ECB preview: a substantial package

Actual and potential monthly net asset purchases (€bn)

- **ECB to the rescue**: The semi-lockdown of the whole of Italy and increasingly stricter measures elsewhere in the Eurozone to contain the spread of COVID-19 exacerbate the near-term economic damage significantly. Adding to that, the fall in five-year inflation expectations to an all-time low of 0.95%, the rise in the euro by more than 6% since the 20 February trough to 1.145 per euro and a rise in southern European, especially Italian and Greek, sovereign bond spreads make substantial ECB action this Thursday look highly likely. While monetary and fiscal policy cannot offset the direct hit from the virus epidemic to supply and demand, the use of monetary and fiscal tools can help to contain second-round effects on liquidity and confidence, and help to arrest a market rout.

- **10bp cut and loans in abundance**: Markets price in a cut of the deposit rate by 10bp this weekend and a further 10bp by June. The ECB has little room to cut. Reducing the deposit rate cut from -0.5% to -0.6% or -0.7% will also make little difference to credit growth. However, as the ECB will probably want to send a clear signal, a 10bp cut now looks more likely than not. We continue to expect the ECB to expand the current round of long-term loans to banks (ie more tranches, longer maturities, and/or less strict conditions) and/or announce a new facility aimed at keeping liquidity flowing to small and medium-sized businesses. In addition, the ECB may provide (more) stimulus in three ways.

- **More generous tiering**: We now expect the ECB to exempt more excess reserves from the negative deposit rate. The more its measures would raise reserves among and/or make them costlier for banks, the more generous we would expect tiering to be so that – whatever package the ECB decides on – it benefits rather than hurts banks. The ECB could thus make more use of the spread between its lending and deposit rate.

- **More corporate asset purchases**: The ECB will most likely raise the amount of monthly bond purchases, possibly to €30bn instead of €20bn for at least six months (see chart), and tilt these purchases more towards corporate bonds. The ECB may even go for an open-ended increase. The remaining supply of corporate bonds is still ample, unlike that of some sovereign bonds. The ECB could probably purchase corporate bonds worth more than €45bn. This dwarfs the ECB’s net purchase of €4.5bn in monthly net corporate bonds on average since November.

- **“The limits are ours”**: Possibly, the ECB may signal it is willing to start a discussion on the limit of 33% on the proportion of a Eurozone member state’s outstanding bonds it can buy – if necessary. Continued widening spreads between southern European relative to German bond yields, which suggest markets price in a higher risk of cash flow issues for peripheral sovereigns, may sway the more hawkish members on the Governing Council to do so. Similarly, the ECB may suggest that expanding the universe of eligible assets to bank bonds or, more likely, to exchange-traded equity indices could become an option ultimately if the crisis were to worsen significantly further.

- **Looking for circuit breakers**: None of these monetary measures will stop the spread of the virus. But they are among the best measures to prevent the economic damage being even more severe in potential second-round effects.

Source: ECB, Berenberg
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