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What is the difference between the policy instrument launched ten years ago by the ECB after the famous "Whatever it takes" pronounced by Mario Draghi, and the one recently approved under Christine Lagarde?

They have many things in common. The most important is the absence of quantitative limits, implicit or explicit, on the size of the intervention conducted by the central bank. Both in the case of the OMT (Outright Monetary Transactions), launched in 2012, and for the recent TPI (Transmission Protection Instrument), the Central Bank can intervene in significant, potentially unlimited, amounts in order to influence government bond market conditions. The goal is to create a strong deterrent for market participants to take positions opposite to that of the central bank.

The other similarity concerns the sterilization of interventions necessary to ensure that they do not produce undesirable effects on the overall monetary policy stance. The reference to sterilization is different for two instruments. For the OMT it indicated that the liquidity created with the OMT will be fully sterilized. In the case of the TPI, "the ECB will address the implications for the scale of the aggregate Eurosystem monetary policy debt security portfolio and the amount of excess liquidity. Purchases under the TPI would be conducted such that they cause no persistent impact on the overall Eurosystem balance sheet and hence on the monetary policy stance."

The different language may lead to believe that the TPI is subject to greater constraints than the OMT, but this is misleading. As for the SMP (Securities Market Program) adopted in May 2010, at the outbreak of the Greek crisis, the ECB has all the tools to sterilize the impact of the purchase of securities on liquidity, in particular through the issuance of certificates of deposit. Liquidity sterilization could also take place through the sale of securities already in the ECB's portfolio.

Finally, in both cases, the decision to activate the instrument falls, ultimately, within the prerogatives of the European Central Bank, in a discretionary manner, without any automatism, based on its own assessments of market conditions.

Let's move on to the differences. The declared objective of the two shields is partly different. The ÒMT, which was launched in 2012, in the face of strong tensions on the financial markets that were expecting the possible exit of some countries from the euro area, intended to ensure the integrity of monetary policy and its transmission to the real economy. The most recent TPI, adopted in a less dramatic phase, focuses mainly on the transmission of monetary policy in a phase of a generalized rise in interest rates.

The main difference between the two instruments relates to conditionality. It should be made clear from the outset that there are two types of conditions that must be met for the ECB to intervene: the necessary ones and the sufficient ones.

Let's start with the necessary conditions. In the case of the OMT, a country must first negotiate an adjustment program with the ESM (European Stability Mechanism). The ESM can grant financial assistance if this is considered necessary for safeguarding the financial stability of the entire euro area and of the member states. The assistance is provided in exchange for specific commitments to adopt fiscal and structural policies consistent with the macroeconomic adjustment. The decisions are taken unanimously by the Board of Directors of the ESM and subsequently ratified by the member countries.

The TPI does not require the use of the MES. The new shield can be put in place for all countries that comply in advance with the European procedures for coordinating economic policies. Four are mentioned. The first concerns the Stability and Growth Pact. In order to benefit from the new instrument, a country must not have an excessive government deficit, or not diverge significantly from the planned path to exit from this situation. The second precondition concerns the absence of serious macroeconomic imbalances or policies to correct them. The third concerns the sustainability of the public debt. The fourth is compatibility with the implementation of the NRRP.

In summary, unlike the OMT, the TPI does not require a country to enter into negotiations with the ESM to define an adjustment program but rather to comply with existing recommendations relating to the coordination of economic policies. This represents a clear advantage, especially from a political point of view. First of all, the stigma of having to resort to external support is avoided, as it often discourages and delays the request because it is interpreted as the recognition of the failure of the government's action. Furthermore, it is not necessary to submit the adjustment program to the scrutiny of other countries, each of which could block it if it does not consider it appropriate. Finally, the ECB can intervene before a country's access to the financial market is jeopardized, which sometimes precedes the request for support from the ESM and which can lead to debt restructuring.

In fact, some of the shortcomings of the ESM that discouraged the activation of the OMT had been partially overcome with the reform approved last year, which provided for the possibility of adopting precautionary adjustment programs, with limited conditionality. However, the ESM reform has not been yet ratified by all countries, in particular by Italy.

In summary, the TPI can be activated for countries that are in economic difficulties, such as a deficit of more than 3% of GDP or significant macroeconomic imbalances, if their policies are in line with the recommendations and commitments already made with the European institutions. In fact, all European countries - including Italy - currently meet the TPI requirements. Italy currently meets the criteria of consistency with fiscal rules (absence of excessive deficits) and macroeconomic imbalances (it has excessive macroeconomic imbalances, but the European Commission has not activated the next stage of the procedure that requires the presentation of a Corrective Action Plan). In both cases, a new assessment will be made in May 2023 as part of the European Semester. The Commission's debt sustainability assessment procedure indicates a high medium- and long-term sustainability risk: the assessment will be updated next year. Compliance with the fiscal recommendation criterion will be verified when the new government presents the new draft budget law and the Commission issues its opinion. A fundamental aspect in this regard is that current expenditure must grow at a rate lower than the potential growth of Gross Product. The Commission is also verifying the conditions of the NRRP to disburse the first tranche of 2022.

If a country no longer fulfills one of the conditions, for instance following a drastic change in economic policy regarding the consolidation of public finances or the reforms to reduce macroeconomic imbalances or the measures agreed under the NRRP, the ECB could no longer implement the TPI. This would expose the country to severe financial instability. There would remain only the possibility of resorting to the OMT, which however requires the support of the ESM.

The TPI therefore creates a strong incentive for member countries to conduct economic policies consistent with the European policy coordination framework.

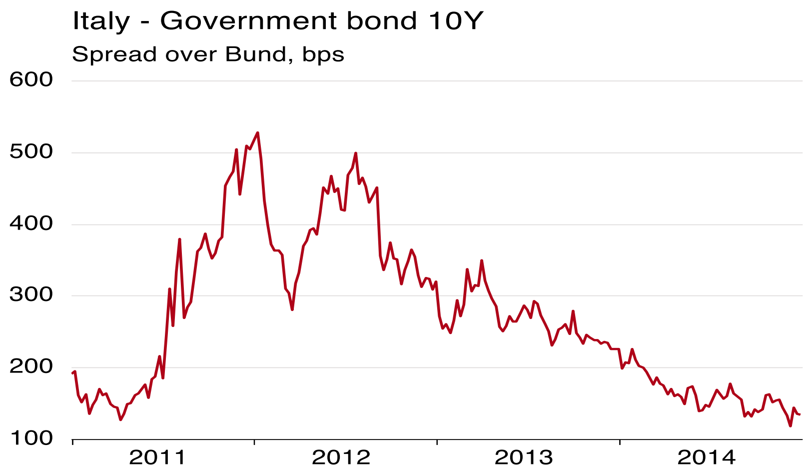
Complying with the conditions necessary for the activation of the TPI does not, however, entail any obligation for the ECB. As with the OMT, the ECB reserves full discretion to decide whether the intervention is justified, based on the objectives indicated above.

It is useful to remind that the OMT has never been used, although several countries had a support program agreed with the ESM as early as 2012, such as Spain, Portugal or Ireland. As mentioned above, the announcement of the OMT itself immediately produced significant effects. However, the spreads of various countries remained high, above 200 points, for over a year without prompting the ECB to intervene. Apparently, the ECB considered that the rate dynamics triggered by mid-2012 no longer posed any danger to the integrity of the euro area and to the transmission of monetary policy.

Similarly, even if the criteria for activating the TPI are met, the ECB reserves the right to intervene at any time, without indicating any target thresholds or making specific commitments regarding the level of the spread that should trigger the transaction. The intent of the central bank is not to replace markets in determining asset prices but rather to prevent the development of destabilizing dynamics generated by self-fulfilling expectations. The intervention aims to promote the proper functioning of the market rather than replace the market itself. It should therefore not be surprising that the new instrument gives the ECB wide margins of operational discretion, while respecting the ex post reporting criteria required for monetary policy operations.

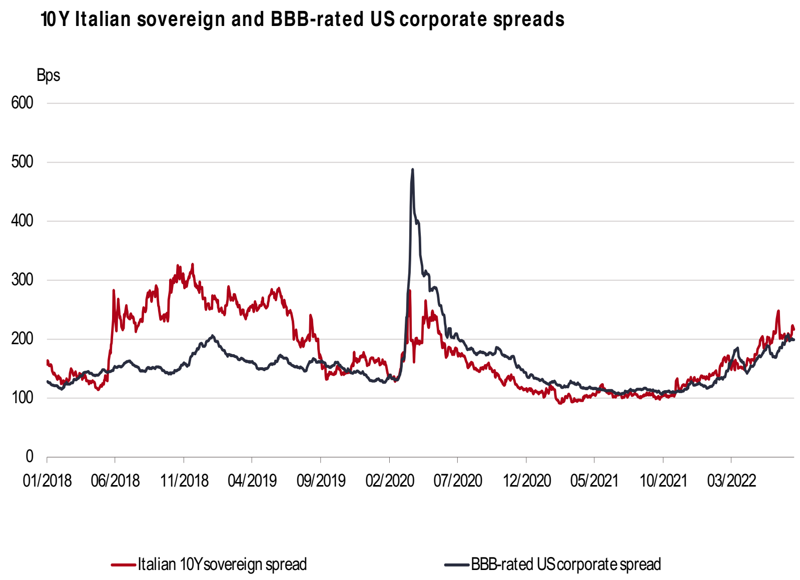
In light of the above, one may wonder if the TPI could be as effective as the OMT. In fact, unlike the "Whatever it takes" announcement, the TPI did not result in an immediate reduction in the spread, in particular between Italian and German government bonds.

Some considerations in this regard. The first is that, in the case of the OMT, the announcement of 26 July 2012 was made in a particularly dramatic environment, with a spread exceeding 500 basis points, and without any reference to the conditionality that would be necessary to benefit from the new instrument. In fact, the markets interpreted those words as a willingness of the ECB to intervene without limits - with the so-called bazooka - and without conditions. The spread dropped by around 100 basis points in just a few weeks. It subsequently stabilized just above 300 points between September and October 2012, precisely during the ECB Governing Council discussions on the terms and conditions of the new instrument. At that stage, however, divergences emerged on the scope and characteristics of the new instrument, which Draghi announced in July, but for which the operational details had yet to be defined.



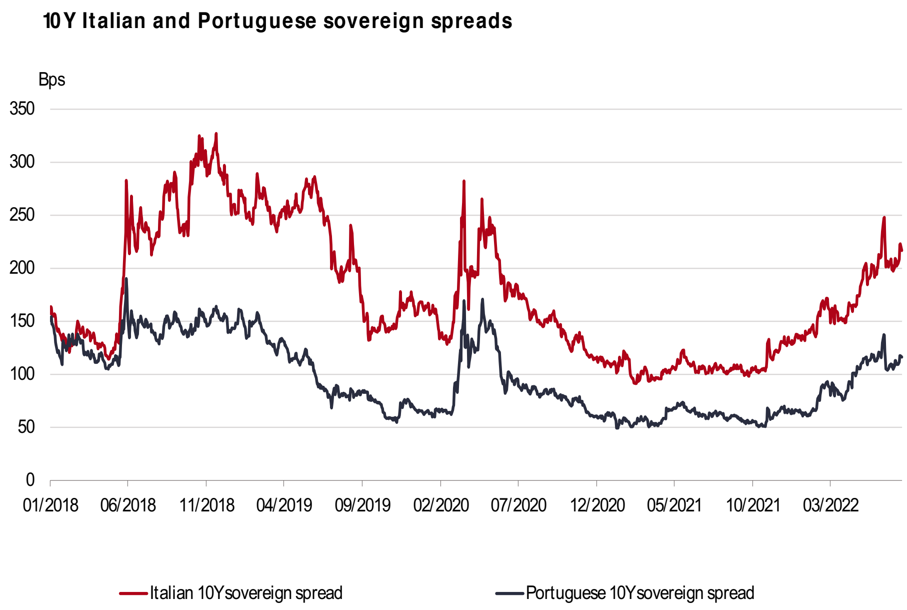
The subsequent easing of monetary conditions, with the reduction of interest rates in negative territory in 2014 and the Quantitative Easing in 2015, favored a further decline in the differential, without the need to actually implement the OMT.

The TPI instead was announced in a phase of rising interest rates, which inevitably involves portfolio adjustments that tend to penalize, at least initially, the riskiest securities. It is therefore not surprising that spreads increase at this stage. The comparison with the spread between securities with a triple B rating (the same as Italy) and triple A (the same as Germany) in the United States shows that in the recent phase of rate hikes that differential has also increased, reaching 200 base points, as seen in the graph below. This suggests that the recent evolution of the spread within the Euro area is not necessarily due to a distortion of the monetary policy transmission mechanism but rather to a normal adjustment of the markets.



In conclusion, the effectiveness of the TPI will depend on the way in which it will be used by the ECB, if and when it will be considered necessary, and on markets' expectations regarding the ECB's determination to use it. However, it would be a mistake to think that the TPI alone can determine the level of the spread between interest rates on Italian and German government bonds. This largely depends on the fundamentals of the Italian economy, in particular the expectations regarding economic policies and long-term growth. Comparison with the performance of another country with a triple B rating, Portugal, is revealing.

When the "Whatever it takes" statement was pronounced, Portugal's spread against Germany exceeded 1000 basis points, which was much higher than the Italian one. In the following years it decreased more rapidly than the Italian one. Since mid-2018 it has fallen below the spread between BTPs and Bunds by over 100 points, as can be seen in the graph below.



Several factors explain the difference. The first is greater political stability, which avoided Portugal's interest rate spread from rising after Italy's 2018 elections. The second factor is economic growth. From 2018 to 2022 Portugal grew by 8.4% overall, against 1.9% in Italy. The latest European Commission forecasts indicate Portugal's growth of 1.9% for 2023 against Italy's 0.9%, the lowest rate in the euro area. The third factor concerns public finances. The European forecasts indicate a progressive reduction of the Portuguese public deficit to 1% of Gross National Product in 2023, which determines a decrease in the debt/GDP ratio of about 12 points, against a deficit of 4.3% in Italy, which should bring the debt down by about 5 points only.

Ultimately, the evolution of the interest rate differential seems to depend more on the underlying conditions of the various countries, than on the actions of the central bank.