

# Fragmentation risk in the euro area: no easy way out for the European Central Bank





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## **Abstract**

The ECB is about to enter the tightening part of the monetary policy cycle. Unlike in the easing part of the cycle, when the two objectives of monetary and financial stability are generally jointly served by the same policy, ECB policy interest rates hikes to tame inflation pose a risk of financial fragmentation in the euro area. Some countries might experience a significant widening of their spreads not necessarily driven by fundamentals. This fragmentation could put a strain on the ability of those countries to borrow. Therefore, the ECB should design a specific tool that will accompany interest rate hikes to neutralise the risk of fragmentation directly for countries facing it, while staying within the bounds set by the EU Treaties and ensuring political legitimacy. We also advocate structural changes to the ECB's collateral framework to avoid unnecessary uncertainty about the safe asset status of European sovereign bonds.

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## **AUTHORS**

Grégory CLAEYS, Bruegel  
Maria DEMERTZIS, Bruegel  
Lionel GUETTA-JEANRENAUD, Bruegel

## **ADMINISTRATOR RESPONSIBLE**

Drazen RAKIC

## **EDITORIAL ASSISTANT**

Catherine NAAS

## **LINGUISTIC VERSIONS**

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## **ABOUT THE EDITOR**

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To contact the Policy Department or to subscribe for email alert updates, please write to:

Policy Department for Economic, Scientific and Quality of Life Policies

European Parliament

L-2929 - Luxembourg

Email: [Poldep-Economy-Science@ep.europa.eu](mailto:Poldep-Economy-Science@ep.europa.eu)

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## LIST OF ABBREVIATIONS

<b>APP</b>	Asset purchase programme
<b>BoE</b>	Bank of England
<b>BoJ</b>	Bank of Japan
<b>BPS</b>	Basis point
<b>CJEU</b>	Court of Justice of the EU
<b>ECB</b>	European Central Bank
<b>ESM</b>	European Stability Mechanism
<b>EU</b>	European Union
<b>Fed</b>	US Federal Reserve
<b>GDP</b>	Gross domestic product
<b>LoLR</b>	Lender of last resort
<b>M5S</b>	5 Star Movement
<b>MoU</b>	Memorandum of Understanding
<b>NCBs</b>	National central banks
<b>OMT</b>	Outright monetary transactions
<b>PEEP</b>	Pandemic emergency purchase programme
<b>PCCL</b>	Precautionary Conditioned Credit Line
<b>PSPP</b>	Public sector purchase programme
<b>SMP</b>	Securities market programme
<b>US</b>	United States

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## EXECUTIVE SUMMARY

- **The European Central Bank (ECB) is about to enter the segment of the monetary policy cycle during which the objectives of price and financial stability might push it in opposite directions.** For as long as monetary policy is eased, both objectives are generally fulfilled simultaneously. But as policy rates are increased and asset purchases end to tame inflation, the risk arises of market fragmentation among euro area countries.
- **The euro area faces this market fragmentation risk** – i.e. some countries might experience a significant widening of their spreads disconnected from economic fundamentals – because of its peculiar and possibly incomplete institutional framework, with 19 sovereign governments that each have their own fiscal policy but share one currency and one monetary authority.
- Given the favourable level of nominal growth compared to the interest paid on the debt ( $r-g$ ), **debt-to-GDP ratios are expected to fall, interest payments are expected to increase very gradually despite the ECB's policy rate hikes**, and thus solvency should not be a big issue for European governments in the next few years. However, there remains a risk of experiencing liquidity crises in euro area sovereign debt markets if the ECB does not do its part to rule out self-fulfilling bad equilibria.
- Although still not considered a central scenario at this stage given that spreads are still well below previous peaks, **the materialisation of this risk would be devastating for the euro area**, because financial fragmentation could threaten financial stability and ultimately jeopardise price stability and the euro itself.
- **The ECB therefore needs to think of tools** to complement its expected interest rate hikes by neutralising the effect on spreads of the most vulnerable countries.
- **We discuss the various policies that have been implemented in the past decade** to deal with liquidity risks and explore which aspects could be used now that the tightening part of the monetary policy cycle is underway.
- **In the current circumstances, the important ingredients for such a tool are** in our view that this tool needs to be country-specific, that it needs, given the difficulty of disentangling solvency and liquidity situations, to be applied only when debt sustainability of the countries in question is validated by a political process, and that it needs to be applied in conjunction with interest rate decisions so the whole framework is consistent.
- **The existing tool that comes closest to having such a set of characteristics remains outright monetary transactions (OMT).** Its country-specific nature serves the purpose of being targeted, and the European Stability Mechanism (ESM) programme that is required to accompany it provides political legitimacy. But the OMT/ESM framework is designed as a measure for when there is a high probability of a solvency crisis while now, a tool is needed for non-debt-crisis times. Moreover, ESM involvement slows down the decision-making process, and the political compromises that ensue do not necessarily constitute first-best policy.
- **None of the options in the current ECB toolbox is fully satisfactory** from an economic and democratic perspective in the current situation. Therefore, we propose a new option with the right economic ingredients and a process ensuring that it is politically legitimate and within the bounds set by the European Union Treaties, but that, contrarily to OMT, could be applied in real time to neutralise the additional risk that monetary tightening could pose for some countries.
- Whatever tool the ECB decides to use, old or new, in the current situation, **we also argue that it needs to rethink its collateral framework** in order to abandon its counterproductive reliance on private ratings, which creates some unnecessary uncertainty over the safe-asset status of European sovereign bonds.



## 1. INTRODUCTION

In 2021, in its first monetary policy strategy review since 2003, the European Central Bank (ECB) mentioned the fragmentation risk in a document that summarised the changes in its strategy and the reasoning behind them (ECB, 2021a): *“Under stressed financial market conditions, monetary policy measures aimed at maintaining price stability typically help to restore financial stability by addressing impairments to the monetary policy transmission mechanism and averting negative macro-financial feedback effects and debt-deflation phenomena”*<sup>1</sup>. However, as this quote shows, the ECB only mentions situations in which the objectives of price and financial stability are served by the same policy. When monetary policy is eased, the tools used (rate cuts and asset purchases) to help stimulate growth and inflation also help contain financial fragmentation. But the two objectives are not simultaneously served when monetary policy is tightened. As the ECB is about to increase its interest rates for the first time in eleven years to tame inflation (probably as soon as July 2022), this policy now risks causing market fragmentation and ultimately financial instability.

Financial fragmentation, the widening of country spreads (sometimes disconnected from economic fundamentals), is unique to the monetary union of 19 sovereign states but only one monetary authority. And it is a significant problem given the non-negligible weight of sovereign bonds in domestic banks' balance sheets, which can actually lead to financial instability. But, given the benchmark role played by governments' rates in the real economy, market fragmentation also impairs the homogeneous monetary transmission channel, which in turn threatens price stability and ultimately the common currency. Given that both price and financial stability are part of the ECB's mandate, it is crucial for the ECB to have the right tools to deal with this fragmentation risk.

As the ECB enters the part of the monetary policy cycle that might pit the two objectives of price and financial stability against each other, we discuss the various options the ECB has in terms of its existing tools, but also what might be missing from the toolkit to deal with this issue. We also discuss which might be the right authority to use those tools and how often.

Particular consideration must be given to ensuring that the risks generated by the few do not jeopardise the whole monetary union. Equally, the ECB's policies, particularly at the current juncture of monetary tightening, should not affect countries so differently that it becomes dangerous. At the very least, effective ways are needed to neutralise the increase in financial fragmentation caused by increasing interest rates, in ways that have political legitimacy.

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<sup>1</sup> Market fragmentation was also discussed in the occasional papers written for the review, discussing legal considerations and efficiency of tools (ECB, 2021b and c).

## 2. WHY DOES A FRAGMENTATION RISK EXIST IN THE EURO AREA SOVEREIGN DEBT MARKETS?

This risk finds its origins in the peculiar, and incomplete, euro area institutional framework, with 19 sovereign governments, each with their own fiscal policy, sharing one currency and one monetary authority. The Maastricht Treaty foresaw a clause that prohibited monetary financing by the ECB in order to prevent undisciplined behaviour by one country affecting the inflationary outcome for all. Even though this is justified in a monetary union in which countries want to prevent any moral hazard from influencing the behaviour of their partners, it can also deprive countries of a monetary backstop by constraining the possible actions the central bank could take in times of stress. This results in an inherent fragility of euro area public debts because of the existence of multiple equilibria in the sovereign debt markets, in which a self-fulfilling adverse crisis becomes a potential outcome.

Indeed, when government debt is high, there might not be only one equilibrium rate paid on sovereign bonds: markets may coordinate expectations either on a good or on a bad equilibrium in which a default is more likely. When markets coordinate expectations on the equilibrium for which there is a higher risk of default, they logically ask for a higher yield. The rise in the cost of servicing debt may, in turn, create the conditions for the sovereign to default, confirming *ex post* the markets' expectations (Camous and Cooper, 2019; Corsetti, and Dedola, 2016; De Grauwe, 2012).

However, this self-fulfilling adverse outcome can be prevented if the country's central bank is ready to play the role of lender of last resort (LoLR) in the sovereign bond market. Indeed, the central bank, thanks to its potentially unlimited resources, is the only institution that can bring back markets from the bad to the good equilibrium. In the euro area, there are good reasons to think that the panic in the sovereign bond market between 2010 and 2012 was, at least partly, driven by the existence of multiple equilibria and the fact that the ECB did not react quickly and forcefully enough to prevent it at the time.

This is very different from other major central banks. The US Federal Reserve (Fed), the Bank of England (BoE) and the Bank of Japan (BoJ), all provide, more or less explicitly, a backstop to the sovereign bond market that ultimately prevents difficulties for the sovereign in financing themselves. This role was particularly important for the Fed and the BoE at the start of the COVID-19 crisis when the two countries experienced some elevated stress in their government bond markets (BoE, 2020; Fed, 2020). However, this responsibility is not new and there is a long history of major central banks providing a backstop to their governments in various historical episodes: for instance, the BoE in 1914, and the Fed in 1939, 1958 and 1970 (Hauser, 2021).

In addition to this issue of multiple equilibria in the bond market, there is a redenomination risk due to the multi-country nature of the monetary union. In other words, markets sometimes believe that the risk of a euro area break-up could materialise in times of stress (for economic or political reasons), resulting in higher interest rates in some countries, as happened in Greece in 2010-15 and in other euro area countries during the 2010-12 period.

Finally, another crucial source of fragmentation risk comes from the fact that the ECB's collateral framework has on some occasions endangered the safe-asset status of various euro area sovereign bonds since September 2006, by giving a crucial role to ratings by private credit rating agencies (Orphanides, 2017; Claes and Gonçalves Raposo, 2018). Indeed, central banks' collateral frameworks play an important role in defining what is considered as a safe asset by financial market participants. The eligibility and haircuts applied in the central bank's monetary operations are thus completely relevant in establishing the safety of an asset in the markets' eyes, as they determine whether financial institutions will be able to exchange these assets easily and almost at par against the ultimate safe

asset: central bank reserves. However, the ECB's framework is unsatisfactory in that regard because of its reliance on ratings from credit rating agencies. As these ratings are pro-cyclical (Vernazza and Nielsen, 2015), relying on them can lead to abrupt swings in haircuts or even in the eligibility of governments' bonds in the ECB's market operations. This, in turn, creates huge uncertainty for financial institutions and encourages them to dispose of assets that are not eligible as collateral, or if their haircut increases drastically during stress situations, therefore exacerbating the acuteness of this stress. The ECB has become aware of this issue in recent years, leading its Governing Council to suspend its reliance on rating agencies during the COVID-19 crisis, but it has not offered a permanent fix to the problem<sup>2</sup>.

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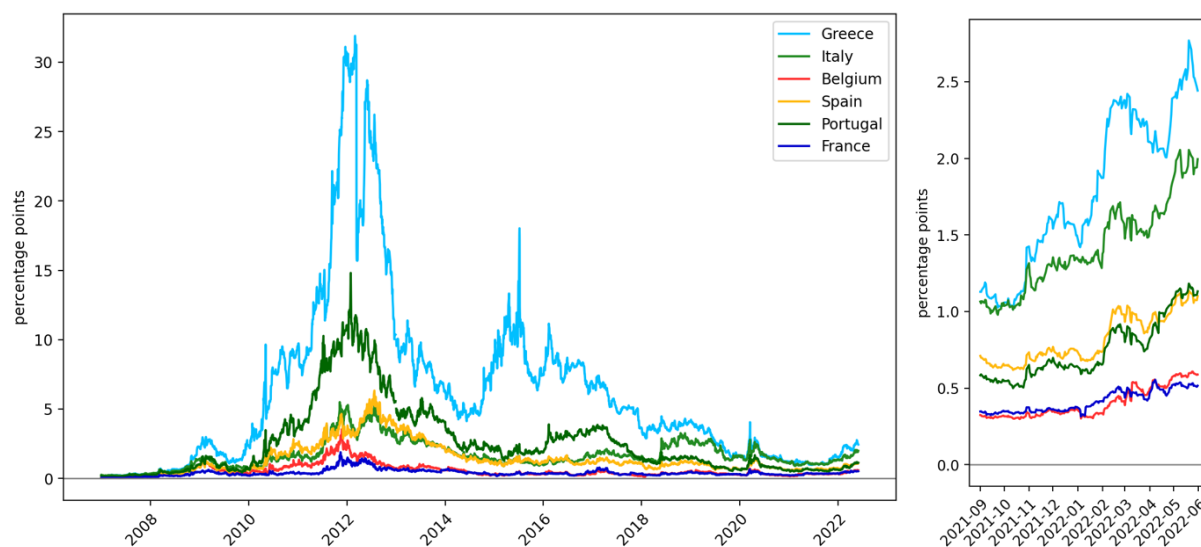
<sup>2</sup> In its 24 March 2022 communication (ECB, 2022b), the ECB states that "the ECB's Governing Council reserves the right to deviate also in the future from credit rating agencies' ratings if warranted, in line with its discretion under the monetary policy framework, thereby avoiding mechanistic reliance on these ratings", meaning that it is ready to suspend its reliance again in the future, but also that, for the moment, it does not plan to reform it to solve the problem permanently to get rid of the uncertainty created by such a feature of its collateral framework.

### 3. HOW HAS THE ECB DEALT WITH THIS RISK UP TO NOW?

In the **pre-euro-crisis period** (from 1999 to 2010), there was no tool designed to deal with the risk of fragmentation between euro area countries. The early days of the monetary union were in any case characterised by a narrowing of spreads in the euro area, so no tool was needed at the time to deal with this risk, which was then largely unthought of. However, when the financial crisis started, it took much more time for the ECB to start its asset purchase programme compared with other central banks, such as the US Fed, the Bank of England and the Bank of Japan. This delay might be explained by the fact that the Treaty-based prohibition of monetary financing was interpreted by the ECB in a strict way, given the absence at the time of political consensus on this point.

From **2010 to 2012**: With the quick widening of spreads, the ECB decided on 10 May 2010 to create the securities market programme (SMP) to address tensions in the market that were hampering the monetary policy transmission channel. However, the limited size of the SMP and the impression that the ECB was doing it half-heartedly left financial markets thinking that the central bank was not ready to intervene sufficiently to circumvent the bad equilibrium. On the contrary, the ECB's initial hesitation made a liquidity crisis possible in the sovereign debt markets of various euro area countries (Figure 1). A possible reason for this hesitancy was that ECB may have interpreted its financial stability mandate in a narrow way because there was no political consensus on what it was allowed to do during a type of crisis not envisaged by those who created the monetary union.

**Figure 1: 10-year interest rate spreads vs Germany for euro-area countries with debt to GDP ratio above 100% (in %)**



Source: Bruegel based on Bloomberg (data retrieved on 31 May 2022).

**In 2012:** Up to summer 2012, the yields of a growing number of euro area governments rose well above levels considered in line with their fundamentals. But with ECB President Draghi declaring on 26 July 2012 that the ECB was ready to do “whatever it takes” to safeguard the integrity of the monetary union, the ECB finally signalled that it was ready to act decisively in a sovereign bond market that it considered dysfunctional and that altered the transmission of monetary policies in some countries. After Draghi’s speech, the ECB formalised this commitment with the creation of a new instrument, the outright monetary transactions (OMT) programme, at the September Governing Council meeting. The announcement of possible – and potentially unlimited – ECB involvement in the government debt market was enough to drive markets towards the good equilibrium as spreads narrowed rapidly (Figure

1). The fact that the ECB did not have to buy a single asset to accomplish this shows that the crisis on the euro area bond markets between 2010 and 2012 was, at least partly, one of multiple equilibria due to the absence of a central bank backstop.

**Since 2015:** with deflation risks intensifying between 2012 and 2015, and with short-term policy rates near their lower bound, the ECB decided at the beginning of 2015 to launch a massive asset purchase of euro area governments bonds in the form of the public sector purchase programme (PSPP). The aim was to lower directly the long-term part of the yield curve to boost investment, which was very subdued after the crisis, and thus bring back inflation towards 2%. Even though the PSPP was not directly designed as an anti-fragmentation tool, there is now clear evidence showing that it played an important role in further compressing spreads between euro area countries given the prominence of the ECB's purchases in the sovereign bond market (Altavilla et al, 2015; Bulligan and Delle Monache, 2018). This programme is now expected by the ECB to end in the third quarter of 2022 (according to Lagarde, 2022b). In the meantime, between 2015 and 2022, the purchases of national and supranational bonds for this programme have amounted to around EUR 2,700 billion as of the end of April 2022.

**From 2020 to 2022:** with the advent of the COVID-19 crisis and after some mishaps (Claeys, 2020a, b) that led to a quick increase in spreads, the ECB launched its pandemic emergency purchase programme (PEPP) on 18 March 2020. The initial EUR 750 billion envelope for the PEPP was increased by EUR 600 billion on 4 June 2020 and by EUR 500 billion on 10 December, for a grand total of EUR 1,850 billion<sup>3</sup>. In addition, in April 2020, the ECB announced an important change in its collateral policy by suspending its reliance on rating agencies for the eligibility and for the determination of haircuts applied to bonds taken as a collateral in its monetary operations. This might have been a crucial decision because the ineligibility of sovereign bonds as collateral due to a downgrade could have undercut the safe asset status of some governments' bonds, and could have led to a fragmentation episode, as discussed above. In December 2020, the suspension was prolonged.

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<sup>3</sup> The book-value holding at the end of the programme amounts to a bit less than the envelope agreed by the Governing Council though, as it stands at around EUR1,700 billion.

## 4. FRAGMENTATION RISKS IN THE NEAR FUTURE

Spreads (vs German yields) for countries with the highest levels of debt-to-GDP ratio have been increasing steadily since September 2021, as can be seen in the right panel of Figure 1. However, it's worth noting that at this stage spreads are still lower than during previous peaks, without even mentioning the extraordinary levels reached during the euro crisis. The Italian spread is around 200 basis points (bps) today, compared to around 280 bps in March 2020 before PEPP was launched at the height of the tensions between the Lega-M5S government and the European Commission in 2018-19, while the spread for Greece stands at around 240 bps today compared to 400 bps at the beginning of the COVID-19 crisis (Figure 1, left panel).

Even if spreads are not at the worrying levels of previous episodes, this increase could still represent a challenge at a time when growth is quickly slowing down following the Russian invasion of Ukraine<sup>4</sup>, and at a time when many countries have historically high levels of debt after the highly expansive fiscal policy put in place during the COVID-19 crisis (Figure 2).

Moreover, this shock happens in a context in which the ECB has announced that it plans to normalise its monetary policy because of the current quick rise in inflation above its target. As confirmed recently by Lagarde (2022b) net asset purchases are coming to an end, with PEPP net purchases having ended in March 2022, and PSPP net purchases expected to end in the third quarter of 2022. Furthermore, the ECB is expected to hike its policy rates by 25 bps in July and by an additional 25 bps in September, which would bring its deposit rate to 0% for the first time since June 2014 (Lagarde, 2022b)<sup>5</sup>. Overall, at the time of writing (May 2022), market participants expect the ECB to increase its relevant policy rate by around 225 basis points by the end of 2023, as is visible in Figure 3.

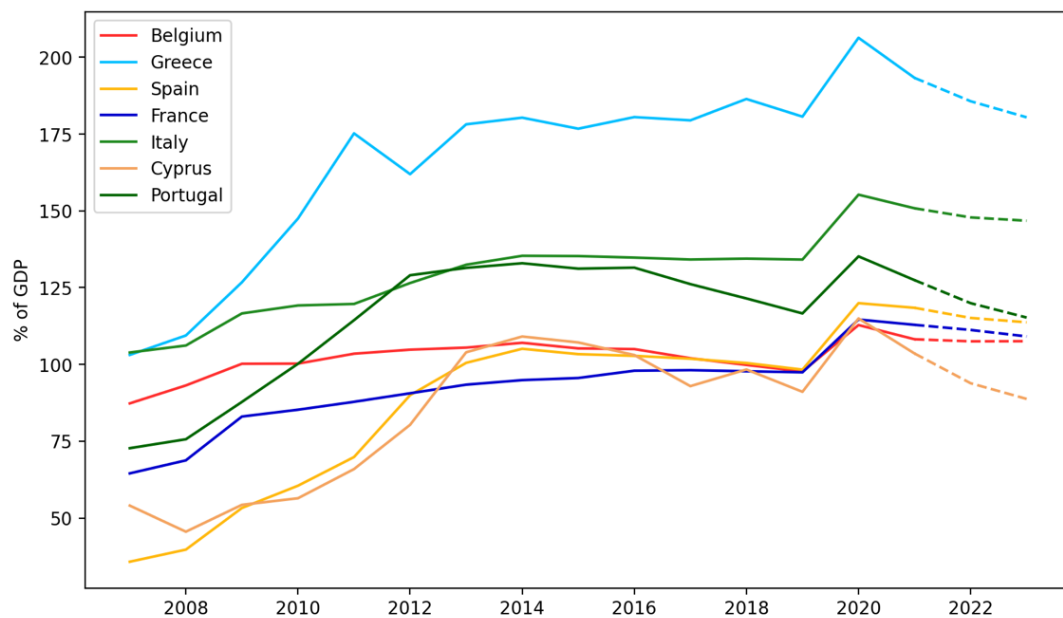
The expectation of higher policy rates and the stopping of asset purchases, combined with declining growth and high levels of debt, is worrying markets. This potentially accounts for the current increase in spreads.

Even if these risks are not negligible, these fears must also not be overstated. Debt-to-GDP ratios are undeniably historically high (Figure 2) but with expected high nominal output growth in the next few years (e.g. 8.8% is expected in the euro area in 2022), and very low implicit rates, these ratios are expected to fall already in 2022 and in the next few years, despite higher policy rates (as visible in Figure 2). Indeed, euro area countries have locked-in low rates thanks to the combination of low rates for a decade and of an increase of the average maturity of their debts. This means that interest payments as a share of GDP, and the interest paid on the stock of debt, are at historical lows (Figures 4 and 5) and are expected to increase only very gradually in the next few years. For some countries, they may even continue to decrease given that high-interest old debts are replaced by new debts with lower rates, despite the rise in the ECB's policy rates and of the rest of the yield curve.

<sup>4</sup> In its spring forecasts exercise published on 16 May 2022, the European Commission revised heavily downwards its growth forecasts compared to its winter forecasts published only three months previously, on 10 February. The baseline forecast for growth in the euro area is down to 2.7% from 4% in the winter forecast, and the two alternative scenarios are adverse scenarios with growth forecasts lower than the baseline, meaning that the risks are heavily skewed to the downside.

<sup>5</sup> Quantitative tightening (i.e. the reduction of the ECB's balance sheet by letting assets mature without replacing them) appears to be still far away on the horizon, with e.g. PEPP reinvestments to stop not before 2024.

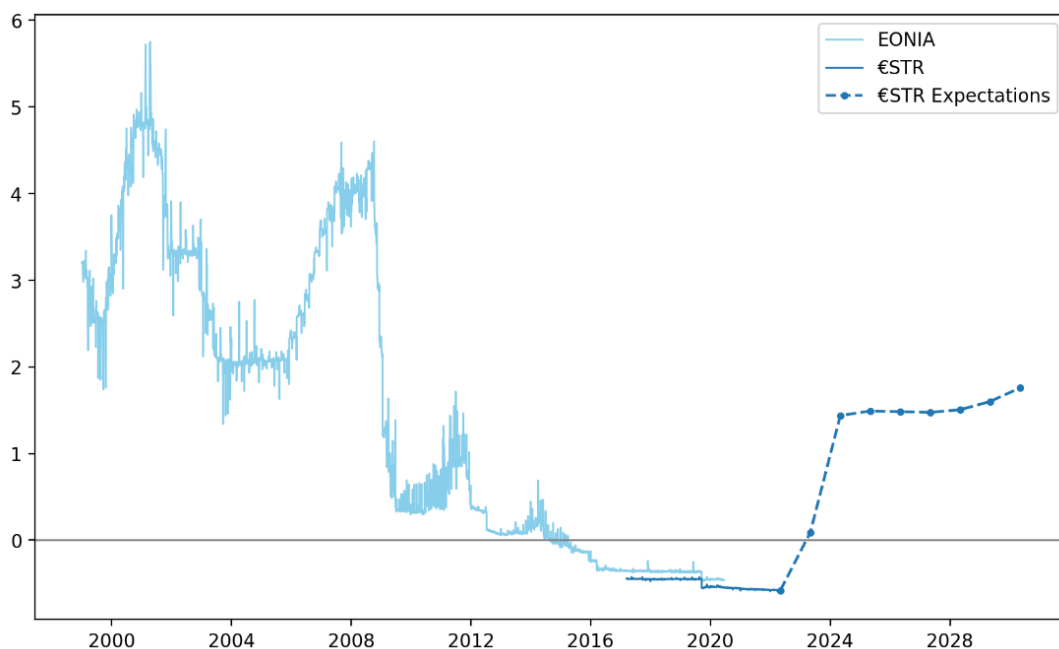
**Figure 2: Debt/GDP ratio and European Commission's forecasts (in % of GDP)**



Source: Bruegel based on AMECO.

Note: Dotted lines are forecasts for 2022 and 2023 made by the European Commission (spring forecasts 2022, published on 16 May).

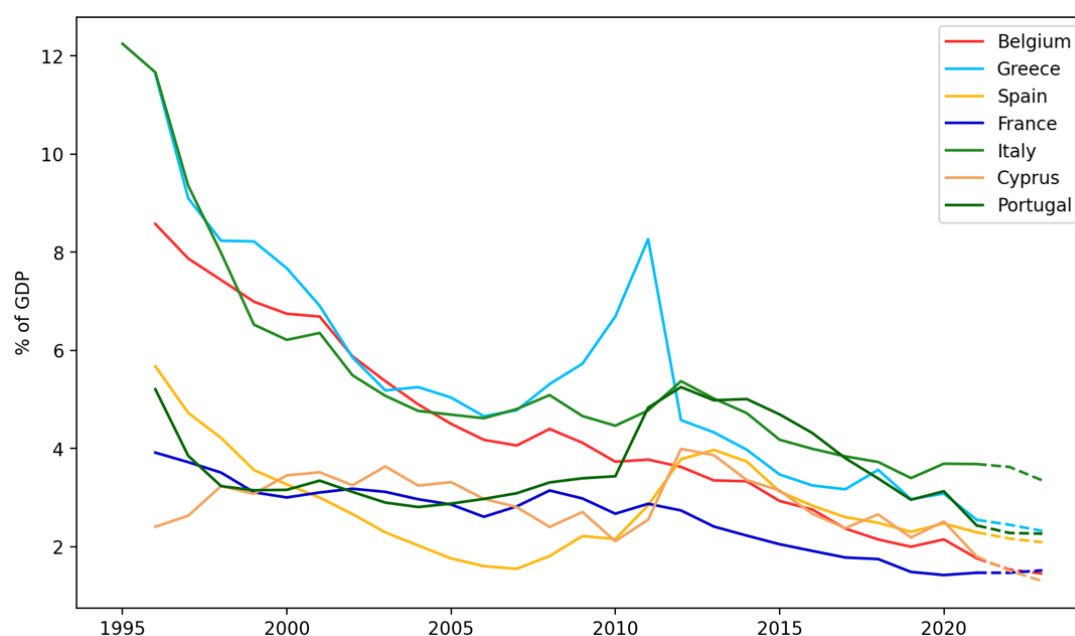
**Figure 3: Market expectations for euro-area short term rates (in %)**



Source: Bruegel based on Bloomberg.

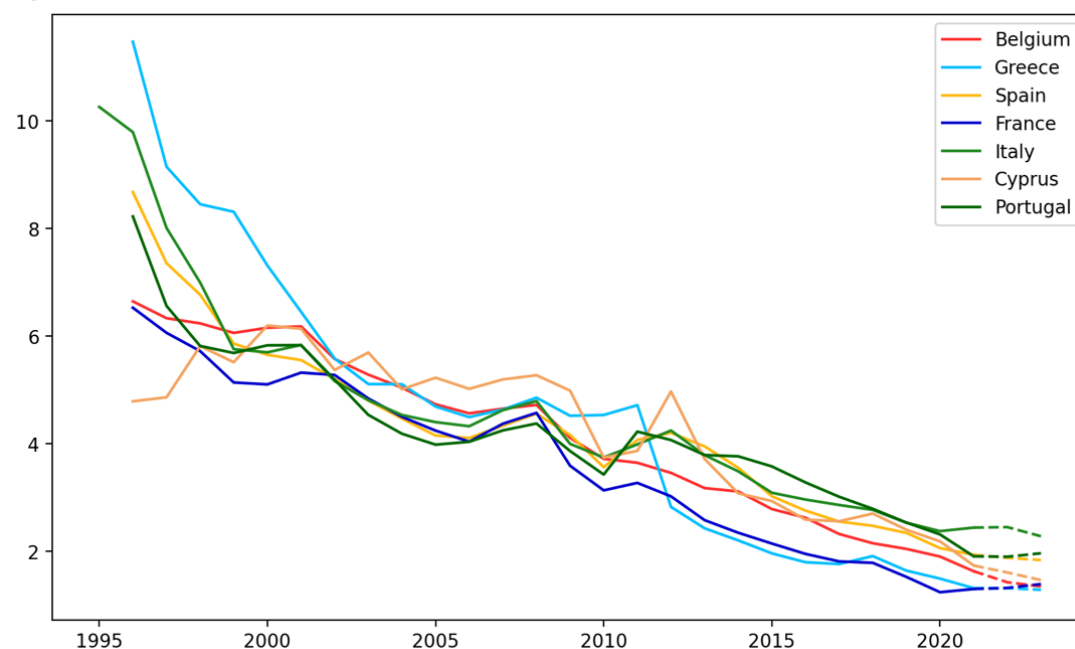
Note: Interest rate expectations are derived from €STR zero-coupon swaps of different terms (1 year, 2 years, up to 10 years), which provide information on market expectations of the compounded overnight €STR over the contract term. Expectations for the 2023 interest rate, for instance, are derived through expected compounded EONIA/€STR over the next year (2022), given by the 1-year swap, and expected compounded EONIA over the next two years (2022 and 2023), given by the 2-year swap.



**Figure 4: Interest payments as a share of GDP (in%)**


Source: Bruegel based on AMECO.

Note: Dotted lines are forecasts for 2022 and 2023 made by the European Commission (spring forecasts 2022, published on 16 May).

**Figure 5: Implicit interest rates (i.e., interest paid on debt stock, in%)**


Source: Bruegel based on AMECO.

Note: Dotted lines are forecasts for 2022 and 2023 made by the European Commission (spring forecasts 2022, published on 16 May).

In addition, the European recovery plan adopted in 2020 at the height of the COVID-19 crisis could also play a positive role in the coming years. First, the adoption of the plan, and the issuance of common debt to finance the plan, has shown that European countries want to stick together for the foreseeable



future, which should therefore reduce significantly the redenomination risk. Second, many market-reassuring and growth-boosting reforms should also be implemented in the next few years as part of the national Recovery and Resilience Plans put forward by EU countries in order to obtain EU funds<sup>6</sup>, which ultimately should help debt sustainability<sup>7</sup>. Finally, Next Generation EU spending will provide a fiscal boost to some countries in the next few years without burdening their national debts directly (Darvas and Wolff, 2021). All these elements together suggest that the fundamentals of debt sustainability are not in peril or might have even possibly improved in the recent period.

Overall, thanks to a favourable  $r-g$  (interest rate-growth differential) in the next few years (i.e. the fact that the nominal growth of output is higher than the interest rate paid on the debt), debt-to-GDP ratios are expected to fall and solvency might hopefully not be such a big issue for European governments. However, this still leaves a significant risk that liquidity crises will be experienced in euro area sovereign debt markets if the central bank does not do its part to rule out self-fulfilling bad equilibria. In that case, how can the ECB play its lender-of-last-resort role in the sovereign debt market if this risk reappears? This could be more complex than anticipated given the current situation and, in particular, the potential divergence between price and financial stability objectives.

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<sup>6</sup> See details on the Commission's webpage: [https://ec.europa.eu/info/business-economy-euro/recovery-coronavirus/recovery-and-resilience-facility\\_en#national-recovery-and-resilience-plans](https://ec.europa.eu/info/business-economy-euro/recovery-coronavirus/recovery-and-resilience-facility_en#national-recovery-and-resilience-plans).

<sup>7</sup> The case of Italy in 2018-19 and in 2021-22 is striking in that regard: despite the fact that the debt barely changed in 2018-19, markets were worried because they believed that the government would implement unsound policies and clash with the Commission, leading to a significant increase in the spread, while in the last few years the debt has increased significantly but the spread has not increased as much, possibly because markets believe this time that the money is well used today (to protect the economy during COVID-19, and to finance useful investment and reforms, that might improve debt sustainability in the long run).

## 5. DEALING WITH FRAGMENTATION RISK: WHAT ARE THE ECB'S CURRENT OPTIONS?

The ECB could pursue multiple options to deal with fragmentation risk. In this section, we explore the four main options the ECB could consider if it were to face an adverse self-fulfilling equilibrium in one of the euro area sovereign debt markets<sup>8</sup> using either the tools already in the ECB's toolbox (possibly tweaked) or tools that have been used in other jurisdictions. We discuss their rationale, in which particular situation each of these options might be useful, and the political economy obstacles that each of them might face.

**1. Adjust the access to OMT.** The main attraction of OMT is that it is country-specific and in principle unlimited, and thus credible for markets. Even though it has never been actually applied, it has already proved to be a powerful instrument, as demonstrated by the fact that spreads fell rapidly on its creation in 2012 (Figure 1). However, OMT needs to be accompanied by an ESM programme, which is considered as tough conditionality. On the one hand, an ESM programme implies that it is politically validated by elected officials, i.e. by the Eurogroup (which constitutes the ESM's board), which in several countries needs to be backed by parliaments. On the other hand, the approval of an ESM programme requires unanimity, which makes the decision very slow and difficult and leads to compromises that may not actually always end up serving the interest of the affected country or necessarily the euro area as a whole. Designed as a debt crisis measure, the current OMT/ESM framework would probably not be the best option at the current juncture and should be used when there is a clear solvency risk that should be dealt with jointly through an ESM macro programme with the help of the ECB's OMT.

One could therefore rethink the OMT/ESM not just for genuine debt crises but for other types of shocks. ESM conditionality makes sense if the increase in spreads is a result of unsound policies that call for a change in policies guided by an ESM programme with a memorandum of understanding (MoU). On the other hand, in the case of exogenous shocks or self-fulfilling crises, ESM precautionary programmes, and thus OMT, could be made easily accessible with no, or minimal, conditions (see Claey's, 2020a). However, although attractive in theory, this solution does not seem to be easily feasible in practice given the constraints built into the ESM institutional and legal setting. First, the recent amendments to the ESM Treaty signed in early 2021 did not go in that direction and actually made the use of a Precautionary Conditioned Credit Line (PCCL) even more difficult, as the criteria to access it were made more precise but tighter. Second, the creation of an *ad-hoc* ESM tool with minimal conditionality, such as the Pandemic Crisis Support instrument that was enacted in April/May 2020, could have been a way to solve the problem, but the fact that no country ended up using this instrument shows that the ESM involvement is politically toxic. Thus, instead of trying to reform the ESM so that it can be used as a political validation mechanism, maybe trying to pursue another institutional arrangement would be easier and thus preferable.

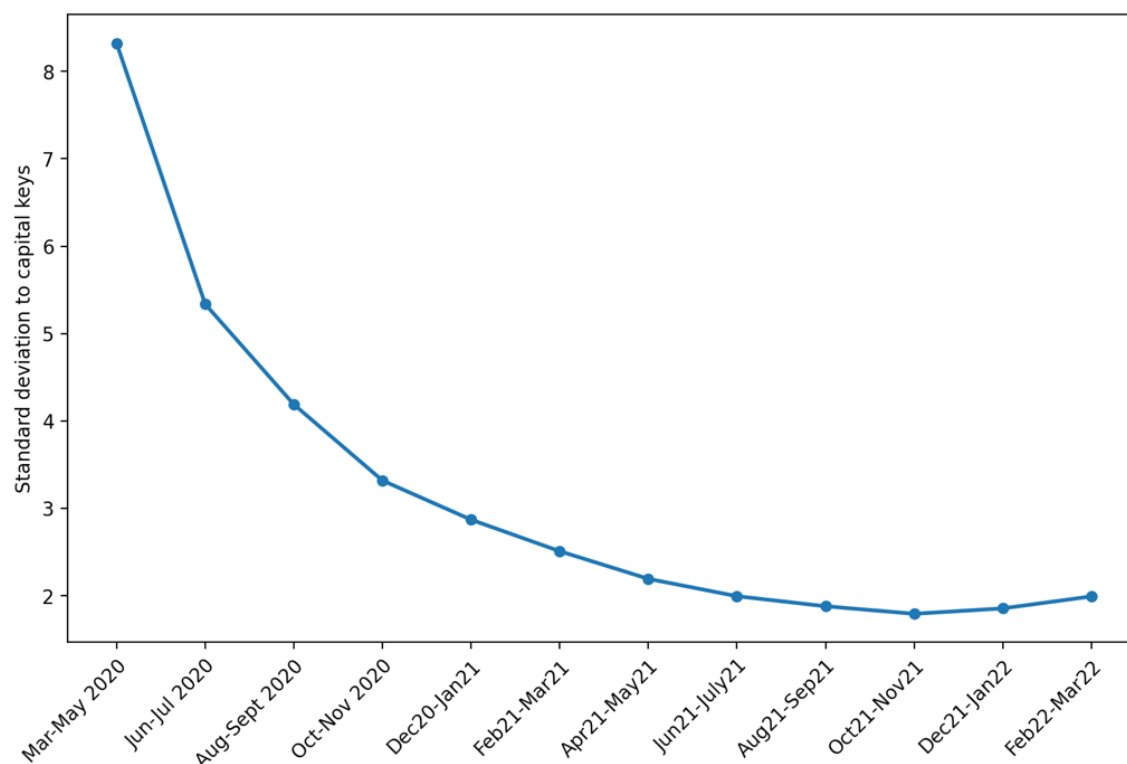
**2. Consider reusing current asset purchase programmes.** There are different ways for the ECB to continue some form of quantitative easing to prevent fragmentation:

- a. Restart the PEPP.** The ECB could consider restarting the PEPP (which net asset purchases stopped in March 2022). This programme has the advantage of being quick – as we saw in March 2020 when the ECB designed and launched it in only a few days – and powerful – it achieved a reduction of the spreads immediately after it was launched (Figure 1). It is also, in

<sup>8</sup> In the case in which there was a clear risk of a solvency crisis, the OMT/ESM framework in its current form (with an ESM macro adjustment programme to re-establish clear solvency) should be used.

our view, compatible with current Treaties<sup>9</sup> and has the advantage of not being constrained by the issuer limit introduced when the PSPP was launched<sup>10</sup>. But PEPP was easy to justify from a legal perspective thanks to its dual purpose: it was presented by the ECB both as an anti-fragmentation tool (because increasing spreads were impairing monetary transmission in some countries) and as a price stability tool (because deflation was looming as a result of the COVID-19 crisis). To perform this double task, the asset purchases were flexible in terms of distribution across countries at the beginning – i.e. the share of purchases deviated significantly from the ECB's capital keys that were used in the PSPP to allocate purchases – but in line with capital keys when the programme ended in March 2022 (see Figure 6). However, PEPP remains at the edge of the legal framework and does not have full political validation. It is sometimes perceived to be a mutualisation of sovereign risk by stealth without any democratic validation, even if, similarly to the PSPP, this risk sharing remains limited as it is national central banks (NCBs) that buy 80% of sovereign debts, and the ECB itself only 20% (Claeys, 2020b). Therefore, given that today's situation does not require a double-purpose tool, restarting PEPP does not appear to be the most appropriate tool in the ECB's toolbox.

**Figure 6: Deviation of PEPP purchases from the ECB's capital keys over time**



Source: Bruegel based on ECB.

Note: Standard deviations of countries' shares of cumulative asset purchases from ECB capital keys over time.

- b. Alter the PSPP to make it more flexible.** An alternative would be to alter the PSPP to make it more flexible and allow the distribution of purchases to deviate from the ECB's capital keys. This would be difficult because the PSPP is supposed to be a monetary tool to ensure price stability (it was introduced in 2015 when deflation was looming) and thus is meant to be an indiscriminate, not country-specific tool. Moreover, the PSPP is still limited by the issuer limits, as the 33% limit still applies to PSPP. In our view this could be removed, given that in its 2018 judgement on the PSPP (Weiss case, CJEU, 2018), the EU Court of Justice considered that the

<sup>9</sup> See discussion on the legality of the PSPP in Claeys (2020b)

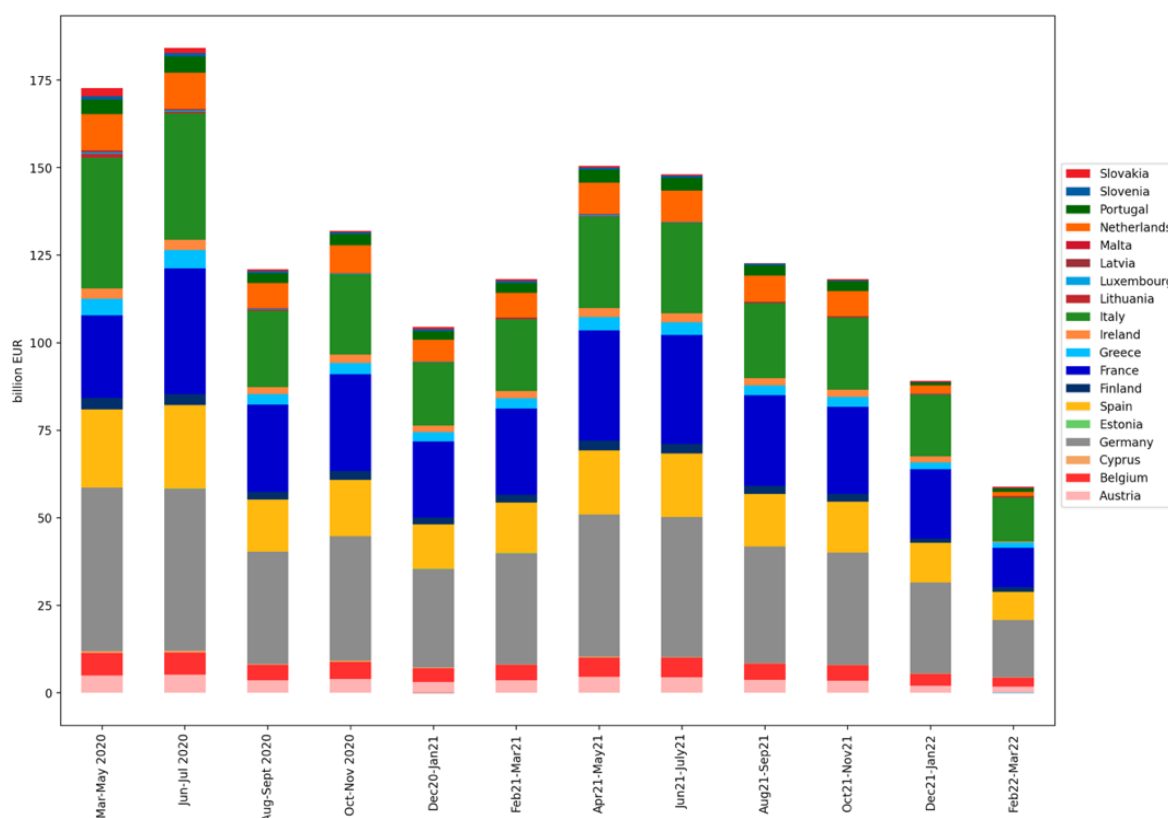
<sup>10</sup> PSPP and PEPP holdings are not consolidated.

relevant limit of the ECB's public-sector purchase programme compatible with the EU Treaty is not to buy all the bonds issued (see Claey's, 2020b, for details).

- c. Reinvest maturing PEPP assets in a flexible way to address fragmentation.** The ECB mentioned in December 2021 that it could reinvest PEPP maturing assets in a flexible way to address fragmentation, for example, by concentrating purchases on countries for which spreads increase for non-fundamental reasons. More recently Schnabel (2022) mentioned: *"We will decisively counter any sudden jumps in yields that have no fundamental justification. We will prevent euro area fragmentation driven by speculation. We already have a programme available for this as we can flexibly reinvest maturing securities under the PEPP."*

However, the volume of maturing assets available to be reinvested would probably not suffice to contain spreads in the event of market stress. The redemption of PEPP bonds will amount to around EUR 200 billion over the next 12 months (as estimated by Ducroz et al, 2022), i.e. around EUR 17 billion per month. Even if we added the EUR 242 billion of PSPP bond redemptions over the next 12 months<sup>11</sup>, this would lead to a total of around EUR 36 billion/month. Overall, this would be much smaller than the purchases during the last episode of market stress at the beginning of the COVID-19 pandemic, when sovereign bonds purchases peaked at EUR 90 billion per month and were concentrated on distressed markets (Figure 7). It would also represent a very small share of the euro area sovereign debt not held by the Eurosystem, which stands at about EUR 6.6 trillion. The high level of the bi-monthly purchases by country and the deviation from capital key in the spring of 2020 (both visible in Figures 6 and 7) suggest that that PEPP was mainly an anti-fragmentation tool at the beginning.

**Figure 7: PEPP asset purchases by country over time (bimonthly, in EUR billion)**



Source: Bruegel based on ECB.

<sup>11</sup> This possibility is not contemplated by the ECB's Governing Council at this stage, given the objective of the PSPP explained earlier.

**3. Implement yield curve control:** Alternatively, the ECB could consider an instrument to control the yield curve, a monetary policy tool introduced by the Bank of Japan in September 2016. However, such an explicit targeting of sovereign yields would probably not be compatible with the EU Treaty. According to the Court of Justice of the EU, the prohibition of monetary financing by the ECB was introduced in the Treaty to avoid moral hazard and “*encourage the Member States to follow a sound budgetary policy*” (Gauwailer case, CJEU, 2015). This type of market discipline, from differentiated and possibly increasing spreads (which sometimes happen for fundamental reasons), would fully disappear if the levels of euro area countries’ yields were explicitly decided by the ECB’s Governing Council<sup>12</sup>. The ECB should therefore not pursue this option.

**4. Invert the sequencing of monetary policy normalisation.** The ECB could also consider inverting the sequencing of its monetary policy normalisation by increasing its short-term policy rates first (if the Governing Council thinks this is necessary to ensure price stability), and continue its PSPP asset purchases for the time being (as proposed for instance by Reichlin et al., 2022). From an economic perspective this would be a peculiar solution if financial stability and price stability concerns diverge – i.e. if policy rates need to increase to contain inflation<sup>13</sup> but spreads widen at the same time. In that case, if the objective was to cool down the economy, it could be counterproductive to increase short-term policy rates while buying sovereign bonds, indiscriminately for all countries, which puts pressure on the long-term part of the yield curve at the same time, given the prominence of medium- to long-term rates in the real economy (as households and companies do not borrow short-term to invest).

On the other hand, a more targeted purchase programme could serve this purpose better, if it were to be backed politically. Moreover, from a political economy perspective, the commitment to follow the current sequencing was also probably established as way of removing a degree of tacit risk-sharing that at least some countries find uncomfortable.

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<sup>12</sup> One possibility to circumvent this could be that the spreads targeted by the ECB would be a function of the debt/GDP ratio or debt sustainability metric. However, this would stretch a little the idea of market discipline and could be seen as unfair by some countries and lead to a politicisation of the ECB.

<sup>13</sup> This might not necessarily be totally the case in the current situation as the current rise in inflation is mainly driven, at least for the moment, by an exogenous factor – i.e. the rise of energy prices, on which the ECB’s policies have no influence.

## 6. WHAT ELSE COULD THE ECB DO NOW?

In our view, none of the options outlined above are appropriate for the current situation. We believe the ECB needs to consider two other options. First it needs to design a new country-specific tool that will be able to neutralise the risk caused to some countries by a monetary policy tightening. And, second, from a more structural perspective, the ECB should re-think fundamentally the way it treats euro area sovereign debts in its collateral framework, as this would also help reduce the frequency of fragmentation episodes.

**1. Design a new specific tool to neutralise the fragmentation risk caused by a monetary policy tightening**<sup>14</sup>. None of the above options are fully satisfying at the current juncture, so in our view the ECB needs to design a new pure (i.e. single-purposed) anti-fragmentation tool that should be used when financial stability and price stability concerns diverge<sup>15</sup>. Such a tool should be designed to allow the whole risk-free yield curve to move upwards in sync with short-term policy rates, while keeping country spreads in check. And it should be applied, or at the very least decided, in conjunction with interest rate hikes in a consistent framework that aims to neutralise the risk of fragmentation.

Such a tool would take the form of an asset purchase programme but should be country-specific, not applied to all countries<sup>16</sup>. However, the risk with the ECB playing the role of lender of last resort (LoLR) is that it is difficult to distinguish liquidity from solvency issues, especially for governments. If the ECB was the LoLR in all cases in which yields increase significantly, without knowing whether these increases are related to a self-fulfilling issue or linked to fundamentals, this would put an end to market discipline (which would be difficult to reconcile with the EU Treaty and its interpretation by the CJEU). An *ex-ante* condition therefore, which would be both necessary but also sufficient for the ECB to justify national asset purchases, would be for that country's debt to be sustainable, and for that country to commit to maintain sound policies for its debt to continue to be sustainable in the future.

But legitimate political economy concerns would remain. Should the ECB be able to decide on such schemes unilaterally without political validation? Given that this kind of tool is purely discretionary, can the ECB be relied on to always make the right decision in similar cases going forward (given that decisions in 2012 and 2020 are generally considered adequate, legitimate and proportionate, but decisions in 2010-12 are now, *ex post*, generally considered as flawed)? Is there an alternative way to legitimise such programmes? Sapir (2022), for instance, proposed recently that the ECB should create a new "OMT for external shocks" (such as the Ukraine war) that would not be conditional on ESM but would be implemented in another institutional setup.

Indeed, the OMT is the scheme that comes closest to dealing with the problem of fragmentation. But the OMT was also a tool designed to be used in case of debt crises, whereas now a tool is needed to accompany interest rate decisions. Moreover, the involvement of the ESM makes it too slow and subject to political compromises, as we discussed earlier.

We could envisage a framework in the which the European Commission analyses and confirms the sustainability of a country's debt from a technical perspective, which would then be approved

<sup>14</sup> Such a possibility of introducing new instruments was mentioned by President Lagarde in a speech on 17 March (Lagarde, 2022a) and during the 14 April 2022 press conference (ECB, 2022a).

<sup>15</sup> The reason why the PEPP was an easy sell (both legally and politically) is that it was both a monetary policy tool to contain the risk of deflation and an anti-fragmentation tool at the same time. It thus benefited from the fact that price stability and financial stability were calling for policies going in the same direction. A single-purpose tool, in particular when inflation and fragmentation objectives diverge (as it is the case at the moment), might be more complex to design for the ECB.

<sup>16</sup> Like the OMT, the selective nature of such a programme should not be a legal issue as long as it is clearly designed to "rectify the disruption to the monetary policy transmission mechanism caused by the specific situation of government bonds issued by certain Member States" (CJEU, 2015).

politically by a majority of the Eurogroup or the Council<sup>17</sup>. This would enable the ECB then to consider a targeted asset purchase programme that neutralises the increase in spreads that follows after an interest rate increase (or when stopping QE), without fearing that it oversteps its mandate or that it makes political choices<sup>18</sup>.

In practice, while the interest rate and asset purchase decisions need to be taken together, the examination of debt sustainability does not need to happen at the same frequency. The Commission's fiscal monitoring and Macroeconomic Imbalances Procedure, which happen annually, can serve as a sufficient system of checks and balances<sup>19</sup>.

**2. Finally, whatever tool is used to deal with the current situation, the ECB should definitely reform its collateral framework.** In particular it should consider stopping once and for all its reliance on private rating agencies for its collateral framework. This is not a stand-alone measure, but a structural change to complement the other tools. For the moment, however, the ECB plans to phase out the suspension of the use of private ratings decided in 2020 between July 2022 and March 2024, as decided on 24 March 2022 (ECB, 2022b). But, as discussed in detail in Claeys and Goncalves Raposo (2018), going back to mechanically using ratings from credit rating agencies in central banks' collateral framework is not fully satisfactory. So, what should be done?

First, the ECB should try to find a permanent solution instead of easing temporarily and under full discretion its collateral framework during crises, as it did during the COVID-19 crisis. Lack of a permanent solution creates uncertainty for financial markets' participants about what the ECB will do in each crisis, which is damaging.

Second, in terms of how the collateral should evolve in practice, a first possibility would be for the ECB to not rely on external ratings but to use its own criteria to value haircuts and decide on eligibility of assets, as many other central banks (such as the BoE<sup>20</sup>) around the world do. However, given the multi-country nature of the euro area and the potential distributional consequences that significant ECB losses could induce between countries in case of default – through a reduction of future seigniorage profits, or possibly through higher inflation – the ECB is in a much more complex situation than central banks that have to deal with only one treasury.

In this context, to avoid the risk of the ECB looking politicised (as in February 2015 when it decided to withdraw the waiver that was making Greek bonds eligible as collateral despite their low rating), it might be preferable for the ECB to still rely on an external risk assessment<sup>21</sup>. In that case, an alternative to private ratings could be to use a technical debt sustainability analysis that would be done, for instance, by the European Commission and then validated by the Eurogroup or the Council. This situation would not be perfect either, as it could lead to heated political debates between countries and the Commission. But, in our view, it would still be better than delegating these decisions to private rating agencies which cannot be held accountable for their potential mistakes and for the procyclicality of their ratings. For lack of a better institution (e.g. a euro area treasury or any other form of

<sup>17</sup> As discussed before, if this is not the case and the EU Commission establishes that there is a clear risk of insolvency, the ECB should not use this new tool but use the OMT/ESM framework in its current form (with an ESM macro adjustment programme to re-establish clear solvency).

<sup>18</sup> To be clear, the ECB's independence would not be in danger as the ECB would then be sole decision-maker in terms of whether this anti-fragmentation tool should be used or not, but it would decide knowing that there is an independent validation of the solvency of the country and thus it is not doing monetary financing and not breaching the limits set by the European Treaty.

<sup>19</sup> For instance, this could be formalised once a year when the Commission publishes its Fiscal Sustainability Report.

<sup>20</sup> See details on the BoE framework in Claeys and Goncalves Raposo (2018).

<sup>21</sup> This political economy problem is in the end very similar to the one discussed in the new option presented above.



executive body) and despite its flaws in terms of governance, the Commission and the Eurogroup finance ministers are currently the only bodies able to take this type of decision<sup>22</sup>.

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<sup>22</sup> Alternatively, eligibility and haircuts could also be based on the past performance of countries in terms of their respect for European fiscal rules, but these would first need to be reformed in depth to avoid mistaken recommendations.



## 7. CONCLUSIONS

Ten years after Draghi's 26 July 2012 "*whatever it takes*" speech, which led to the creation of the OMT programme and thus prevented a break-up of the monetary union, it is time to review the ECB's anti-fragmentation toolbox. The fact that the ECB's monetary policy is at crossroads forces us to discuss this issue once again. Given current inflation – 8.1% in the euro area in May 2022, well above the ECB's 2% target – the ECB has announced its plan to normalise its monetary policy: its net asset purchases are ending and the first interest rate hike in 11 years is expected this year. This ECB's willingness to normalise its policies combined with a degraded economic outlook because of the Ukraine war could pose some significant challenges to euro area countries if market fragmentation similar to previous episodes reappears in the near future.

Starting with OMT in 2012, several ECB tools have been created in the last decade to deal with fragmentation risk outbursts that are inherent to the euro area macro architecture. However, as we have seen, none of these existing tools are fully satisfactory, both from an economic and democratic perspective, in the current situation.

The ECB should thus consider doing two things at the current juncture. First it should design a new country-specific tool that will be able to neutralise the risk caused to some countries by a monetary policy tightening, and which is not conditional on an ESM macroeconomic adjustment programme but on another setting that ensure its political legitimacy. Second, from a more structural perspective, the ECB should renounce the phase out of collateral easing measures introduced during the COVID-19 pandemic, and re-think fundamentally the way it treats euro area sovereign debts in its collateral framework to ensure that it doesn't endanger the safe asset status of its members. The ECB needs to stop tweaking its collateral framework in crisis times and permanently reform it, as this back and forth constantly creates unnecessary uncertainty for financial markets' participants about the safe asset status of euro area countries' debt securities.

To conclude, this discussion once again highlights both the incomplete nature of the euro area macroeconomic architecture and the democratic issues it entails. Therefore, an alternative to this whole debate on how to create an anti-fragmentation ECB tool could also be to think about a deeper and systemic reform of the euro area architecture. In that regard, some form of European fiscal integration would help because if a highly significant share of countercyclical tools – such as unemployment insurance schemes – were centralised at European level, then the ECB could simply focus on ensuring the liquidity of European bonds (like the Fed does in the US with federally-issued bonds) and not on the liquidity of national sovereign bonds.

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The European Central Bank is about to enter the tightening part of the monetary policy cycle. Unlike in the easing part of the cycle, when the two objectives of monetary and financial stability are generally jointly served by the same policy, ECB policy interest rate hikes to tame inflation pose a risk of financial fragmentation in the euro-area. Some countries might experience a significant widening of their spreads not necessarily driven by fundamentals. This fragmentation could put a strain on the ability of those countries to borrow. Therefore, the ECB should design a specific tool that will accompany interest rate hikes to neutralise the risk of fragmentation directly for countries facing it, while staying within the bounds set by the EU Treaties and ensuring political legitimacy. We also advocate structural changes to the ECB's collateral framework to avoid unnecessary uncertainty about the safe-asset status of European sovereign bonds.

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