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ECB: AT ODDS WITH MARKETS

Berenberg Macro Flash

Markets in panic mode

Markets and the ECB do not seem to see eye-to-eye today. After the ECB presented a bundle of measures, which did not include a cut in the deposit rate, markets sold off sharply. Of course, the adverse market reaction may not be just a market verdict on the ECB's package. It could also reflect a growing realisation that monetary and fiscal policy cannot be the genuine circuit breakers in a medical emergency.

The negative deposit rate, which the ECB left unchanged, is not the key tool for the current circumstances, in our view. A cut in that rate might have sent a strong signal – but without much economic impact in the end. For the financing conditions available to companies in the Eurozone, the additional purchases of €120bn of bonds over ten months, temporarily lower capital requirements for banks and the additional and even more generous liquidity provisions for banks (LTROs and TLTROs III, respectively) matter more.

Communication mishaps

Whereas we view the actual ECB decision as sensible, as discussed in our ECB flash ahead of the press conference, the ECB has to accept some of the blame for the adverse market reaction. Yes, ECB President Christine Lagarde had primed markets a week ago to expect a "targeted response". That was likely meant as a cue that a rate cut would not be the top priority for the ECB. However, when markets were pricing in an ever-higher probability of a cut in the deposit rate in response to bad news about the spread of the virus and the market reaction to the Covid-19 pandemic and lower oil prices, the ECB should have signalled in one way or another that such a cut might not be forthcoming. Keeping quiet in the pre-meeting "purdah" period usually makes sense. But allowing markets to go far down a cul-de-sac in such volatile times is a communications mistake. The ECB should have prepared highly nervous financial markets better for it. On its own, the adverse market reaction now accentuates near-term risks.

In a further communications mishap, Lagarde sent sovereign yield spreads in the Eurozone up during her press conference by reminding bond markets that the ECB's role is not here to close spreads in sovereign debt markets. The subsequent surge in spreads apparently forced her to make a clarifying comment later in a CNBC interview, emphasising that "high spreads clearly impair monetary policy". Both statements are correct, in their own way. It would have been better for Lagarde to not make the first argument so pointedly in the first place. That would have spared her the need to clarify the issue later on. Lagarde also stressed in the interview that the ECB would deviate temporarily from capital keys if necessary. But that calmed markets only a little. Italian bond spreads over German yields started the day below 210bp. After spiking to almost 270bp, they fluctuate around 245bp at 16:15 London time.

In addition, that the ECB today presented staff forecasts for growth, which the ECB itself considers outdated, may not exactly bolster confidence either.

A rate cut in disguise

The ECB's generous conditions for long-term liquidity operations with a rate of up to 25bp below the deposit rate, that is as low as -0.75% currently "if banks maintain their levels of credit provision", can be seen as a 25bp rate cut in disguise. After the decision to introduce a tiering system for the penalty on bank deposits at the ECB in September 2019, this is the ECB's second step to drive a wedge between deposit rates and lending rates. Instead of raising the average rate on deposits again, as it did last year by exempting 6 times the amount of minimum reserves from the negative deposit rate, the ECB today de facto lowered its effective lending rate. While the very favourable terms will apply only for operations outstanding between June 2020 and June 2021, this wedge between deposit and lending rates could develop into a conventional ECB policy tool. Such a system of so-called "dual rates" could become one of the ECB's most powerful tools.

ECB to finance ministers: please act decisively fast

Lagarde also urged governments to come up with an "ambitious and coordinated fiscal response … to support businesses and workers at risk". While national governments and EU institutions are – by their very nature – usually not inclined to act quite as fast as a central bank can which can decide and implement decisions for the entire Eurozone in just one session, we do expect governments to do their bit. Across the region, governments are (i) setting aside more resources for tackling the medical emergency, (ii) devising schemes to ease cash shortages of businesses and prevent excessive dismissals, and (iii) raise the fiscal stimulus to aggregate demand that is already in the pipeline. However, the impact of many of these measures will only unfold over time. They can help to contain some of the downside risks. But for a genuine turnaround, we will probably have to get more clarity on the future course of the medical emergency first.

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