Pandemic Purchase Programme

ECB emergency meeting comment

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Summary

- The ECB held an emergency meeting tonight.
- After last week's easing package, the ECB added another EUR 750bn in asset purchases.
- Recent market turmoil added to the ECB's urgency.
- Moreover, the fiscal plans announced by Eurozone governments removed the ECB's objections against further easing.

Policy decisions

- The existing asset purchases will be expanded with a **EUR 750bn "pandemic purchase programme"**. The purchases will be made in 2020.
- **Non-financial commercial paper** has been added to the eligible pool of assets.
- The statement now explicitly notes that the **self-imposed limits** may be revised if necessary.

Full-blown easing

At an emergency meeting, the ECB announced additional monetary stimulus, just one week after the Council unveiled its previous easing package. The ECB has announced another EUR 750bn in asset purchases, in a specific envelope it calls the "pandemic emergency purchase programme".

Though the ECB will use flexibility when conducting these purchases –across the time, asset class and jurisdiction dimensions– the average monthly volume should amount to just under EUR 80bn. Add to that the EUR 120bn envelope and the EUR 20bn in monthly net purchases. That means that the ECB will be purchasing a grand total of approximately EUR 110bn per month, net of redemptions! So despite the ominous name, this new programme should certainly deliver what markets were missing last week.

No longer just a supply shock

Of course, last Thursday the ECB already implemented another "envelope" of EUR 120bn in additional asset purchases that can be flexibly deployed throughout the year as and when the ECB deems necessary. However, if the ECB were to simply scale up its purchases to the similar volumes as in 2015-2017, this envelope would be empty in three months at best. And since that envelope should be used as much as possible for the private sector purchase programmes, the ECB clearly intended to use this EUR 120bn for credit easing, not quantitative easing.

This envelope, together with the other actions taken by the ECB in March, made for a compelling instrument to support those sectors that are suffering from a temporary supply shock. But the Eurozone has moved beyond this stage already, with a demand shock now also hitting the economy. The ECB estimates that this year the Eurozone economy could shrink by 1.2% due to a one-month lockdown to as much as 5% if the lockdowns remain in place for three months.[1] That clearly warranted additional policy measures.

Governments have done their part…

Neither the government, nor the ECB may be able to do much about the economic slowdown as long as shops and bars across countries are closed, but they can ensure that the collateral damage remains limited so that the businesses can hit the ground running when these restrictions are lifted.

Eurozone governments are now pledging to support sectors and businesses that are affected by the virus or the containment measures. By our calculations, the five largest Eurozone economies have already unveiled spending plans amounting to, on average, 1.6% of GDP, and that excludes contingent costs that may arise from guarantee schemes. **In doing so, the governments have arguably removed one of the ECB's main objections against further easing. The ECB has been of the view that fiscal policy should take the lead.**

…but that does come at a cost

Tightening of financial conditions

However, the flipside of this fiscal stimulus is a rise in sovereign yields across the board, but mostly so in peripheral Europe. This is negatively affecting financial conditions in Eurozone markets.

Intraday, Italian 10y bonds were briefly yielding 3% as markets were pricing the impact of the stimulus measures on the country's debt metrics; in February these yields were still below 1%. And Italy wasn't the exception. In recent days yields have increased across the Eurozone sovereign space, including in Germany.

That rise in yields caused a tightening of financial conditions, especially since it adds to the upward trend in credit spreads that had already been established (figure 2). This was an unwelcome development for the ECB, since this increase in interest rates offsets some of the measures they have taken in March in order to reduce the borrowing costs of companies and households as much as possible.

Figure 1: The decline in yields is unwinding fast

Source: Bloomberg

Figure 2: On top of a sharp rise in credit spreads

Source: Bloomberg

[1] As covered here by the newspaper Frankfurter Allgemeine Zeitung (in German)

Major debt issuance

Secondly –and at least partially the cause of the abovementioned rise in yields– large scale fiscal stimulus will bring about substantial issuance of new debt. The ECB's asset purchase programme is by far the largest buyer and can help ensure smooth absorption of the required new issuance.

Assuming that the abovementioned 1.6% of GDP in fiscal expenditures is also representative for the other countries, total Eurozone spending will amount to roughly EUR 200bn. Again, that does not include any contingent claims, such as guarantees, nor does it include any spending on the Eurozone level. So this number is likely to increase, especially if containment measures remain in place for a significant time and additional fiscal support is needed. Moreover, the funds for these spending plans are needed on short notice, which also means that issuance will not be spread out over a long period. Instead, it will probably have to be clustered in the near-term.

Without higher asset purchases by the ECB, this net new issuance will start to whittle away at the 'stock effect' of the ECB's asset purchases, which was keeping yields depressed. And even if the ECB isn't allowed to participate in sovereign bond auctions, their increased presence in the secondary market should suffice to ensure that governments can issue the required additional debt, without flooding the market. The EUR 750bn in additional purchases should provide ample new ECB demand to offset the upcoming sovereign issuance.

A first stab at the limits…

Of course, the substantial expansion of purchases could come with some tough choices on the part of the ECB. As we have argued in the past, the ECB is already quite close to its self-imposed limits of buying no more than 33% of each bond's outstanding amount whilst also sticking to the capital key in the distribution of purchases. By scaling up its purchases significantly, the Bank will likely start hitting these limits, and the ECB may have to remove one of them. Tonight's statement includes a first acknowledgement of this.

Sure, all governments will have to ramp up their spending in order to combat the fallout of the virus, but if our current ballpark estimate of EUR 200bn in new issuance is roughly correct, that still leaves net ECB buying of EUR 550bn. Whilst this will not all be directed at the public sector, sovereign bonds will probably make up for a large portion of the package, due to the relative size of that market.

Therefore, the ECB may have to let go of one of these constraints in order to scale up its purchases; either temporarily or definitively. The ECB now officially acknowledges this, and its statement explicitly noted that *"to the extent that some self-imposed limits might hamper action that the ECB is required to take […] the Governing Council will consider revising them"*. It is hard to say which of the two would be the least contentious for the Governing Council, but we could see the decision being informed by the market circumstances.

If the sole purpose of extra asset purchases is to re-establish lower yields, and there is no sign of fragmentation in the Eurozone sovereign bond markets, the ECB could probably opt to let go of the issuer limit so that it can keep purchasing according to the capital key.

However, since peripheral countries have a higher debt/GDP ratio to begin with, peripheral spreads may be oversensitive to fiscal largesse even if core countries are forced to do the same. To the extent that the recent spread widening can be seen as a sign of fragmentation risk being priced in, amending the issuer limit will likely backfire as it reinforces the notion that the ECB would be unwilling to support countries like Italy; especially after Ms. Lagarde's *"we are not here to close spreads"* gaffe at the March press briefing. In such a situation, the ECB may prefer to deviate from the capital key instead, in order to support peripheral markets. Even if this deviation is intended to be temporary and the ECB aims to get its portfolio back in line with the capital key at the end of the programme, the near-term implications of a capital key deviation should support the periphery. Then, when calm has returned, the ECB could gradually rebalance its portfolio again.

…or will governments make the difficult choice?

And quite possibly, the ECB won't even have to make such a contentious decision. Instead, the European leaders may decide to jointly borrow the funds required to help the national economies overcome the coronavirus. This would eliminate a huge political hurdle on the ECB's side.

Italian Prime Minister Conte suggested to use pooled Eurozone borrowing. That probably won't surprise anyone. However, the fact that German Chancellor Merkel was not immediately opposed to the idea may have. According to Bloomberg, Eurozone officials are now looking to use the European Stability Mechanism to fund the COVID-19 response of member states. This means that the ESM would extend credit lines to the governments, rather than each government having to raise the funds on their own. The ESM could then use its abilities to issue bonds and attract the necessary capital.

Since the ESM's debt is amongst the assets that are eligible for purchase by the ECB, new issuance by the ESM would allow the central bank implement its purchase programme without serious concerns about the abovementioned constraints.[2] And at the same time, the fact that the ECB can snap up these bonds –to the extent that this doesn't raise questions about monetary financing– should support the ESM when coming to the market in substantial size.

Of course, the difficult political decision of a *de facto* partial debt mutualisation then still lies with the Eurozone leaders. However, we would argue that this hurdle is significantly lower than it was during the sovereign debt crisis. After all, where the latter was caused by some countries' budgetary policies, the coronavirus cannot be blamed on the periphery. Plus, all of Europe will have to deal with the implications, and this support will thus not be solely for the benefit of one country. We therefore think that it would be a much easier story to sell to the national audiences. And, as has always been the case in Europe, under pressure everything becomes liquid.

[2] Admittedly, the limits may still be a problem, given the speed at which bonds may need to be bought. After all, the ECB can only buy part of each newly issued ISIN.

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