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Follow-up note to Bruges Group paper "The ECB's Pandemic Emergency Purchase Programme"

Given the size of the Bank of England's bond purchases, and particularly of UK government debt, why are we doing so much better over here?

26th April 2021

This is the first of two notes deriving from discussion and questions after the launch of the Bruges Group paper. The other justifies the contention that the public credit ratings of EU and Eurozone issuers are four notches too high.

Here are the reasons that the UK's situation is structurally and materially better than that of the EU/Eurozone:

1. The UK has transparency: we can see what the BofE owns
2. The UK does not have a 'concert party' of other funds, programmes, mechanisms and entities who can own one another's bonds and serve to obscure the total ownership
3. The UK has a centralised Central Banking system and not a decentralised one
4. The UK's central bank issues one set of accounts, not six - and on different dates so there could be window-dressing (see note on page 2)
5. The UK does not have a diverse set of supranationals (EU/EIB/EIF/ESM) above the member state, which take on their own debts and create their own contingent liabilities for which the member state bears the risk of repayment
6. The UK's power, water and transport utilities are generally privatised so their debts are not the responsibility of the government
7. The UK's PFI model is not in expansion mode, whereas the EU's counterpart - the InvestEU programme through the EIB and EIF - has doubled the size of the EIB/EIF activity since its launch and creates public sector obligations without creating public sector debts as recorded by Eurostat
8. 5-7 mean there are large extra layers of debts and contingent liabilities above and below "general government gross debt" in the EU/Eurozone as recorded by Eurostat, whereas the UK's equivalents are far smaller
9. The debts in these levels have been rapidly expanded precisely because it is the "general government gross debt" figure that is the anchor for measuring compliance with the Fiscal Stability Pact and the Stability & Growth Pact
10. The UK does not have an equivalent to the non-settling TARGET2 payment system, in which there are large and opaque debts between participating central banks: the UK's CHAPS system requires its participants – who are commercial banks – to defund their Settlement Accounts at end-of-day and not leave a lying balance overnight
11. The credit quality of Eurosystem collateral is already far lower than its public ratings infer (as the other note will detail) by as much as four rating notches, meaning that collateral with a public rating of BBB- has an intrinsic quality of B+
12. The weakening of Eurosystem collateral requirements means that the Eurosystem can own and lend against collateral with a public rating of BB, which is already of Speculative Grade without the factoring in of grade inflation: its intrinsic quality is B-

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and that is the lowest notch of Speculative Grade and just one notch above Junk Grade

13. Since Eurosystem collateral can be bonds rated BB (intrinsically B-) which sit on top of a pool of banks' "credit claims", the pool will contain individual "credit claims" of equivalent to a public rating of B and to an intrinsic quality of CCC-, which is well into the Junk Grade
14. Eurosystem haircuts are far lower than the ones enforced on commercial banks for valuing the same bonds as Liquid Assets for the purposes of the Basel III Liquidity Coverage Ratio (see Bruges paper p46)
15. By contrast the BofE collateral lists are much tighter and even the Level C Securities Collateral requires a rating of A-, meaning it would need 4 downgrades to take it into Speculative Grade
16. The UK does not have an exact equivalent of Targeted Long-Term Financing Operation, a EUR1.9trn unsecured lending to banks; the worst the UK has in terms of lending by the central bank is loans with Level C Loan Collateral. The central bank at least does take collateral, which the Eurosystem does not for TLTRO. The next argument is about the quality of the loan collateral that the UK central bank takes

All of the above amount to a situation where the UK can, for the time being, make a turn.

We are currently heading in the wrong direction. A group of leading economists recently wrote an open letter to the Bank of England urging it to stop its bond purchases.

In all of the Coronavirus Business Interruption Loan Scheme, the 95% mortgage guarantee scheme, the COVID-19 Recovery Loan Scheme, the UK's proposed new investment bank and the new green investment fund, we have an echo of EU/EIB/ECB/Eurosystem thinking: the supposed necessity for the taxpayer to intervene to replace the "missing investor", being the commercial bank that ought to make a mortgage loan of 95% loan-to-value, or that ought to finance businesses after the pandemic.

The absence of the investor best able to assess the risk is taken as a market failure, justifying putting the taxpayer on-risk. This is inflationary and misguided.

The UK can still make the necessary handbrake turn, but it will need to summon up an act of great willpower to do so.

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Note on ECB/Eurosystem sets of accounts:

#	Name	When issued
1	Consolidated financial statement of the Eurosystem	Every Friday
2	Disaggregated Assets & Liabilities of the Eurosystem	Every 4 or 5 weeks: a Friday at the end of the month but sometimes in the next month
3	Breakdown of Eurosystem aggregated balance sheet	Monthly at "end of period"
4	TARGET2 balances	Monthly at "end of period"
5	ECB Annual Report	31st December annually
6	Consolidated balance sheet of the Eurosystem	31st December annually

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