Who owns the losses on bonds in Euro area?

The massive Euro 5 trillion money printing and bond buying programme of the European Central Bank was undertaken in conjunction with the Central Banks of each member state. Most of the bonds bought were the debts of individual Euro member governments. 80% of the risk on those bonds rests with the individual member states Central Banks. They were required to buy up bonds issued by their own government and are liable for any losses on them. This is an added complication compared to the position in the US or UK where there is just one sovereign state and one Central Bank involved.

The Bundesbank has reminded us that a 1% rise in Euro area interest rates would lead to a loss of around Euro 48 billion on the Quantitative easing positions for the zone as a whole, with the bulk of that loss resting on the balance sheets of the individual member states Central banks. Each member state is responsible for ensuring the solvency and capital adequacy of its own system. The Euro area is now designing a scheme that will allow it to continue to buy up the bonds of any country with weaker finances in order to prevent their interest rate for longer term loans getting too far out of line with the rest of the zone. There will be interest in whether the bonds bought and added under such a scheme will be at the risk of the member state concerned or whether the European Central Bank will take on the risk.

The Eurozone has particular problems with this for another reason as well. Only in the Eurozone did they take rates down so low that many of the better sovereign bonds were for quite a long time offering a negative interest return. This meant that they were particularly expensive even by the standards of dear advanced country government bonds worldwide, putting them more at risk when rates have to go up.

The Italian general election seems likely to elect a centre right coalition. Whilst they remain committed to EU and Euro membership they may well prove more questioning and difficult in responding to some of these internal EU stresses.