



## A dangerous path

### The ECB should not cap bond yields

Two news items from Germany over the weekend highlight the problems and risks for the ECB. On the one hand, Jörg Asmussen, the German member of the ECB's Executive Council, has joined the chorus of those supporting Mr Draghi's plans for conditional bond-buying by the ECB. This is now all but certain to go ahead, with details probably announced at next month's meeting of the Governing Council.

But of greater interest is a story from *Der Spiegel* indicating that the ECB is considering capping bond yields. This is not a new thought. It has for quite a few months been clear that at least some EA national central banks are sorely tempted by the idea that EA governments should issue bonds with a yield they consider justified by fundamentals - and that if these are not bought by markets at that yield, they should be bought by EA institutions. This is but a variant of the ECB directly capping bond yields or spreads by (presumably) unlimited purchases, whether on the primary or on the secondary market. Nevertheless, this is a dangerous path to tread. First, it would make the ECB the buyer of first resort – a clear infringement of its independence, of the treaty and of its mandate. Second, artificial caps do not deal with underlying issues – like price controls, they can at best temporarily hold back price pressures. Once the ECB stops implementing the cap, yields or spreads will surge, unless, of course, fundamentals have in the meanwhile truly changed. But, although any bond buying is supposed to be conditional on reforms, it will threaten to introduce moral hazard, as the ECB's Securities Markets Program already shown (once the ECB started buying Italian bonds, the Berlusconi government reneged on its reform promises). Of course, the ECB could then stop buying bonds – but then we're back to Square One.

However, a more problematic issue is if conditions in a country were to deteriorate – or, indeed improve. Is the ECB then supposed to announce that the previously acceptable yield or spread of X, should now be replaced by Y? If so, the ECB essentially becomes the sole relevant market for EA government bonds – price setter and only buyer, and determinant of justified spreads. This is clearly untenable, probably even in the shortest of terms. No wonder that the Bundesbank has expressed doubts about ECB bond-buying.

Short term, any proposal to move along these lines is an opportunity to offload holdings of Bonos and BTPs. But a substantial move beyond temporary bond buying must be bad news for all EA bonds - ultimately even German.

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