ECB: A Do-Over is Coming

- **The ECB provided a "surgical" suite of policy measures to support the Eurozone economy and financial system, with abundant, subsidized liquidity for banks and additional QE to hold down yields on private-sector debt. This represents *massive* support to the European financial system, but still failed to meet market expectations because the package did not include cuts to policy rates nor the immediate prospect of action to hold in peripheral European sovereign yield curves.**
- **We expect further action from the ECB, possibly before its next scheduled monetary-policy meeting on April 30, to shave its policy rates and support sovereign credit markets.**

NOT WHATEVER IT TOOK, MORE WILL BE IMMINENT

The European Central Bank (ECB) knows better and yet underwhelmed anyway. After strong moves from the Fed and the BoE over the past week, there was some confidence that the ECB's Governing Council (GC) wouldn't disappoint market expectations today and that it would instead replicate past efforts to do "whatever it takes" to get ahead of the gathering crisis in the markets and the real economy. In the end, the suite of measures announced this morning followed through on several moves that we and other analysts anticipated, but by skimping on specific actions and in some of the details on the measures announced today, the ECB let down markets at a time when it instead needed to impress them with its clear resolve. Perhaps it was more difficult than usual to forge a consensus for additional action amongst the Members of the GC with representatives from Estonia, Italy, Latvia, Lithuania, and Portugal all participating by remote.

Table 1

ECB December 2019 vs March 2020 Macro Projections	December 2019				March 2020			
	2019	2020	2021	2022	2019	2020	2021	2022
Real GDP, % y/y	1.2	1.1	1.4	1.4	1.2	0.8	1.3	1.4
HICP Inflation, % y/y	1.2	1.1	1.4	1.6	1.2	1.1	1.4	1.6
Unemployment rate, %, eop	7.6	7.4	7.2	7.1	7.6	7.6	7.6	7.5

Sources: Scotiabank Economics, ECB.

Table 2

BNS Forecasts as of 12/03/20	2018	2019	2020f	2021f
Real GDP (annual % change)	1.9	1.2	0.6	1.3
CPI (y/y %, eop)	1.5	1.3	1.1	1.4
Central bank MRO rate (%, eop)	0.00	0.00	0.00	0.00
Central bank deposit rate (%, eop)	-0.40	-0.50	-0.60	-0.60

Source: Scotiabank Economics.

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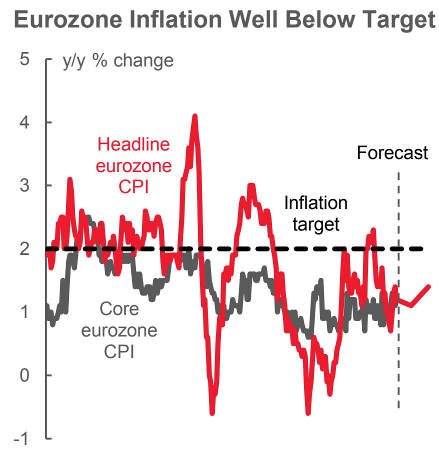
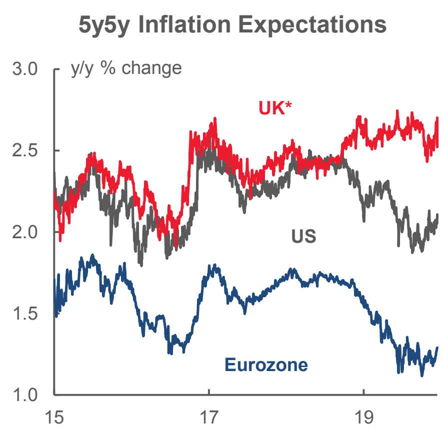
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



*UK inflation shown 1 percentage point lower to adjust for gap between RPI and CPI.
Sources: Scotiabank Economics, Bloomberg.

Given the market's negative response to today's announcements, we think the ECB is likely to attempt a "do-over". It may undertake an inter-meeting move ahead of its next scheduled meeting on April 30 because today's package isn't going to be sufficient and any complementary fiscal actions are likely to be too little and too late to stem the hemorrhaging in markets.

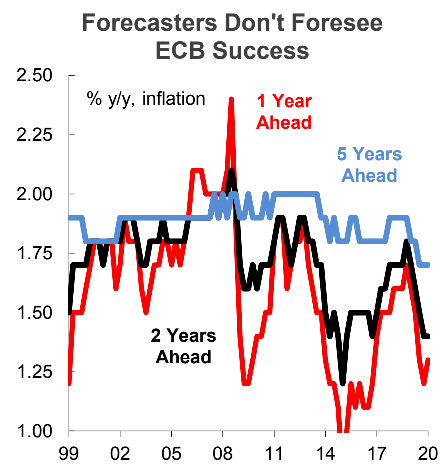
TOO SURGICAL RATHER THAN COMPREHENSIVE

Pres. Largarde called today's measures "almost surgical" in their intended support for vulnerable sectors of the Eurozone community, but going into this meeting it was clear that a broad-spectrum response was needed. The principal disappoint for markets was based on the GC's decision to leave its interest-rate complex unchanged when markets were priced for a 10 bps cut in the deposit rate now, with another 10 bps cut in June. Given market reaction, we continue to view this as a live possibility for an inter-meeting move or the GC's next monetary policy meeting on April 30. Pres. Lagarde emphasized several times that the decision was unanimous, but she also noted that they "can lower their key interest rates if needed."

Markets—and likely many Eurozone governments—were also surprised to hear Pres. Lagarde aver that, "The ECB is not here to close bond spreads." Closing bond spreads was one of the ECB's signal achievements in its response to the Eurozone crisis a decade ago. Italian, Spanish, and Portuguese sovereign curves duly widened in response. Peripheral European bond markets had been expected to benefit from enhanced asset purchases owing to their outstanding debt stocks, but the "temporary envelope" of new quantitative easing announced today will be focused on private debt, not sovereign bonds. Still, Pres. Lagarde later backtracked and noted that wider spreads "clearly impair" the action of monetary policy and that the ECB "will use (today's) package forcefully, using the flexibility that we have." She went on to note the ECB would look at "deviating temporarily from capital keys if necessary" under its asset purchase programme (APP), a clear nod that the Bank could act to dampen spikes in sovereign yields in Italy and other peripheral sovereigns.

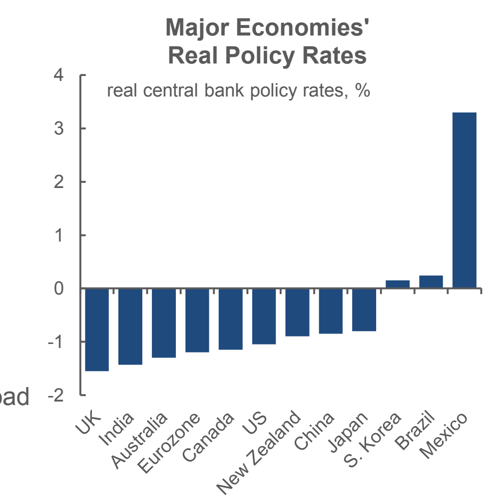
The "surgical" policy package was doubly disappointing seeing as it was accompanied by some further downward revisions in the ECB's macroeconomic forecasts (table 1). The Eurozone's outlook wasn't particularly strong even before the COVID-19 outbreak took on greater momentum: inflation is well below target and expected to stay there (charts 1, 2, and 3). Today's forecast changes, while entirely expected and in line with our projections (table 2), make the case even stronger for a broad rather than surgical policy response from the ECB.

Chart 3



Source: ECB Survey of Professional Forecasters, Scotiabank Economics.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

MASSIVE FOR THE BANKS, NOT FOR SOVEREIGN BONDS

Notwithstanding the market's disappointment, it is important to acknowledge that today's package delivered substantial support for the European financial system and real economy and keeps real policy rates amongst the most accommodative of the major economies (chart 4).

Big, low-cost liquidity support for banks. Additional, temporary liquidity support will be provided to the financial system through additional longer-term financing operations (LTROs) until June 2020, when improved terms will kick in on the third targeted longer-term refinancing operation (TLTRO III, see next point). Financing will be, in Pres. Lagarde's words, "super cheap", with an interest rate that is equal to the average rate on the deposit facility.

For all TLTRO III operations outstanding during June 2020 to June 2021, the interest rate will be 25 bps below the average rate applied in the Eurosystem's main refinancing operations. Financial institutions are incentivized to maintain their stock of outstanding lending, particularly to small- and medium-sized enterprises (SMEs): through the June 2020 to June 2021 period, TLTRO III interest rates for banks that maintain their levels of credit provision could dip to as much as 25 bps below the average interest rate on the deposit facility, which currently implies a rate as low as -0.75%. The maximum amounts bank can draw on the TLTRO III is also raised to 50% of their stock of outstanding eligible loans as of end-February.

This makes EUR 2.3 tn potentially available to Eurozone banks. If they can't find borrowers for the funds, they can still benefit from a direct subsidy by taking out financing from the ECB at -0.75% and depositing it at -0.5%. This is huge, riskless support.

Looser collateral conditions so more bank capital can be deployed. Collateral easing to make sure banks can take full advantage of the TLTRO III, similar to the relaxation the Bank of England provided to banks on their countercyclical buffers. This could make somewhere between EUR 600 bn and EUR 800 bn available in capital relive.

Additional quantitative easing (QE). The GC agreed to a "temporary envelope" of additional net asset purchases of a total of EUR 120 bn until end-2020, which, at the equivalent of EUR 13.3 bn in additional QE each month, fell in the middle of expectations. This additional envelope will be focused on private-sector debt and won't help contain moves in peripheral Europe's sovereign curves. The GC reaffirmed that QE under the asset purchase programme (APP) will run until just before it next intends to raise rates.

ECB CAN'T DO IT ALL: FISCAL ACTION BETTER COME SOON

Pres. Lagarde reiterated her pleas that "an ambitious and coordinated fiscal policy response is required to support businesses and workers at risk." She said action should come "in the next few weeks and not months." Pres. Lagarde noted that currently announced fiscal measures in the Eurozone amount to only EUR 27 bn, of which EUR 25bn come from Italy, equivalent to only about 0.25% GDP. Much more "decisive and determined" action will be needed by governments, starting at the Euro Group meeting on Monday. France's Finance Minister called for "massive fiscal measures" while Germany's Chancellor Merkel indicated that her government will do "whatever is necessary" to combat the crisis.

Eurozone fiscal rules aren't due to be revised until later this year with any changes to be implemented in 2021. We expect this calendar to be accelerated.