

# »» ECB policy has saved euro states from severe economic hardship since 2012

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The policy of the ECB has provided for a normalisation of funding costs, which had risen to excessively high levels in some euro states in the course of the debt crisis. After the famous 'whatever-it-takes' speech delivered by ECB President Draghi, yields on government bonds fell, particularly in southern Europe.

KfW Research estimates the cumulative additional costs prevented by this policy at EUR 26 billion for Spain and EUR 50 billion for Italy since the summer of 2012. The ECB has saved both countries from increased risk premiums and from the need to make stronger budget corrections in the middle of the recession. In Germany the government funding conditions were already improving after the financial crisis, so Draghi's speech had a low impact on them.

If interest rates remain on their current low level, funding costs will continue to fall. Governments should seize this opportunity for structural reforms. After all, the ECB will not continue its expansionary monetary policy indefinitely, and the amount of time it buys governments is limited.

Monetary policy in the euro area aims to preserve price stability. The ECB's main focus is therefore on inflation. But monetary policy measures also affect other economic parameters such as exchange rates and yields on government bonds. This is particularly true of unconventional monetary policy, which began with Draghi's famous words 'whatever it takes' and the OMT (outright monetary transactions) programme in the summer of 2012.<sup>1</sup>

## Funding costs for euro area states normalised after OMT programme was announced

The measures taken by the ECB at the height of the debt crisis have to be seen in the context of the excesses that built up on the government bond market during that time. Considerable distortions occurred here between 2010 and 2012, and the funding costs of some euro area states increased drastically. The ECB is committed not only to containing inflation, but also to stabilising financial markets. As investor confidence was rapidly eroding, even a collapse of the euro area and ensuing panic on the financial markets could not be ruled out. In this critical situation, in which austerity measures and protracted structural reforms were the only way for governments to build new trust, the ECB was the only stakeholder with the necessary rapid response capability and the tools to resolve the acute crisis.

The ECB policy has removed the high liquidity premiums on the bonds of some states and enabled the normalisation of funding costs. The yield spreads relative to German bonds have dropped to a sustainable level. Figure 1 shows the trend in yields on ten-year government bonds returning to greater convergence following Draghi's speech on 26 July 2012. Since then the yields on Spanish and Italian bonds, for example, have dropped by three quarters, or 4.5 to 5 percentage points.

**Figure 1: Trend reversal – back to convergence**

Yields on ten-year government bonds in per cent



Source: OECD

## How high were the liquidity premiums?

The decline in funding costs for newly issued ten-year bonds is well mapped on the basis of data and easily quantifiable. What needs to be estimated, however, is the increased costs the states have ultimately avoided, that is, the reduction in crisis-induced premiums, denominated in euros. There are three reasons for this: First, states borrow on the capital market not only through ten-year government bonds. They issue a number of bonds with maturities ranging from several months to several decades. To avoid comparing apples and oranges, the interest payments due on newly issued bonds have to be seen in relation to payments due on bonds of equal maturity prior to the ECB intervention. Second, with respect to cost savings it is important at what dates major portions of debt are rolled over, that is, when old bonds fall due and are replaced by new – lower-priced – bonds. If this occurred frequently in the year 2013 when yields on Spain's ten-year government bonds still averaged 4.6% for the year, the advantage was lower than when major portions matured only in 2015 at a yield of 1.7%.

**Estimated results depend on assumed reference interest rate**

Third, in order to estimate the avoided increased cost, a reference interest rate has to be determined which the euro states would have paid without the ECB's accommodative policy. That makes the results sensitive to subjective assumptions. The additional costs vary considerably depending on whether the reference interest rate is e.g. the mean of the values between 1999 and 2012 (prior to Draghi's speech), the peak level achieved in the summer of 2012, or – on the assumption that the funding costs would have increased further still – even above this level.

Studies that estimate the cost reduction resulting from the ECB policy for euro states use different methods and diverging observation and reference periods. That limits their comparability. DZ Bank, for example, determined avoided increased costs totalling EUR 9.5 billion for Germany, and EUR 53 billion for Italy, between the summer of 2012 and the end of 2015.<sup>2</sup> Unicredit studied the impact of the ECB's QE (quantitative easing) programme and calculated the funding costs in 2015 in comparison with the previous year. It estimated that in 2015 alone the cost for Germany was EUR 5.1 billion lower and for Italy EUR 6.6 billion lower than it would have been without the ECB's corresponding monetary policy.<sup>3</sup>

**KfW Research estimates: Additional funding costs for Italy reduced by EUR 50 billion since 2012**

In an estimate of our own we calculated the reduction in funding costs for the four biggest economies of the euro area between August 2012 and March 2016. On the basis of the respective bonds issued in the period of May to July 2012 – at the height of the debt crisis – we determined a yield structure curve that serves as a reference scenario.<sup>4</sup> The funding advantage can then be quantified for each bond issue since August 2012 in comparison with bonds issued with the same maturity in the reference period.<sup>5 6</sup>

The table shows the results of our estimate. The funding costs in Germany fell by a total of EUR 2.2 billion since the summer of 2012. In Spain the reduction was significantly higher at EUR 26 billion, and in Italy it was the highest at EUR 50 billion.<sup>7</sup> In both these countries the liquidity premiums were greatly increased in the reference period. The ECB policy reduced the premium which southern European states in particular have had to pay at the height of the debt crisis.

If, on the other hand, the year 2008 is chosen as a reference period, the cost reduction in Germany (EUR 95 billion) actually exceeds the reduction in Italy. Unlike in Italy, however, yields had already fallen prior to Draghi's announcement (Figure 1). The reason is Germany's status as a safe haven for investors in the debt crisis. Besides, Germany benefits from an easing of the situation in southern Europe because it contributes to stability in the euro area overall.

**Table: Diverging cost reduction**

	Cumulative cost reduction	
	EUR in billions	Per cent of GDP in 2015
Germany	2.2	0.1
Spain	26.2	2.4
France	8.0	0.4
Italy	49.7	3.0

Note: Cumulative funding advantage between August 2012 and March 2016

Source: own calculations

**ECB policy saves countries from strong fiscal adjustments**

Overall, the cost reduction for the Italian state in just under four years was 3 % of GDP in 2015. If the excesses on the government bond market had continued until today and if investors in southern European countries had continued to charge the high risk premiums they were still charging in mid-2012, some governments would have been forced to adopt additional austerity measures in order to prevent (higher) breaches of the conditions of the Stability and Growth Pact. That would have affected Italy and Spain in particular for two reasons. First, they benefited more than average from the normalisation, and second, Spain's budget deficit consistently exceeded the 3 % of GDP deficit ceiling in the past years while Italy's was close to it at any rate. In order to achieve the same savings of 2.5 and 3 % of GDP, respectively, distributed across almost four years, the governments would have had to raise taxes and/or cut spending to an extent that would have compromised the recovery in Spain and dragged Italy further into recession.

**Relief will continue at a growing pace for the time being**

The normalisation of funding conditions increasingly reduces costs in comparison with the reference period the longer the yields on government bonds stay on their low level. The reason is that an increasingly larger portion of old debt with high interest is gradually maturing and being replaced by lower-interest bonds. This reduces funding costs until all bonds of a state have been issued in the low-interest environment. Given that the mean bond maturity is six to seven years, governments will continue to benefit from reductions for a limited period of time.

Figure 2 breaks down the estimated increased costs avoided by the ECB policy by calendar year. A rising trend is visible for all four economies. Figure 3 displays the bond maturities in the years 2016 and 2017. It shows that a major portion of government debt held in the form of bonds will mature in the near future especially in Italy and Spain.<sup>8</sup> As a result, these countries in particular will be able to reduce their funding costs in the near future.

The prerequisites for low yields on government bonds were created not just by the ECB policy, but by the deeper integration of the euro area. The ESM as a functioning crisis management mechanism, more consistent supervision of national budget plans, and the banking union have

contributed to building new trust in the euro states' debt sustainability.

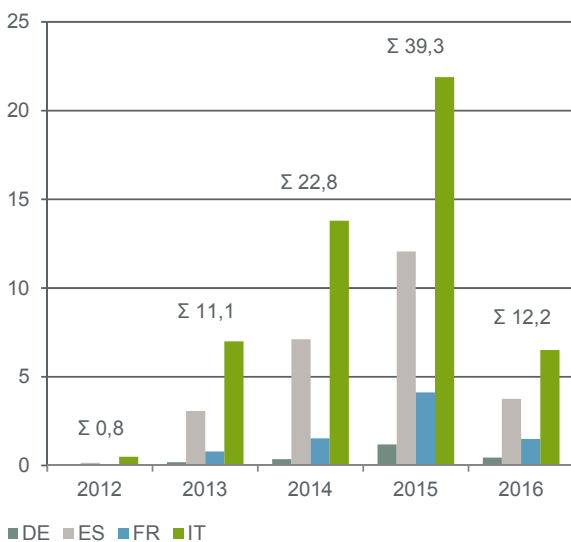
**Conclusion: ECB policy saves states from severe economic hardship**

During the debt crisis the OMT programme protected some southern European states in particular from excessively high risk premiums and billions of euros in additional funding costs. Thus the ECB has prevented deeper budget cuts that would otherwise have been necessary to achieve the deficit targets.

The states should now initiate structural reforms and strengthen their resilience against future excesses. After all, the interest rate risk is rising. The states' funding costs will probably rise again once the expansionary monetary policy ends, or even as its end becomes discernible. Such a trend can be interpreted as a correction of risk premiums that may currently be distorted downwards. The historically low level of interest rates in itself suggests that funding costs can be expected to rise. The ECB will not continue its expansionary monetary policy indefinitely because low interest rates are not just the states' joy but also the banks' sorrow. With its policy the ECB has bought the governments time, but that time is limited. ■

**Figure 2: Funding advantages are increasing**

Funding cost reduction in EUR billions

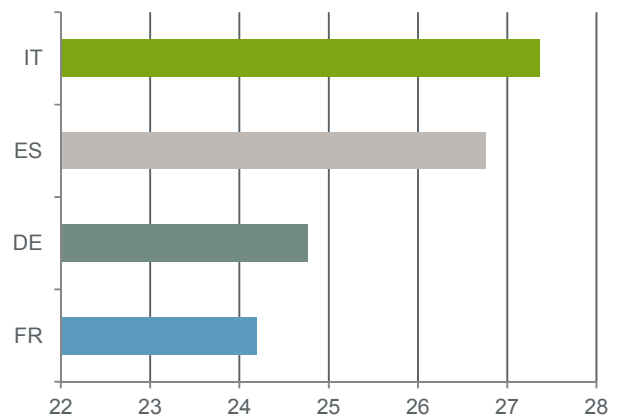


Note: 2012: August–December, 2016: January–March

Source: own calculations

**Figure 3: Further cost reduction in the immediate future – particularly in Italy and Spain**

Total volume of government bonds maturing in the years 2016-2017 in per cent



Source: Thomson Reuters

<sup>1</sup> Speech by Mario Draghi, President of the European Central Bank, at the Global Investment Conference in London 26 July 2012, <https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html>.

<sup>2</sup> Cf. DZ Bank (2016), Die Draghi-Dividende, Staatsanleihen Flash, 7 March 2016 (in German).

<sup>3</sup> Cf. Unicredit (2016), One year of quantitative easing, Economics & FI/FX Research, Economics Special, 8 March 2016.

<sup>4</sup> During this period the four economies each issued between 19 and 71 bonds. The yields for maturities not available during the reference period are estimated as average values from the existing data.

<sup>5</sup> The analysis did not include the rare cases of a funding disadvantage compared with the reference period due to temporarily increased yields, e.g. in Germany at the end of 2013. This was based on the assumption that temporary funding disadvantages that could compensate for the advantages gained elsewhere were not attributable to the ECB's policy.

<sup>6</sup> The analysis focused on the yields of government bonds. The interest advantage it calculated was therefore not based exclusively on the coupon payments, but on the overall funding cost reduction. It was assumed that the ECB policy changes the perception of the probabilities of default of government bonds and thus increases the demand and, accordingly, the price achievable at the time of issue. This contributes to reducing the costs for the states.

<sup>7</sup> In addition to this reduction, which materialises in the form of yield spreads when bonds are rolled over, the states' funding costs decrease in direct consequence of the ECB's bond purchase programme. The national central banks have been purchasing bonds of their respective governments under this programme since March 2015. By the end of March 2016 Banca d'Italia, for example, purchased Italian government bonds worth EUR 105 billion. The coupon payments for these bonds flow to the Italian central bank and are later distributed as a profit and reimbursed to the state. This generates EUR 1 billion in additional savings for the Italian state.

<sup>8</sup> In addition to bonds, states also fund themselves through other sources such as loans. Debt securities make up 73 to 84 % of total debt in the four states considered.