

When will the ECB support France?

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French government bonds are under pressure. However, the ECB is likely to activate its TPI bond-purchase programme only as a last resort, should developments in the bond market become disorderly. Before then, it would probably try less forceful measures. We outline the ECB's policy options.

French government bonds under severe pressure

French government bonds are under severe pressure. While the yield spread between ten-year French government bonds and comparable German Bunds widened only moderately in August, it has recently surged (Chart 1). At 140 basis points, it is now at its highest level since 2012, at the peak of the sovereign debt crisis.

Investors are particularly nervous because the government, lacking political majorities, is not reducing the excessively high budget deficit. However, it would need to be cut by around 5% of GDP over the coming years merely to prevent French government debt from continuing to rise faster than GDP (see, for example, **Week in Focus of 18 September**).

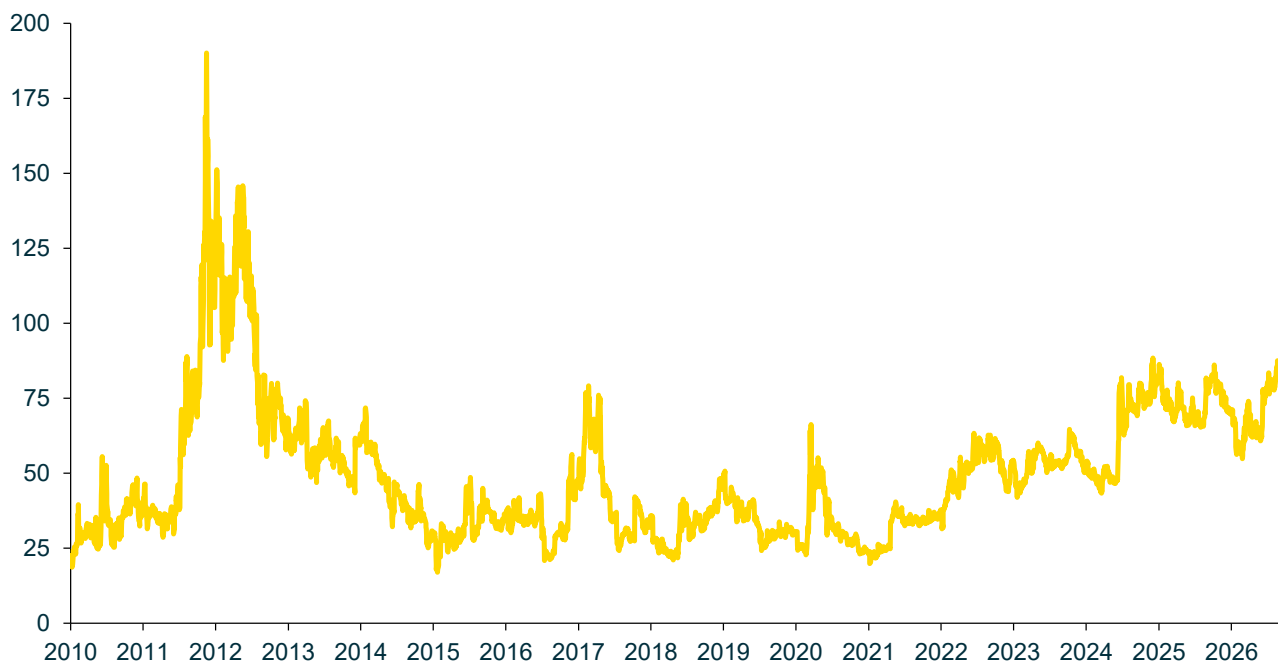
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Chart 1 - French government bonds under pressure

Yield spread of ten-year French government bonds over ten-year German Bunds, daily data in basis points



Source: Bloomberg, Commerzbank Research

The hurdles for activating the ECB's bond-purchase programme are actually low, ...

Many investors are wondering when the ECB will come to France's aid with its **Transmission Protection Instrument (TPI)**, adopted in 2022. The TPI provides for large-scale purchases of government bonds if financing conditions in a member state deteriorate sharply without this being justified by country-specific fundamentals. In other words, the country would effectively have to be without blame for the sharp rise in bond yields.

The ECB lists four criteria in this respect, including compliance with the EU's fiscal framework. But even if a member state is subject to an excessive deficit procedure – which is the case for France – it would still qualify for the TPI provided it does not breach the EU Council's fiscal recommendations, which tend to be very loosely worded. Furthermore, it should be noted that these criteria are only "an input" for the decision-making of the Governing Council. The Governing Council may come to different conclusions.[1]

... but the ECB is likely to wait for now

In principle, the ECB would activate the TPI for France, though probably not as quickly as some hope. After all, the ECB is unlikely to want to relieve French policymakers – who are ultimately responsible for the fiscal problems – of pressure too early. In addition, a pre-emptive activation, i.e. before the onset of a sovereign debt crisis, would clearly run counter to the TPI's objective of countering "unwarranted, disorderly market dynamics". Ultimately, bond markets would therefore need to come under considerably more stress before the ECB activated the TPI.

The ECB's less forceful instruments

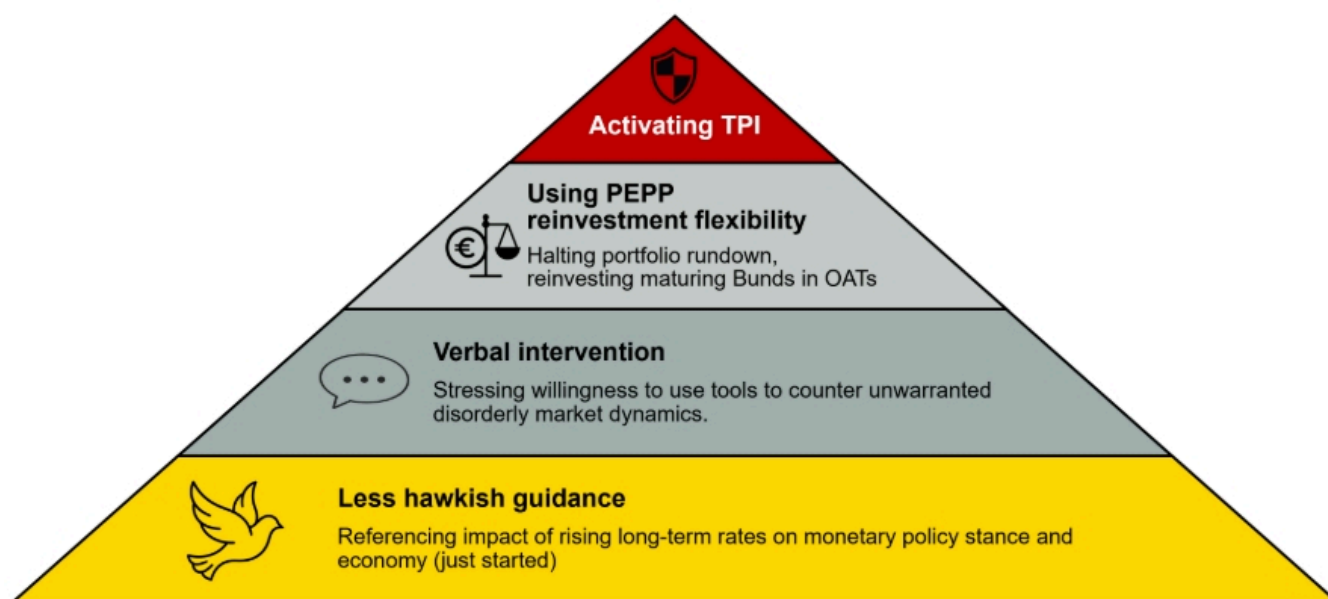
The case against a swift activation of the TPI is also supported by the fact that the ECB has less forceful instruments at its disposal (Chart 2):

- First, despite inflation, ECB representatives could adopt a less hawkish tone in their public comments, thereby dampening expectations of interest-rate hikes and easing pressure on government bonds. Christine Lagarde's recent remarks before the European Parliament's Committee on Economic and Monetary Affairs appear to point in this direction. She said that the sharp rise in bond yields would dampen economic growth and limit the pass-through of higher energy costs to consumers.
- As a next step, the ECB could intervene verbally in support of French government bonds by stressing its willingness to deploy the instruments at its disposal – such as the TPI – if disorderly market movements were to occur.
- Should this also prove ineffective, the ECB could begin reinvesting the proceeds from maturing bonds purchased under the



pandemic emergency purchase programme (PEPP), with a particular focus on French government bonds. The PEPP allows the ECB to temporarily deviate from the capital key of the national central banks. In the early stages of the Covid pandemic, for example, the ECB bought a disproportionate amount of bonds issued by countries more severely affected by the pandemic.

Chart 2 - The ECB has other options before activating TPI
options for action



Source: Commerzbank Research

In the event of a crisis, the TPI would only buy time

If, in a risk scenario, French government bonds were ultimately subject to disorderly market dynamics and the ECB deployed the TPI as an *ultima ratio*, investors would probably not bet against the ECB with its effectively unlimited firepower. However, the ECB's bailing out of a highly indebted member state would have considerable side effects.

Politicians across the euro area would feel encouraged to continue their debt-driven fiscal policies. Governments would absorb even more resources, thereby dampening the private sector's growth momentum. In addition, longer-term inflation risks would rise further.

A genuine solution, by contrast, requires fiscal discipline. Policymakers – including those in Germany – must finally reduce budget deficits at least enough to ensure that government debt no longer grows faster than nominal GDP.

[1] The situation was similar in the run-up to monetary union, when the EU Council admitted countries such as Italy to the monetary union even though they violated the fiscal rules of the Maastricht Treaty with public debt exceeding 60% of GDP. This is because, the Treaty (Article 109j(4)) merely stipulated that the EU Council should decide which countries to admit "taking account of" the fiscal rules. ([Back to text](#))



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