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Special Report: ECB Yield Caps: Confusing Symptoms For Causes?

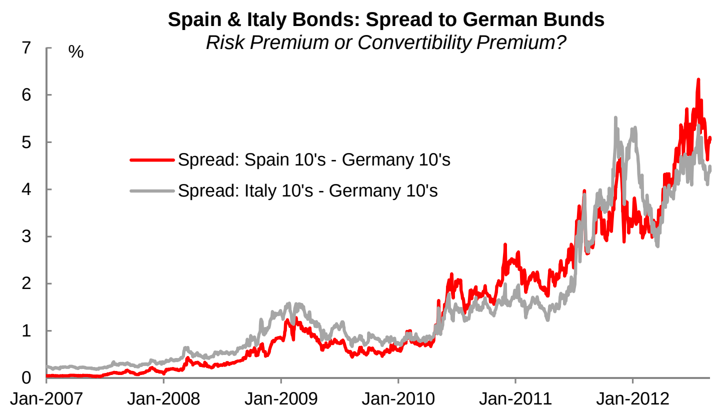
- **Yield or spread caps are being suggested as one of the ECB-led solutions to the Eurozone crisis. While there is some merit to the idea, on balance the ECB should tread carefully in our opinion.**

We explore the pros and cons of yield or spread caps upon stressed sovereign debt markets as an ECB-led policy solution to Europe's debt woes. On the face of it, yield caps may appear to be among the more novel solutions, but they have been discussed in monetary policy circles for years and owe their origins to an unfavourable history of rate ceilings and price floors that have been applied by governments across many markets from time immemorial. As economists, we're fundamentally trained to view such measures with deep skepticism. Our bottom line is that because this is a policy option fraught with significant risks and concerns, we do not believe that the ECB will pursue it. We do, however, believe that there is a solid chance the ECB will roll out some form of bond buying program that will be treated as constructive to the markets in the near term if truly combined with the requirement that bond buying will target countries which submit a request for funding from the ESM and accept the concomitant conditionality. Whether this happens as soon as next week is unclear. This could well be positive if followed through by aggressive fiscal austerity and credible adherence to fiscal targets. If yield or spread caps are pursued, however, then the immediate reaction may be positive but a deeper understanding of the risks is necessary in order to assess whether this is just another step — like the LTROs — that could ultimately stumble.

The Case For Caps on Yields Or Spreads

There are at least four main arguments in favour of setting yield or spread caps. The main argument for ECB intervention has been advanced by ECB President Mario Draghi upon noting that there is a 'convertibility' premium on eurozone break-up that in his view is irrational because the European Union is resolved not to allow the eurozone to break up or to cause any country to exit the common currency. This convertibility premium refers to a premium demanded by security holders to compensate them for the risk that a security might change its currency of denomination or no longer be convertible into a second currency. The ECB therefore sees intervention in European markets as perfectly in keeping with its role although this is disputed. The evidence that one could cite to the effect that there is a convertibility premium in European sovereign bonds is not just the level of Spanish and Italian yields, but also the low and even negative nominal yields on German bonds, which markets think are worth more than their face value even if they carry no yield (chart 1). Some will immediately dispute this proposed policy rationale by countering that eurozone break-up may well not be a fully irrational bet. Thus, Draghi is rightly or wrongly arguing that there is a market failure.

Chart 1



Source: Bloomberg, Scotia Economics

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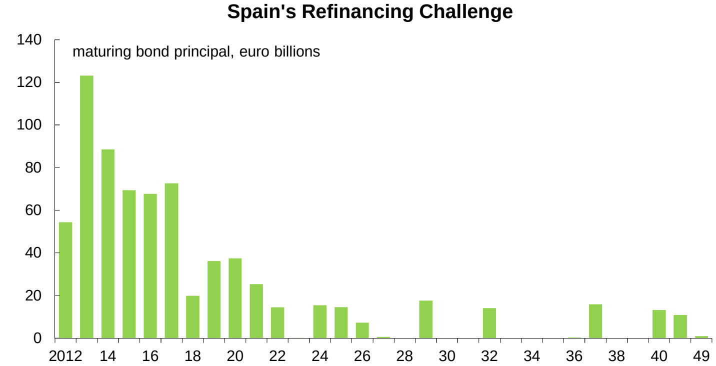
The second main possible policy justification for yield caps relates to their likely focus upon shorter-dated securities perhaps up to three years in maturity. This could buy time for sovereigns to pursue restructuring and reforms given the enormous amount of refinancing that is concentrated in the next few years as in the case of Spain (chart 2). Further, for some sovereigns and indirectly for some sub-sovereigns, such a program would restore access to capital markets that is presently not available.

The third main possible policy justification for yield caps is as a back-door way of recapitalizing banks by offering capital gains on bond holdings.

Fourth, if the ECB is successful in capping sovereign yields or spreads, then there should be concomitant benefits to other private issuers with benefits for corporate and household access to markets that could translate into lower private borrowing costs.

There are, however, many caveats to pursuing yield or spread caps to which we now turn our attention. On balance we think they net out to what could well be very positive near-term influences, but we question the longevity of such a solution on the view that the balance of risks could tip in the opposite direction.

Chart 2



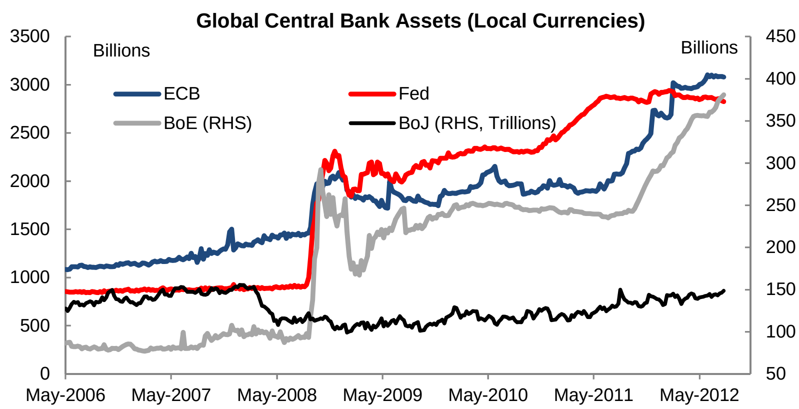
Source: Bloomberg, Scotia Economics.

The Case Against Pursuing Yield Or Spread Caps

1. Extreme Monetary Policy

Yield caps entail no hard purchase targets that provide the market with a sense of the limits to central bank balance sheet expansion, and because of this yield caps are among the most extreme policy tools that a central bank can pursue. They are potentially more extreme than anything done to date by the US Federal Reserve, the ECB and the Bank of England through their quantitative easing programs that have been conducted through specific purchase targets. Such a policy stance must also be weighed against the fact that the ECB's balance sheet (and the BoE's) has grown much more rapidly over the past year than ever before due to past rounds of bond buying that did not sustainably work (chart 3). If viewed as credible, then perhaps few if any purchases and money printing need to be done and in this sense the market might do the work of the central bank. This is, however, taking monetary policy to the casino on a complete gamble that we feel would probably come to be tested by market participants particularly in light of internal dissent at the ECB. Regardless, a central bank must stand committed to be unlimited in its purchases in order to defend the target. Thus, yield targeting is arguably more extreme than nominal GDP targeting whereby new stimulus ceases once GDP is restored along a trend path.

Chart 3



Source: Bloomberg, Scotia Economics

Spread caps are of little difference in this regard. In one sense they would not be new as evidenced by the Maastricht Treaty entry criteria requirement for a 2.5% maximum spread above the best three countries' yields. Apart from entry criteria, however, actually defending the spread target through monetary policy also entails no theoretical upper limit to balance sheet expansion. The only appeal of spread caps over yield caps is that the base yield (say, on German bunds) is allowed to drift such that only the spread target is being enforced and not the all-in yield. Both policies therefore raise the next several concerns that flow from this consideration.

2. Higher General Inflation Risk On Euro-Denominated Bonds

Long run inflation expectations would stand a higher chance of becoming unseated in the case of a potentially limitless commitment than in the case of the incremental approach to quantitative easing used elsewhere through finite purchase amounts and horizons. In evaluating this risk, it must be noted that yield or spread targeting is an out-of-sample unprecedented policy move and thus it is impossible to ascertain its ultimate consequences.

What drops out of inflation risk is a potentially vicious cycle of monetary policy influences. Bond buying to defend the target may push term and country premia lower, but inflation premia higher. Higher inflation premia would then put upward pressure upon nominal yields (or spreads if inflation exerts itself unevenly), thereby requiring more bond buying in a feedback loop that at some point gets short-circuited by inflation concerns. Yield caps and their implicit unlimited easing framework could set long-run inflation expectations more dangerously out of control for Europe than for the US Fed.

All that said, the default assumption for countries that are in difficulties is that inflation should be slowing rather than accelerating. This is not assured in a yield or spread capping scenario. Whereas inflation risk is low and likely to fall in the strained economies, if stagflation arises through exchange rate depreciation that we touch upon in #4 below, then this could undermine the benefits of yield or spread caps and pose greater imbalances yet.

3. Lost Ability To Assess Relative Inflation Risks

The prior point addressed generalized inflation for bonds denominated in euros. There is, however, a second form of inflation risk and it reflects the impact that local inflation has upon local government finances. For instance, Spanish inflation is a driver of Spanish revenues and expenditures and the net fiscal position, whereas German inflation may have very different influences upon German government finances. The markets need a way of assessing this risk, and yield or spread caps would risk stamping out differential inflation premia across issuers and how it could be subject to change over time.

4. Euro Risk

Also flowing from point #1 above, it is not clear to what extent FX markets may react negatively to the potential for rapid balance sheet expansion at the ECB. Fears of debasing the USD through rapid central bank balance sheet expansion have thus far not materialized given the relatively tight range of the USD on a trade-weighted basis throughout the crisis. Indeed, the USD by this measure has been less volatile than it was over the prior decade. We don't know if the euro would run with the same experience given its lower appeal as a safe haven and the greater potential for growth in the monetary base under yield or spread capping. Euro weakening through potentially unlimited balance sheet expansion could therefore be counter-productive to yield/spread caps from a foreign bond investor's standpoint.

This leads to the issue of whether a weaker euro would actually be desirable to the eurozone. Exchange rate weakening could be helpful in providing a boost to export competitiveness, but as the UK has shown, pound sterling depreciation added to inflation and thus squeezed disposable income and corporate profits. Further, the benefits of greater export competitiveness would be unevenly dispersed and that could further aggravate tensions. An added risk lies in how labour unions respond. Normally exchange rate deprecation would motivate a first round response of depressed real wages via imported inflation, but if labour unions respond with higher nominal wage expectations and/or strike activity then the real wage benefits to competitiveness would not be sustained.

5. Moral Hazard

There is also a strong moral hazard argument to be made. Yield or spread caps could therefore put European monetary policy under the explicit control of fiscal policy makers in various countries should countries ultimately fail to deliver necessary policy reforms to curry greater favour with bond markets. It is this issue that draws the first order of criticism from the Bundesbank by way of potentially putting the ECB at odds with the restriction against directly funding governments. If accompanied by strict fiscal targets and enforcement, then yield/spread caps can avert this criticism. What is also unclear is whether the ECB may impose additional conditions in order to mitigate the impression that it is too close to government influences. If, however, countries are unable to deliver the goods on fiscal targets then the ECB's balance sheet is potentially at the whim of politicians or it locks the ECB into the awkward position of ceasing bond purchases should a country violate its targets. The unwillingness of Catalonia to accept conditions on its aid request to the Spanish Regions Fund and its implications for Spain's fiscal position is but one example of the hesitation of countries or regions to embrace the ECB's likely conditions for bond buying at the sovereign level. As such, a risk is that it exposes the ECB's targets toward being gamed by sovereign issuers. Further to this is the risk that private investors repeatedly game the ECB upon speculation that a country may not meet its fiscal targets.

6. Distorted Bank Funding Markets

Yield or spread caps would likely carry positive implications for capital gains on existing holdings of sovereign bonds — of which banks are the biggest holders. Against this positive effect on bank finances as a back door way of recapitalizing them are potentially negative implications for bank funding costs at the margin. Yield caps could distort bank funding markets as understood through a loanable funds framework. Imposing a yield cap would increase debt issuance (compared to a world marked by the absence of such a policy) and thus raise demand for deposits and market funding (again, relative to a world in which such controls are not in place) and in such a manner that puts upward pressure upon bank funding costs. The ECB would be supplying the funding for sovereign debt through bond purchases under a yield or spread capping scenario, but demand for bank funding would be indirectly lifted if the rate ceiling over time lifted private credit demand as a knock-on effect alluded to in the first section as one of the primary reasons for pursuing yield or spread caps in the first section.

Yield or spread capping also flattens the curve given the anchor of the lower zero bound (or close to it) which means less money to be made borrowing short to go long which is the classic policy remedy for recapitalizing banks. Thus, there is no free lunch to be had here.

7. Capital Reallocated From Private Credit Markets?

If unaccompanied by the buying of private credit, yield or spread caps on sovereign debt could raise a problem opposite to that which the Fed encountered in the early days of QE1. Back then, the Fed started buying credit first and, upon realizing that this would distort relative prices of government debt versus private credit as investors chased what was being targeted, then altered the program to begin buying Treasuries in complementary fashion as a way of anchoring the sovereign base yield. Thus, against one of the primary rationales for yield or spread caps by the ECB, the outcome to targeting only sovereign debt could be a deterioration in private spreads as investors chase what is being targeted (sovereign debt) more so than private credit. This could raise both bank- and non-bank funding spreads at the margin. This would raise the risk that the ECB would then be pulled down the path of buying private credit.

Of added consequence here is that if the points raised regarding a possible negative impact upon bank funding costs in isolation of other influences turn out to be correct, then credit substitution could be reinforced by banks passing on higher credit costs to other private borrowers. That too would jeopardize one of the policy goals of lowering private borrowing costs.

8. Pressure To Seek Alternate Ways Of Allocating Capital

Normally, when you impose any kind of price caps (whether for loans, or gasoline, or sugar), you need a way to allocate those goods, unless you are willing to considerably increase supply. That is also true if you offer an implicit guarantee. So what is the mechanism they will use here? This applies as much to governments and their departments as it does to private borrowers and savers. In Latam markets where interest rate ceilings have been applied over time the outcome was often credit allocation through let's just say non-market mechanisms. It's not clear to us that southern Europe is immune to this same outcome. More interference from regulators means that capital will be allocated by regulators rather than by the market. It explicitly entails more money going to weaker countries versus strong ones, unless different yield caps are placed upon different countries. In that case a different set of problems arises as now the central bank has to put individual numbers on the credit-worthiness of each country and as such crosses the line toward becoming a quasi rating agency.

9. Central Banks Have Not Had Much Success At Intervening

It is not clear that a single party like a central bank can sustainably interfere with price discovery in capital markets. Much like FX intervention, repeated bond buying does not necessarily have a sustainable impact upon markets in isolation of many other market influences. Indeed, the US Treasury market provides a further example; through repeated rounds of bond buying, US Treasuries have traded between a low of about 1.4% and a high of about 4% for a variety of reasons beyond just monetary policy. While some may cite the Swiss National Bank's cap on the rate of exchange between the Swiss Franc and the Euro as an example of how a central bank can indeed set a target, this is a fundamentally different matter. When printing local currency to debase it, should inflation risk be ignited then that would only reinforce the policy goal of weakening the currency. The trick is not to go too far, lest the opposite problem of an overly weak currency be encountered. But when printing money to buy bonds in an effort to set a price floor, should inflation risk be ignited then this would run counter to the policy goal by weakening bond prices and thus putting upward pressure upon yields.

10. Concessions Could Rise As A Non-Price Way Of Rationing Sovereign Credit Demand

If private market participants are unsatisfied with the capped yields, then sovereigns could be forced to pay through non-interest mechanisms in an effort to ultimately appeal to private buyers. In private credit markets this can include concessions through restrictive covenants and other bond indenture features. In private or sovereign markets it can include requirements to secure loans against assets via the provision of collateral. The sinking fund secured against FX and gold reserves as well as tax revenues that is at the heart of the proposal for a redemption fund advanced by Germany's "Council of Economic Experts" (a.k.a. the 'wise council') is but one example of this and makes it evident that the sovereign-to-sovereign market is more likely to demand such measures than even private markets.

11. Destabilizing Dissent At The ECB

Bundesbank President Jens Weidmann has been the subject of resignation rumours recently. We don't view the source as necessarily credible (a member of Germany's CDU party), but the point struck a raw nerve. Weidmann has made clear his opposition to aggressive ECB action particularly in terms of yield caps, and this could well be his line in the sand moment especially with German Chancellor Angela Merkel's softened stance toward ECB intervention. A resignation would hardly be unusual and each of the Fed, BoE and ECB has experienced them over the ongoing crisis period. We wouldn't think it would come to this, but the risk showcases a significant constraint upon the ECB and President Draghi's questionable attempts to isolate the Bundesbank President and indeed bypass him in direct pleas to the German electorate. While the ECB can mathematically do without the Bundesbank's support, it is doubtful that the ECB can isolate the German contingent. One legitimate German fear is that ECB policies could result in imported inflation that depress German real wages while inflation remains muted in the strained economies which would lead to the opposite of the likely required steps toward addressing economic imbalances. This is also said with the recent spike higher in German inflation readings in mind. The full economic and political ramifications to dissent within the ECB are clearly to be monitored carefully. It may well be that Europe is moving forward toward pan-European, majority-based institutions that mean Germany's vote is no longer dominant at the ECB, just as France's views on the size of the state and foreign policy might have to stray toward a European average. That said, isolating the Bundesbank conjures up the risk of Charles De Gaulle's "la politique de la chaise vide" (the empty seats policy) in the 1960s to block decisions at the EU level that were not in favour of France.

12. Unintended Consequences

Ranking this last is likely doing the point a disservice. The history of rate caps including Regulation 'Q' in the US and the Interest Equalization Tax (IET) as well as the rich history of interest rate and capital controls up to the 1960s at which point many had been dismantled is replete with unintended consequences. One such case was how Regulation 'Q' contributed to the thrift crisis, or how the combination of the IET and the US freeze on Soviet deposits in the US drove the creation of the Eurodollar market. We simply don't know the unintended effects that would flow from yield or spread caps including how perhaps over the longer run issuers and buyers would seek to circumvent such controls.

Indeed, there is a literature on financial repression in emerging markets, started by McKinnon and Shaw in the 70s. They argue that artificial ceilings on interest rates reduce savings and capital accumulation in developing countries, and also lead to an inefficient allocation of capital. A recent NBER paper by Reinhart and Sbrancia argued that developed countries do this in various ways, essentially keeping interest rates low and restricting investment options so that citizens have to lend to the government at low rates. This comes at the expense, for instance, of institutions like pensions that must fund rising obligations in aging societies. As S&P has noted, this could also impair the stronger countries (See "Financial Repression Would Hurt The Highest-Rated Sovereigns, But Help Those At The Bottom," S&P Ratings Direct, August 30th 2012). This may well be the path the ECB would be setting out upon by embracing yield or spread caps.

Conclusion

Perhaps the biggest issue is that yield caps ultimately confuse a symptom of Europe's financial stress — high yields in Italy and Spain — for the cause. To take an extreme example, Greece did not experience financial stress due to market dysfunction but due to unsustainable domestic government borrowing needs. Italy and Spain are not under financial stress because they are offering bond concessions at auction, but rather due to difficult underlying financial circumstances. In the case of Spain, the twin challenges of its need to recapitalize its banking sector and the unfunded deficits of its autonomous regions are the catalysts for the debt crisis. In Italy, the concern is the long-run debt dynamics of an economy that ranks third globally in terms of nominal debt but only 8th in terms of nominal economic size.

The ECB's argument that market dysfunction — the 'convertibility premium' — is responsible for the high yields demanded of Italy and Spain only makes sense if credible policies are put in place to address these underlying issues that speak more to the 'risk premia' of Italian and Spanish debt. In other words, the ECB can only credibly be believed to be intervening in order to stamp out 'convertibility premia' once risk premia are under control. Perhaps that's why most proposals for secondary market bond buying by the ECB place the restructuring of the financial and government sectors as prerequisites for follow-on secondary market bond buying. President Draghi emphasized during his remarks following the August 2 ECB meeting that the ECB would consider intervening in secondary bond markets for countries premised on "the adherence of governments to their commitments," i.e. it would only intervene on behalf of countries which have applied to the EFSF/ESM for funding, have taken on and adhered to a program of structural reforms, but which still see their bonds trade at very high premia to say German or French bonds of comparable maturity.

The bottom line is that while there are merits in the ECB attempting to impose yield caps for the countries at the periphery, it is a policy fraught with risk. The extent of discussion of ECB bond purchases elides and obscures the primary significance of the needed restructuring — which in any event is the principal way of addressing high sovereign yields in Italy and particularly Spain.