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The ECB worries (once again) about the future of the Eurozone

On Wednesday, the ECB Executive Board convened an emergency meeting, just six days since the last regular meeting. This highly unusual event alone is a worrying sign that it has lost control of the narrative.

What is at stake? The risk premiums for government bonds of the so-called periphery have once again risen rapidly since last week's meeting. All eyes are on the bonds of the Italian government, the highly indebted problem child of the Eurozone. Yields on Italy's ten-year government bonds rose from 3.4% to over 4.1%! The last time they were higher was in 2014. Since then Italy's debt has risen further to just over 150% of GDP (from 135% in 2014). But if one subtracts the bonds held by Italy's central bank, market-relevant debt has fallen.

The ECB wants to prevent the "fragmentation" of the Eurozone

The fear of losing the monetary transmission channel

The ECB has repeated for months that it will not tolerate a "fragmentation" of the Eurozone. This means that it will oppose an "inappropriate" widening of spreads within the Eurozone with all it has at its disposal. It absolutely wants to avoid fragmentation, as it believes that it would obstruct the effectiveness of monetary policy measures and thus make it impossible for the ECB to reach its 2% inflation goal.

That's why the ECB stressed on Wednesday that in future it would focus on buying more of the bonds of those countries whose risk spreads are coming under particular pressure. This is essentially nothing new. The markets therefore reacted only moderately impressed.

The ECB has raised expectations that it must now fulfill.

In addition, the ECB is to work hard on developing a new instrument that it can use to counter widening spreads. Last week, I made the case why the ECB does not need a new instrument to limit interest rates on government bonds. We are not on the brink of a new edition of the euro crisis. The fact that the ECB now stands with the back to the wall is of its own making. Instead of a timely normalization of monetary policy, it had stoked hopes of an ECB rescue should bonds of individual member states come under pressure. It is hardly surprising that the markets are now testing their will. That is what tends to happen when you come forward with half-baked plans.

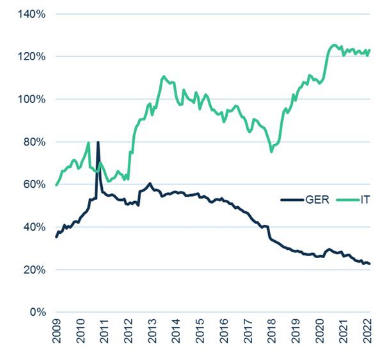
The "Doom Loop" is set in motion

The ECB's implicit promises are not just a matter of "rescuing Rome," and saving the day of Prime Minister Draghi, President Lagarde's predecessor at the helm of the ECB. The Italian government can tolerate the rise in interest rates. I explained why back in April.

More likely is the risk of a banking crisis in Italy. Over the past decade, Italian banks have stuffed their balance sheets with Italian government bonds. These now account for 1.2 times the banks' equity (see chart). A decline in the value of these government bonds (the flipside of widening spreads) could cause the capitalization of Italian banks to fall below minimum regulatory standards. Who would recapitalize troubled banks to allow them to continue to operate as a going concern? Probably the Italian government, through additional debt. This would stress public finances and further reduce the value of the bonds, requiring new capital, and so on.

This potential vicious circle, or doom loop, has long been known. Hoping that things will somehow work out despite such exposure concentration risks is not a regulatory strategy. The risk of a banking crisis in the Euro area has therefore increased. This would constitute another big step toward a recession in Europe.

Domestic government bonds held by the national banking system (in % of equity)



Source: Bloomberg

A banking crisis in Italy is more likely than a Euro crisis 2.0.