FOCUS · ECB monetary policy and sovereign risk premia

Since the end of 2014, the policies of the European Central Bank (ECB) have helped to reduce the dispersion of the cost of debt across euro area countries.[1] As activity firms up and inflation returns to normal, in the second half of 2017 the ECB will probably start to think about tapering off its asset purchase programme (QE). How will this affect the cost of debt for euro area countries?

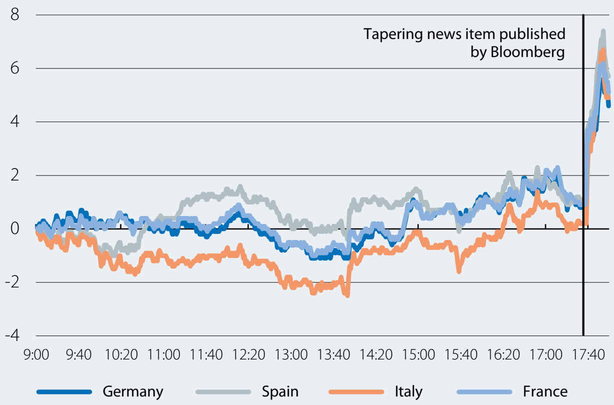
After the euro area's crisis, each country has to face different financing costs whose spread partly reflects the different economic prospects perceived by investors. However, today debt premia are being affected by the ECB's unconventional monetary policies. QE has pushed up demand for public debt, thereby pushing down interest rates. When the ECB withdraws from the market, we are therefore likely to see higher interest rates; a more accurate reflection of the market's true value. One way to estimate the impact of such movements is by analysing how sovereign debt premia react to changes in investor expectations regarding the ECB's monetary policy.

To isolate QE expectations from the huge flow of news influencing investor decisions, we have taken advantage of a «quasi-experiment» from 4 October 2016, when investors were surprised by a news item published by Bloomberg that warned the ECB was thinking about tapering its bond purchases.[2] As can be seen in the first chart, what had begun as a quiet session ended with a sharp upswing in interest rates, precisely at the time this news was published. Given that, until then, the market had not considered the possibility of tapering and that the news item's publication coincided with sharp movements in a question of minutes, we can be relatively certain that this reflects the impact of revised expectations. The second chart shows that the prospect of less expansionary monetary policy pushed up the interest rate on German debt and risk premia. The sensitivity provided by this «quasi-experiment» suggests that expectations of tighter monetary policy that push up the German interest rate by 10 bps would lead to a very slight increase in the risk premia of the core countries (around 1 bp) and a somewhat higher increase for the periphery (around 4 bps).

Other studies[3] have estimated that, for each 10-basis point drop in the German interest rate, the start-up of QE led to a fall in risk premia of up to 6 bps in the core and between 8 and 15 bps in the periphery. The lower sensitivity estimated for QE withdrawal could therefore be the result of the widespread improvement in the macroeconomic scenario. Although there are limitations to this exercise (it only reflects the immediate reaction of a subgroup of investors active at the time of the Bloomberg publication, also influenced by increased uncertainty), the greater sensitivity of the periphery is in line with its higher public debt. This indicates that, although tapering could push up risk premia, ultimately the impact will depend on each country's public finances and economic outlook.

*Sovereign bond interest rates **

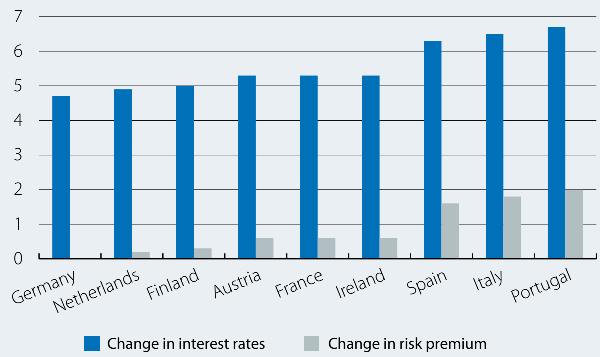
Index (0 = opening value)



Note: **10-year interest rate on 4 October 2016.*
Source: *CaixaBank Research, based on data from Bloomberg.*

*Tapering expectations and sovereign risk premia **

(bps)



Note: ** Change in 10-year interest rate between 17:37, the time when Bloomberg published a news item on tapering, and 17:54 on 4 October 2016.*
Source: *CaixaBank Research, based on data from Bloomberg.*

1. For instance, in 2012 the interest paid by Italy on its 10-year debt was almost 500 basis points (bps) more than Germany; today this figure is below 200 bps.
2. Google Trends shows an unprecedented increase in interest in ECB tapering over the following days.
3. De Santis, R. (2016), «Impact of the Asset Purchase Programme on Euro Area Government Bond Yields Using Market News», ECB Working Paper.