of the ECB worked well, bringing the spreads back to pre-pandemic levels.

The spreads started to rise again toward the end of 2021. One possible reason is the ECB announcement that it would end net asset purchases under PEPP in March 2022. Another reason could be that inflation then emerged as the next challenge faced by the ECB, including the need to eventually raise interest rates, with unpleasant consequences for the highly indebted countries. The spreads have modestly declined since the ECB first started to implement its PEPP reinvestment strategy (displayed in Figure 4) and then disclosed TPI.

Three observations are warranted:

- The decision of the ECB to raise its interest rates have not led to larger spreads, so far at least. A plausible interpretation is that the markets had anticipated this action.
- The announcement that net purchases under PEPP would end by March 2022 deepened market concerns but this effect is now undone by the subsequent decision to selectively reinvest of maturing bonds, as announced in June 2022. An implication of this observation is that the euro area does not suffer from a general lack of liquidity (so QT is possible), but from limits of selective interventions by the ECB. TPI is needed.
- *Next Generation EU*, including the Recovery and Resilience Facility, does not seem to have had any significant impact on spreads. It may be surprising that a EUR 750 billion programme, which includes grants and is partly tilted toward the highly-indebted countries, leaves the markets unimpressed. In fact, it confirms that limited interventions, even very large ones, cannot fully reassure markets, while central bank promises of unlimited interventions are game changing.[1]

So far, the PEPP reinvestment strategy has managed to moderately reverse the spread increases. This first line of defence, however, is limited in time and scope, which means that further turmoil may lead to a resumption of spread increases. If economic and political conditions – including geopolitical trouble – were to worsen, it is likely that the PEPP reinvestment strategy will not be enough. The open question is whether the mere existence of TPI will suffice to contain the spreads or whether the ECB will have to actually intervene. If it does so, it will have to act forcefully to reassure the financial markets. Any hesitation, possibly even any delay, could well result in a power-of-will battle between the ECB and the financial markets.

There is no doubt that the ECB can technically win this battle, but political disagreements could undermine its power. In addition, the life length of TPI is limited by the attached conditions, chiefly the end of the suspension of the SGP, as noted above in Section 4.2. This could be worrisome If, as the

[1] In addition, the funding of the Recovery and Resilience Facility has not been agreed upon. In the end, it indirectly increases national public debts.

deadline nears, the ECB is still in the process of raising its interest rates and conducting QT. The TPI might then have to be updated.

6. A PERMANENT SOLUTION?

The TPI is a powerful instrument but, like its predecessors OMT and PEPP, it is a response to a specific threat. The ECB does not dispose of any permanent instrument that makes it possible to guarantee the public debts of its member governments. This is intended, which rules out the ideal solution sketched in Section 3. Is there a way to design a permanent solution that sidesteps the disagreements that make the ideal solution unreachable?

The core obstacle is that low-debt countries do not want to be liable to bonds issued by high-debt countries. This is understandable. It is what distinguish a multiple-country currency area from a politically unified currency area such as a federal state. Even though recent dramatic events, the COVID-19 pandemic and the Russian invasion of Ukraine, have spectacularly enhanced European solidarity, we are probably a long way from a European federal state.

The alternative is to build upon the unique capability of central banks to wield unlimited interventions. A detailed proposal lies beyond this report, but a few principles can be identified:

- The ECB should stand ready to purchase national debts in unlimited amounts under general conditions, not conditions tied to a particular situation.
- The conditions would not be ex ante, determining lending, but ex post, determining debt service.
- The holding of bonds purchased by the ECB during emergency or exceptional operations must be clarified. Currently, they are held in the balance sheet of the ECB, member countries serve interest on these bonds and the resulting profits are redistributed to the ECB shareholders, the national central banks, in proportion to their shareholding. The result is that each country receives payments equal to its interest service, therefore at no cost and with no inter-country transfers[2]. The PEPP has broken this equality, which explains its effectiveness, but also a reason why lending conditions are attached.
- The presumption is that these bonds will not remain indefinitely on the ECB balance sheet, either because they are not rolled over when they mature, or because of QT. But there is no timetable, which is another reason for imposing lending conditions.
- Lending conditions can be replaced by debt service conditions, such as a standardised schedule for the repayment of the principal. As is the case with borrowing from private investors, each country would be contractually obliged to pay back interest and capital over a set period. Note that the interest payments would lead to transfers from the high-debt countries, which receive support in excess to their capital keys, to the low-debt countries, which receive their share of Eurosystem earnings.

Currently, the Eurosystem holds about half of euro area government debts, much of which has been acquired through the various QE programmes of the last decade. Indefinitely keeping these debts on the book of the Eurosystem implicitly lowers the public debts (Pâris and Wyplosz, 2014), but this strategy precludes QT. Requiring debt service, including the principal, instead stands to bring debts back to levels such that the risk of self-fulfilling crises becomes small[3]. Obviously, this will happen only if governments cease to continue to accumulate debts. It calls for a more effective procedure to enforce

[2] There are benefits for highly indebted countries inasmuch as the interest rate is lower than what they would have to pay had they borrowed from the market.

[3] Many details must be examined, such as whether the ECB would aim at eliminating its holdings of national debts and, if so, what instruments it would use to carry out daily monetary policy.

fiscal discipline than the SGP, which that has not lived to its expectations (see, e.g., Eichengreen and Wyplosz, 1998; Fatas et al., 2003; Larch et al. 2010) and failed to prevent the 2010 crisis or the current concerns that motivate the TPI.

The upshot is that a permanent solution, which recognises that the ECB is the lender of last resort to governments, requires solving two of the most vexing problems of the euro area: 1) The ineffectiveness of the Stability and Growth Pact; 2) The very high levels of public indebtedness of several member governments. It may sound trivial: if all governments are fiscally disciplined and all public debts are low, committing the ECB to be the lender of last resort to governments is easy but useless. It is not trivial, though. Adverse shocks can always happen, as we have seen in recent years, so it is precious to have the ECB available to lend in last resort at all times and without conditions. Taking these steps simultaneously would make the euro area a normal monetary area.

7. CONCLUSIONS

The new instrument, TPI, is well designed and adapted to the current situation. It is supplemented by the PEPP reinvestment strategy which offers a solid first line of defence. TPI stands to assist the ECB as it develops its policy normalisation, which started with the first increase in its interest rates. Indeed, the risk is that a new debt crisis would make it impossible to continue on that path without endangering the proper function of the single monetary policy or, worse if it rekindles the risk of a breakup of the monetary union.

Like previous emergency instruments designed to deal with wide differences in national public indebtedness, TPI comes with lending conditions, in contrast with what is expected from other central banks. These conditions are tailored to the current circumstances, as were OMT and PEPP. Each instrument represents a step in the right direction, but just a step: the ECB still cannot be expected to safeguard national public debts without the creation, each time, of a specific instrument.

Several reasons explain this step-by-step approach. The main one is clearly due to member governments. They disagree on the degree to which the ECB can take risks that may result in explicit or implicit transfers. Despite its independence, the ECB cannot remedy the situation on its own, nor can it put itself at the centre of deep political disagreements as it needs to preserve its authority. Yet, it is encouraging that each of the three steps taken so far has been successful, was built on the previous one and was adopted faster. It is also encouraging that the member governments have been willing to adopt measures, like the creation of the European Stability Mechanism and the Recovery and Resilience Facility, which implicitly or explicitly involve transfers. However, these measures cannot be compared to potentially unlimited central bank interventions that are uniquely effective at eliminating self-fulfilling crises.

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The new Transmission Protection Instrument is well designed to cope with the risks of the monetary policy normalisation now under way. However, it is the third time that the ECB must craft an emergency instrument to cope with new risks. It is desirable to start work toward making the ECB a normal lender in last resort to governments.

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