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ECB PREVIEW: TIME TO WAIT?

Berenberg Macro Flash

In the Eurozone's worst recession ever, the European Central Bank (ECB) will almost certainly have to scale up its asset purchases this year. The ECB may well do so this Thursday already. However, we consider it somewhat more likely that the ECB will wait a little. While its economic number-crunching left brain half may suggest the ECB it can afford to wait, its political intuitive-thinking right brain half may encourage the ECB it should indeed wait and not take finance ministers fully off the hook at this stage. However, the ECB may well decide to buy so-called "fallen angel" bonds. The ECB could also lower its effective lending rate further by making the terms for its long-term liquidity injections into the banking system even more generous.

The ECB will probably opt to temporarily buy below-investment grade corporate bonds if they lose their investment grade rating amid the Covid-19 recession. Doing so, would limit the pro-cyclical drag from downgrades of rating agencies for the economy at large and the most vulnerable debtors in particular – think small- and medium-sized enterprises (SMEs). **Similarly, with respect to sovereign bonds, the ECB may signal that it could extend the waiver for Greek bonds to bonds of other sovereigns, in case they would lose their investment grade.** The ECB could justify such a move by also stressing it thereby ensures a more equal transmission of its monetary policy across the Eurozone – ECB speak for containing bond spreads. So far, the ECB limits its bond purchases to issuers with an investment grade rating of at least one of the big four rating agencies. Recently, the ECB changed its rules to accept "fallen angel" bonds as eligible collateral to maintain bank's access to the ECB's liquidity.

While the ECB will most likely keep its main policy rates unchanged (deposit rate at -0.5%, main refinancing rate at 0%, marginal lending facility rate at 0.25%), **it could decide to lower its effective lending rate of its long-term refinancing operations from 25bps to 50bps below the current deposit rate, that is from -0.75% to -1%.** Doing so would both help to accommodate surging liquidity needs and raise banks' profitability as the ECB's own bank lending survey published yesterday showed. Such support for banks, and their clients, would also be much less controversial than a commitment to purchase bank bonds. While the ECB may decide on such a move if bank lending came to a standstill, the hurdles remain high. The Euribor-OIS spread, which points to some fragmentation in the Eurozone banking system, would have to widen significantly further. After the EU Commission adopted additional measures as part of a banking package yesterday, that looks a little less likely though.

We expect the ECB to stress it stands ready to do more if necessary, but to refrain from deciding on an expansion of its PEPP already this week. According to the regular pre-meeting Bloomberg survey of economists last week, only 27% of the panellists expect such a decision this week.

At some point, more likely in June than this week, the ECB will increase the total amount of purchases under PEPP beyond the current €750bn, by €500bn at least or temporarily without a pre-set limit. 58% of the economists panelled by Bloomberg expect a bigger PEPP eventually, with €500bn as the median size of the increase. The amount of debt issued by Eurozone governments this year will likely dwarf what the ECB has committed to under PEPP and its regular asset purchase programme (APP, together €1.1trn). To avoid spiralling borrowing costs for some of its member states, the ECB will continue to hoover big chunks of the debt issued. Given the speed at which the ECB has purchased bonds since the announcement of PEPP on 18 March, it could hit its PEPP limit in autumn. Going forward, an even bigger miss of its "below, but close to, 2%" inflation target could also trigger the ECB to do more. At least for 2020, the bigger risk, in terms of both consumer and asset price inflation, is clearly not doing enough, instead of doing too much. "Whatever it takes, whatever works, as long as it takes" in action.

As of now, however, economic logic suggests the ECB can afford to wait. The emergency work is largely done. The room of the purchasing programmes remains ample. In the first four weeks, the ECB bought close to €100bn under its PEPP. If the ECB waits for more evidence of economic data on the size of the hit, it will have a better idea of how much more money it needs to inject. Also, relative to last week, bond spreads have tightened. It remains unclear whether this has been driven by EU leaders selling the progress of last week's summit better, S&P's decision to keep Italy's credit rating unchanged (because of the ECB's "backstopping this additional public borrowing"), or by actions of the ECB itself. It may have increased its bond purchases after the EU summit a little relative to before. The bottom line is, nothing can be ruled out, but, as of this week, increasing PEPP is probably a matter of less urgency.

Political calculus may argue against expanding PEPP already this week. Central bankers should only respond to the state of the economy and take policies of other policy makers as given. But they are hardly immune to political dynamics. Their left brain half guides them to do everything necessary within their mandate to achieve the ECB's primary objective of price stability. Their right brain half may tell them, though, that in order to get there, it may be suboptimal to be the only game in town. Better to have fiscal policy makers also play along in a strong, coordinated fashion at the Eurozone level "through more unified fiscal measures". The hope of getting them to do so, or quicker than so far,

may be in vain, though. The history of European fiscal policy makers relying on the ECB as both the first and last line of defence is long and rich. Most likely, the ECB will have to expand PEPP before EU leaders finally agree on the size, funding and expenditure of a recovery fund. This week, however, the ECB may be in the position to not relieve EU leaders too much from the pressure to come up with a common fiscal policy response fit for purpose.

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