‘One size… fits some’

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Abstract

The discussion on monetary policy transmission within the euro area is critical given the evolving economic landscape and diverse challenges faced by the region.

Historically, yield-spread differences have emerged in particular at times of stress, when financial markets are not treating the euro area as one region, but rather as individual countries. This paper delves into the market dynamics influencing sovereign spreads in the euro area, focusing particularly on the front end of the curve (OIS) and the sovereign curve. These components are crucial as they serve as the starting point for the pricing of many market instruments. Our analysis aims to provide a framework for understanding the heterogeneity in the transmission of monetary policy across different euro area economies with a focus on Germany, France, Italy and Spain.

1 Framework and methodology

To understand what drives sovereign spreads, we have developed a framework incorporating multiple factors, where the first step of our analysis is an estimation of country-specific term premiums for Germany, Spain, France, and Italy, using the well established ACM model.[2] This forms one of three country specific factors in our framework. Additionally, we integrate the following measures: fiscal stance/risk premium, captured by the CDS and the funding rate, which is a factor that assesses the impact of funding strategies, regulations, and country risk on sovereign spreads. Here we use the 3M bill for each country. On a formular basis, it looks like the following

(Sovereign yield spread vs. OIS swap) = CDS + term premium + funding rate + residual

This differentiation allows us to pinpoint specific country factors influencing yield spreads, which is the goal of our analysis. Moreover, any unexplained variances, represented by residuals, may require intervention or attention from the European Central Bank (ECB).

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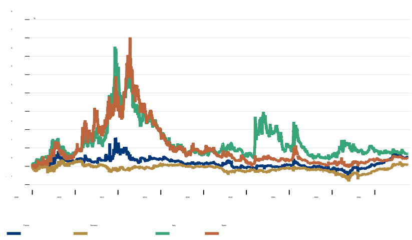
2 Treasury Term Premia: Tobias Adrian, Richard K. Crump, and Emanuel Moench, "Pricing the Term Structure with Linear Regressions," Journal of Financial Economics 110, no. 1 (October 2013): 110-138.

For this study, and to gauge the heterogeneity across the euro area in the various episodes, we focus on the residuals of our estimates, as these capture liquidity and scarcity premiums as well as institutional differences in demand due to factors such as regulation and accounting. Some of these factors are in the remit of the ECB, others not.

We focus on the 5-year yield curve due to liquidity considerations related to CDS. Our analysis shows that using the 10-year point would lead to similar conclusions, though. We have deliberately excluded the current policy rate and ex-post inflation rate, assuming the 5-year point encapsulates an entire monetary policy cycle

Our estimation period spans from the aftermath of the sovereign debt crisis until the onset of COVID-19 (2013-2019), deliberately focusing on 'normal' times to avoid distortions caused by fiscal risk spikes during crisis periods.

Chart 1: 5y sovereign spread vs. OIS

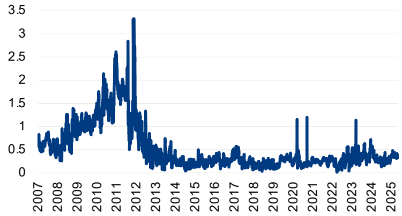


Note: Past performance is not a reliable indicator of current or future results.
Source: Macrobond Financial, Danske Bank

1.1 The following key takeaways emerge from our study

Homogeneity of transmission. Currently, monetary policy transmission seen through the bond market is more uniform than it was two decades ago, but less so than during 2012-22. This is observed as a lower min/max spread of the country-specific residuals compared to pre-GFC,

Chart 2: Homogeneity in residuals compared to pre-GFC shows convergence in monetary policy transmission (pp)

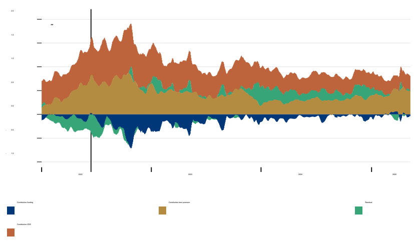


Note: Difference shows the max-min difference between the residuals in our estimation
Source: Danske Bank

Financial stability is a pre-requisite for price stability.

For the ECB successfully to achieve its monetary policy transmission, it needs to respond to sovereign spread widening if judged to be risking financial stability and thus impairing monetary policy transmission, and that even if the catalyst is not a traditional monetary policy matter. However, those measures also need to be calibrated not to overdo the stimuli. Our case study of the recent hiking cycle starting in 2022 shows a significant spread widening in certain euro area countries, which simply was a reflection of the term premium rising, as a consequence of the anticipated ECB hiking cycle. Thus a well calibrated TPI was a success, with no actual purchases were needed (Chart 3). In other words, the ECB responded to 'a feature, not a bug', of expected monetary policy tightening, due to stability considerations.

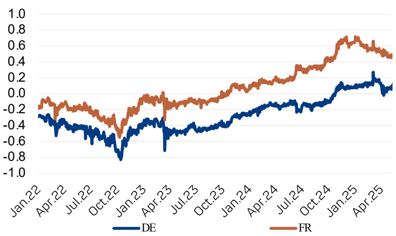
Chart 3: Breakdown of drivers of Italian sovereign yield spread vs. €STR



Note: Vertical line marks ECB's ad hoc meeting on 15 June 2022
Source: Macrobond Financial, Danske Bank

ECB policies (liquidity and bond purchases). While the ECB's so-called non-standard measures tightened sovereign bond market spreads through compression of the credit risk and term premium, we argue that the spread tightening eventually was larger than fundamentals otherwise would suggest in the period from 2015-22. This is observed by the negative residuals in Germany and France in particular in the period. This suggest that a scarcity / liquidity premium was a contributing factor to sovereign yield spread compression and thus monetary policy transmission. Normalising residuals for these jurisdictions only started once the ECB's balance sheet reductions began in late 2022 (Chart 4).

Chart 4: German and French residuals



Source: Bloomberg, Danske Bank

Challenges in achieving full homogeneity. While convergence in monetary policy transmission has been observed relative to the pre-GFC period, it is unlikely to be fully achieved as long as we do not have a common framework, which lies outside the remit of the ECB. Until a full common framework is achieved, the ECB will have to play its role via various policy measures, such as bond purchases and liquidity measures, albeit careful calibration is warranted, as side effects emerge using various policy instruments. While longer-term liquidity operations could likely reduce heterogeneity, the biggest difference is not in the remit of the ECB (for example the capital market union) and thus cons may outweigh the overall calibration of monetary policy implications relative to the pros. Therefore, monetary policy and its transmission from a market perspective will not be a perfect fit for all countries for the foreseeable future: 'one size fits some'

1.2 In conclusion: one size fits some

We argue that from a financial market perspective the transmission of monetary policy can be split into instances which we refer to as 'peace times' and 'war times', which should be understood as times of calm and stressed marked periods. During 'war times', in order for the ECB to meet its primary mandate of price stability, it must ensure a proper transmission and thus ensure financial stability or put differently, without financial stability, there is no reason to pursue price stability. These ‘war time’ episodes need to be treated differently from the ‘peace time’ episodes. In the case study from summer 2022, we saw that the ECB did very well with the calibration of the policy response, and while theoretically there should not have been a need, given that rising term premium is a feature, and not a bug of increasing rate hike expectations, it was warranted for financial market considerations.

We also observe that recent bond market developments are encouraging in terms of a larger homogeneity of monetary policy transmission. Also, the recent reduction in the sovereign yield spreads against OIS have been due to a declining contribution from the fiscal positions (CDS). Finally, while longer-term liquidity operations can likely reduce heterogeneity, the biggest difference is not in the remit of the ECB, and thus cons may outweigh the overall calibration of monetary policy implications relative to pros. Therefore, monetary policy and its transmission from a market perspective will not be a perfect fit for all countries for the foreseeable future: ‘one size… fits some’.