ECB Review: July 2020

MNI Point of View:

As one of the most consensual monetary policy meetings for some time, yesterday's GC decision and press conference played out largely as expected. The ECB made no adjustment to its main policy tools, reaffirmed its commitment to adjust all policy instruments as necessary, and maintained the core message on the economic trajectory. President Lagarde acknowledged the apparent bottoming observed in economic data and the strength of the rebound. However, as we expected, the optimism was muted with continued reference to persistently weak demand over the medium term, 'heightened uncertainty' and downside risks to the ECB's central forecast.

Some commentators had wondered beforehand whether Lagarde would echo recent comments made by Lane, Schnabel and Knot on the possibility of the current PEPP envelope not being fully utilised. While this possibility was acknowledged in the event that economic activity surprises strongly higher, Lagarde stressed that the ECB did not view this as likely and that the PEPP had been carefully calibrated to satisfy its dual function (preventing financial fragmentation and countering the shift lower in the inflation trajectory caused by the coronavirus crisis) and that the full envelope was expected to be used under the baseline scenario. It is difficult to determine whether the previous comments from Lane et al on the PEPP reflected an assessment that economic conditions may not warrant the use of the full envelope, or whether policymakers were attempting to reinforce the ECB's commitment to proportionality in light of the recent GCC ruling.

In addition to the ECB's interpretation of economic conditions and the PEPP envelope, the market was also looking for any additional insight on possible adjustments to the tiering multiplier and the inclusion of 'fallen angels' in the list of eligible PEPP securities. In the case of the former, Lagarde stressed that the two-tiered deposit system had proven particularly effective and, again, indicated that it was appropriate calibrated. Although this suggests that there is no active discussion on raising the multiplier at the moment, eventually the build-up in excess liquidity on the back of the expanded purchase programmes could tip the balance in favour of an adjustment to the multiplier.

There was also no substantial discussion on the inclusion of 'fallen angels' to the PEPP. With Lagarde repeatedly stressing the effectiveness of the successive policy innovations in supporting bank lending to the economy, reducing financial fragmentation risks and more broadly supporting economic activity, there is no urgency to do more at this stage. Any movement on this front is more likely in a situation where periphery-core spreads start to widen again or corporate downgrades (and perhaps even corporate bankruptcies) start increasing.

As we mentioned in our ECB Preview, the more interesting questions (for us, at least) are how the ECB will interpret incoming economic data, how it will navigate the recovery and how it will determine when the coronavirus crisis is over. We suspect that the ECB will continue to downplay rebounding economic data and instead stress 'heightened uncertainty' and the likelihood of persistent demand weakness over the medium term and fundamental economic restructuring. Overplaying the strength of incoming data could conflict with the ECB's central message. That said, a string of strong data outturns in the coming months would make it increasingly difficult for the ECB to stay on point.

In terms of the PEPP, our questions around its lifespan and whether it could eventually morph into a semi-permanent policy tool (or perhaps a similar tool is devised in the future) unsurprisingly remain unanswered. Obviously, it is still early days in terms of the PEPP implementation, so there may not be much market interest in this question for a while. However, the ECB will at some point need to indicate how it will determine when the coronavirus crisis is over and specifically which metrics will be used (as this will determine when PEPP is concluded). Again, we believe it is possible that if staff analysis showed persistent economic scarring from the pandemic, it is conceivable that the PEPP is retained for significantly longer than the current scheduled expiration.

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Analyst Reviews:

BBVA

- The wait-and-see approach adopted at the July meeting suggests that the ECB will stay put in the short-run and will instead await more clarity on the shape of the economic recovery and financial conditions.
- However, a change in the deposit tiering system after the summer cannot be discounted.

Berenberg

- With more data available by the time of the September monetary policy meeting, the ECB will have a better idea about the pace of the recovery and the impact of its recent policy decisions.
- Provided that the economy evolves in line with a tick-shaped recovery, the ECB is expected to maintain its current policy stance.
- It may not be before the December meeting (when the first forecasts for 2023 are published) that the ECB makes a call on when it deems the coronavirus crisis to be over.
- In the meantime, the ECB may raise the tiering multiplier

Citi

- The repeated reference to 'flexibility' for the PEPP programme should be understood as a willingness to step up stimulus if needed.
- However, there are no signs of active discussions about providing further stimulus.
- With the tiering multiplier left unchanged and President Lagarde talking up the effectiveness of the measure, there is a reduced likelihood of the ECB raising the multiplier in the coming months.
- Although the EUR did not feature at the meeting, Citi expects this to feature in policy debates in the coming months.

Goldman Sachs

- Given the subdued outlook for inflation, President Lagarde's comments that the PEPP has been carefully calibrated to satisfy its dual functions (containing fragmentation risks and offsetting the pandemic-related shift down in the inflation path), has supported GS' expectation that the expanded PEPP envelope will be used in full and run until June 2021.
- Despite there being no mention of including high-yield corporate debt instruments in the eligible PEPP universe, GS believe it is possible that PEPP will be expanded to include new asset classes and may be required later in the year if corporate downgrades become more of an issue.
- The APP is expected to be stepped up as the Governing Council tilts from PEPP to APP in mid-2021, while the APP is expected to run until mid-2023. Moreover, this will likely require an increase in the 33% sovereign issue/issuer limits.

HSBC

- The ECB has signalled that the PEPP is correctly calibrated, suggesting that there will not be a further expansion of the programme in September.
- Although there was no adjustment to the tiering multiplier at this meeting, the increase in excess reserves means that a slight increase may eventually be warranted. However, the ECB will not rush to do this.
- Similarly, possible purchases of 'fallen angels' under the PEPP are likely to be kept in reserve for worse times.

ING

- ING sticks to its view that the ECB will wait until September, if not the late October meeting, before deciding on any next steps.
- This is after the initial V-shaped rebound the eurozone economy when there will be a better picture of the actual recovery.

Morgan Stanley

- As expected, the ECB did not change policy or its stance ahead of a political agreement on the Recovery Fund.
- The message is seen as relatively dovish, with the ECB standing ready to do more if needed and not changing its outlook on the initial rebound of the economy on re-opening.
- According to Morgan Stanley, a weak inflation outlook means that the ECB will eventually have to do more. They call for a further PEPP top-up, likely of EUR400bn, in early 2021, and an extension of the facility until end-2021.

SEB

- In line with expectations, the ECB did not adjust monetary policy at the July meeting.
- SEB expects an increase in the tiering multiplier in the autumn in order to mitigate the cost of excess liquidity to banks.
- In addition, another increase in asset purchases is quite likely, although an end to net purchases for PEPP in mid-2021 remains SEB's main scenario for now.

Société Générale

- Given that President Lagarde indicated that the current PEPP envelope will be used in full, this implies some tapering from the high weekly flows in April and May.
- It will be a challenge for the ECB to end the PEPP next year, suggesting that a further extension is likely or alternatively a boost to the APP.
- Although an adjustment to the tiering multiplier was not discussed at the July meeting, Société Générale believe that the ECB may only raise the multiplier in the middle of 2021 when the TLTRO incentive starts fading.

UBS

- The ECB is expected to use the full PEPP envelope of EUR1.35trn and will increase it again in Q4 as well as extending the lifespan by a further six months to end-2021.
- There are two reasons for this. First, it is expected that inflation will take a longer time to return to the pre-Covid path. Second, factoring in the seasonal slowdown in purchases, the PEPP envelope could be fully utilised by March/April 2021.
- The ECB may announce the PEPP increase/extension on 10 December, particularly if markets remain calm.
- The ECB may also consider buying new asset classes (junk bonds, bank loans with state guarantees), but only if this is considered necessary to calm market tensions.
- The deposit rate is expected to remain at -0.50% for the foreseeable future, but the technical details of the two-tiered deposit system could be adjusted.