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The “monster” of fragmentation is haunting the ECB again

Ignazio Angeloni: To overcome the European Central Bank’s mistakes of the past, the sequencing approach needs to be abandoned

Renewed interest on monetary policy has coincided with new problems and risks facing central banks. How to deal with the pandemic – particularly the exit from it? Can the rise in inflation be controlled? Should wartime risks be factored in? Undecided on how to move, central bankers are dragged into controversies which risk denting their leadership and prestige.

And yet, those problems should not be too difficult to deal with. At least not for central banks with clear statutory goals – all central banks have them now – and sufficient resolve.

The Fed has put itself on the path

The US case is easiest. Its economy was hit by two shocks: one with mixed supply and demand effects, the pandemic; the other with pure demand effects, Biden’s fiscal expansion. The obvious response was a monetary restriction. After some delays in recognizing this reality, Jerome Powell’s Federal Reserve has put itself clearly on that path.

The ECB’s situation is trickier. To start with, the eurozone had no fiscal shock: Next Generation EU, Europe’s response to the Covid crisis, has still to produce its effects. The increase in inflation during the pandemic originated solely from supply constraints. Assuming these were temporary, after making a big initial move in 2020 with its securities purchase program PEPP (Pandemic Emergency Purchase Programme) the ECB put itself on a wait-and-see mode.

The ECB has made two errors

Unfortunately, after this sensible start the ECB committed two errors which now present their bill.

The first was to enshrine this fundamentally tactical posture into a “strategy” which prescribed in essence – let’s spare the details – prolonging wait-and-see until clear and present inflation signs were seen. This was wrong for two reasons. First, because the monetary stance was already out of balance with negative rates unjustified in absence of any deflationary risks. The second reason was that the particular uncertainties connected with the developments of the pandemic required maintaining flexibility to react to all unforeseen events, including an unexpectedly rapid exit. A wait-and-see approach written in stone made this more difficult.

The golden opportunity to fix the situation came in late 2021, with the eurozone growing more strongly than expected and the first signs of broad-based price rises appearing. At that point, more than ever, were negative rates out of place and a correction needed. That’s when the second and related error set in. Prolonging wait-and-see, this window of opportunity was missed.

The risk of reigniting the eurozone’s fragmentation

The ECB’s real problem is that loosening the expansionary stance risks reigniting fragmentation of the eurozone. The “monster” which took away the policymakers' sleep during the 2010-12 crisis is raising its head again with Italian sovereign spread now towards 200 basis points – the level of early 2011. The existential risk for the euro that fragmentation implies must be faced squarely, not let bring down the whole conduct of monetary policy with it.

As the ECB President, Christine Lagarde, has emphasized in her blog post on 23 May 2022, in presence of rising inflation, both actual and expected, unchanged interest rates imply a further and inappropriate expansion of the monetary stance. As the ECB therefore proceeds with raising its policy rate from its negative level as a matter of urgency, it should however retain flexibility and "constructive" ambiguity in its securities market purchases. This instrument has demonstrated to work well against fragmentation. Purchases do not need to happen to be effective; the mere possibility that they may happen creates in the bond market the type of two-way risk which makes traders cautious. The traditional "sequencing approach" which requires the ECB as a matter of principle to stop purchasing bonds before raising rates needs abandoning.

Impact of the ECB's monetary policy

As Bundesbank President Joachim Nagel said, fragmentation is a constraint but should not overwhelm the whole of the ECB's mandate. It is a technical problem – because it affects the impact of monetary policy – with broader political ramifications. The central bank, with its unrivalled market intervention capacity, has considerable power to deal with it. As its 24th birthday nears, with its experience and reputation well-established, it is time for the ECB to take this problem more in its hands.

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