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Why ECB risks running out of ammunition

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Constraints lie in 25% issue and 33% issuer limits on bond purchases

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The European Central Bank's quantitative easing programme announced in January has been well received by financial markets. Its size (€60bn a month) and open-endedness have positively surprised.

The fact that 80 per cent of the bond purchases will not be subject to loss sharing between national central banks has rightly been seen as the price worth paying to get a bigger programme and a wider consensus within the ECB governing council. Indeed, this so-called risk-sharing issue has been overemphasised since all the monetary claims created by the programme will remain a joint and several liability of the eurosystem, whatever the loss-sharing arrangement on asset holdings.

Having said that, the ECB is now close to running out of ammunition. The true constraints on further ECB intervention lie in the 25 per cent issue limit and 33 per cent issuer limit on its sovereign bond purchases.

These limits are not arbitrary and could not be easily raised or removed: they are the byproducts of the conditions set in January by the European Court of Justice Advocate General in its opinion on the legality of outright monetary transactions (OMTs), the sovereign bond-buying backstop revealed by Mario Draghi, ECB president, in 2012 after he promised to do "whatever it takes" to bring order to sovereign debt markets.

Except for Greek debt, the 25 per cent and 33 per cent caps should not prove binding in a scenario where the ECB keeps its monthly asset purchase pace of €60bn. However, the limits could be reached in worst-case scenarios where the ECB would have to boost the size of its QE programme or implement OMTs targeted on specific sovereigns.

The first type of worst-case scenario would be a new global deflationary shock. It might be triggered by faltering US growth or a sharper than expected slowdown in China. The consequence would be fiercer currency wars with balance sheet expansion races among central banks.

In this competition, the ECB would be handicapped: it would not have much room to significantly increase the size of its bond purchase programme. For instance, if monthly purchases had to be raised to €100bn, the 25 per cent issue limit would be reached after only eight months in the case of German government debt.

Given the narrow size of the eurozone corporate bond market, any substantial further expansion of the asset purchase programme would then have to include equities. But this could prove controversial within the ECB governing council.

Another option would be for the ECB to take its policy rates deeper into negative territory, especially if there was upward pressure on the euro exchange rate. Indeed, compared with recent actions by Swiss, Danish and Swedish monetary authorities, the ECB still has some room below zero, although it has said the lower boundary was reached after the September cut. Nevertheless, there is a limit to how far below zero interest rates can go, due to arbitrage with physical currency holdings.

The second type of worst-case scenario would be the return of the redenomination risk premium in certain peripheral sovereign bonds, for instance in the event of a Greek exit from the euro becoming a serious threat.

There is little doubt that the introduction of an alternative currency in Greece would lead markets to reinterpret the euro as a fixed exchange rate arrangement rather than as an irrevocable monetary union.

As recently restated by Mr Draghi, the QE programme does not alleviate the need to make recourse to OMTs in order to remove this redenomination tail-risk in specific stressed countries.

However, contrary to its initial design, the OMT programme could no longer be seen as "unlimited". In the case of Portugal, for instance, the 25 per cent and 33 per cent limits leave barely any room for OMT purchases in addition to the planned QE purchases.

The new ECB asset purchase programme further lowers the probability of these worst-case scenarios. But investors would be ill advised to fully dismiss them: should they happen, their impact might prove even more damaging and persistent as the ECB would have exhausted all its room for manoeuvre.

Governments would be wise to use the time bought by the ECB to make the future of the euro area less dependent on monetary policy alone.

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