Not if and when, but what and how much

ECB post-meeting comment

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Contents

Summary

- The ECB left its policy fully on hold, as expected, but the tone of ECB's statement was decidedly more dovish, with clear hints at new stimulus in December.
- This will most likely at least include extended PEPP support, but other tools were explicitly not ruled out.
- We now also expect easing of the LTROs in December, in order to counteract hiccups in the bank lending channel and to ensure that the monetary policy continues to be transmitted.
- However, the ECB can only do so much to help the economy through a new lockdown, and additional government support is vital.

Policy decisions

- The ECB left the **deposit rate unchanged at -0.50%**, while keeping the refi rate at 0.00%.
- The **PEPP envelope was left at EUR 1,350bn.** The ECB expects to spend the full amount.
- The Council **tasked the relevant committees to investigate a recalibration of the ECB's policy measures**.

Decidedly more dovish

It does not happen often that an ECB statement starts with the observation that *"risks are clearly tilted to the downside"*. Normally one would expect this to be followed by an announcement of monetary easing, but the ECB stopped short of that. This has only reinforced our conviction of imminent policy action, supported by a gloomier set of economic projections in December.

An extension (and expansion) of the PEPP remains most likely, but Ms. Lagarde hinted at a broader package of measures. We expect this package to also include further easing of the TLTROs or similar cheap liquidity providing operations, due to concerns that the bank lending channel may not fully transmit new easing. But the impact of all these measures largely depends on a similar response from the fiscal side.

Clouds continue to gather

Despite not taking action today, President Lagarde did say that, based on a *"thorough reassessment of the outlook"* in December, the ECB *"will recalibrate its instruments, as appropriate, to respond to the unfolding situation and to ensure that financing conditions remain favourable"*. It doesn't get much more dovish and clear than this, and it is safe to assume that December will see more ECB stimulus.

Dark clouds continue to gather over the economy, after France announced another full lockdown yesterday, and Germany a partial one. Indeed, Ms. Lagarde admitted that the economic recovery is losing momentum more strongly than expected, and that the recovery in Q3 had been strong, but uneven across sectors of the euro area economy.

As a result, there was unanimous support in the Council to thoroughly analyse the situation in December, and to recalibrate the ECB's toolkit as appropriate at that juncture. She added that the relevant committees have been asked by the Council to look at this recalibration, which is generally a pre-announcement of stimulus. And for anyone still not convinced after all this, President Lagarde said there is *"little doubt"* the ECB will act in December.

In terms of policy tools, she noted that the committees will look at all instruments, but that they will clearly be looking at PEPP more than others. Nonetheless, Ms. Lagarde seemed to hint at a broader stimulus package, rather than only a PEPP adjustment. We believe that the ECB's (T)LTROs are the most likely tool to be used in conjunction with the PEPP.

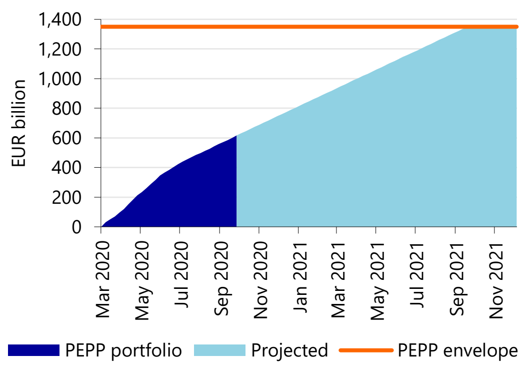
Clearly, the ECB is looking to ensure that all the financial conditions are there to help the economy through the second wave. However, as Ms. Lagarde also noted, the past six months have seen a strong synergy between fiscal and monetary policy, which has reinforced the efficacy of both. We therefore note that the effectiveness of December's easing will largely depend on continued help from the fiscal side.

Dangling the PEPP carrot

Asset purchases remain the main policy instrument to our minds. The overhang of ECB purchases has helped keep spreads compressed, even though countries and sectors were hit asymmetrically by the Covid-19 shock. The ECB is likely to extend and increase PEPP in December. But the success of this move will largely depend on euro area governments joining forces with the ECB.

The ECB's asset purchases, and in particular the introduction of the PEPP in March, have significantly contributed to easy financial conditions in the euro area, particularly the low yield environment and tight credit spreads, even though countries and sectors were hit by an asynchronous adverse shock. And the ECB achieved all this without even spending half of the earmarked EUR 1,350bn.

Figure 1: PEPP can still last to 2021Q4



Note: projected portfolio based on average purchases in the last 4 weeks. Source: ECB, Rabobank

For some time now, we have argued that the continued overhang of the PEPP is its main strength. In terms of remaining spending power, there is currently little need to increase the programme significantly. Extrapolating the recent pace of buying, the ECB can last until 2021Q4 with its current envelope. But against a darkening outlook, the ECB may find itself needing to scale up its weekly purchases again.

More importantly, we noted that the date-based guidance of the programme (*"until at least the end of June 2021"*) is increasingly incompatible with the expected time it takes for the economy to return to pre-Covid levels; let alone inflation. We therefore continue to expect an increase of this date-based guidance, at least until the end of 2021. And while the envelope technically doesn't need to be increased yet, we believe that a small addition would be required to avoid a potential hawkish perception of this decision: after all, increasing the time frame of PEPP purchases without adding firepower could be seen as a signal that the Council intends to lower its monthly purchases. We therefore remain of the view that an EUR 250bn increase seems fair, although market expectations have recently jumped to double this amount – which adds upside risks to our EUR 250bn call.

Will governments bite?

Keeping the markets sedated remains important to ensure that governments and private borrowers can continue to rely on cheap market-based funding. In that sense, it is a carrot that the ECB is dangling in front of euro area governments to persuade them into a repeat of the fiscal measures deployed in Q2 during the second wave as well. These fiscal measures were vital in avoiding widespread job losses and defaults. A promise that the PEPP will continue to linger over the markets for a prolonged period should take away governments' most immediate concerns of the budgetary impact of further easing, and a resultant increase in borrowing costs.

Without further support from the fiscal side, an increase in PEPP will be much less effective; particularly looking at the longer-run. If governments do not extend their fiscal stimulus, unemployment will likely rise sharply notwithstanding the ECB's best efforts to provide monetary easing. In that case, a deteriorating outlook may force the ECB to pile on even more stimulus in the longer-run – again with probably much more limited effects.

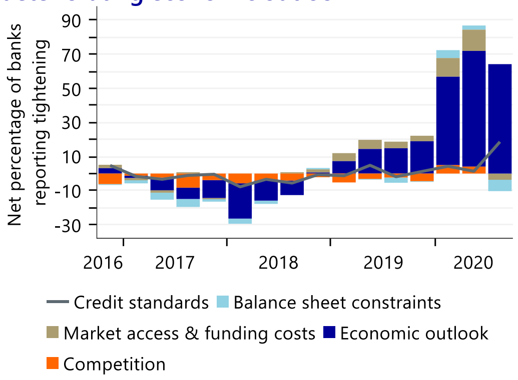
LTRO easing to combat credit tightening?

Additionally, we now expect an easing of the LTRO instrument in December. The most recent Bank Lending Survey reported a tightening of credit standards in Q3, with respondents expecting this tightening to continue through the final quarter. This may cause concerns about the effectiveness of the bank lending channel in transmitting monetary policy. While we see a role for government guarantees, that has certainly increased the likelihood of further easing of the TLTROs or similar cheap liquidity providing operations.

Indeed, remarks made by Lagarde today, in which she specifically pointed to the BLS, also seem to point in that direction. The ECB's Q3 Bank Lending Survey surely made for a bad omen last Tuesday. Through the first wave of this Covid-19 crisis, banks' credit standards broadly remained unchanged. The fact that credit standards tightened only very modestly despite the sharp deterioration of the economic outlook (figure 2) was a major difference with the financial and sovereign crises. This has likely prevented many companies from defaulting on obligations, since they were able to access bridge loans for working capital during the lockdown.

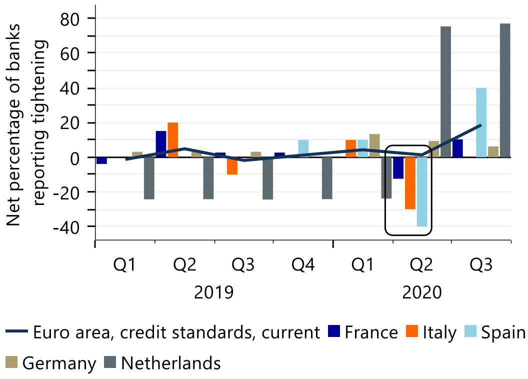
To some extent, this should be credited to the ECB. The combination of very generous TLTRO-III conditions –in particular the temporary discount– and regulatory easing have supported bank lending. But government guarantees on corporate loans made an even bigger difference. That effect becomes especially clear when looking at the cross-country differences: the measures taken by the French, Italian and Spanish governments led to a substantially stronger easing of credit standards in these countries, as compared to Germany and the Netherlands (figure 3). Crucially, though, these government guarantee schemes are expiring, which has caused a sharp turn-around from easing to tightening in these countries in the latest BLS.

Figure 2: Modest tightening in H1, despite the deteriorating economic outlook



Source: ECB, Rabobank

Figure 3: Banks are tightening credit standards



Source: ECB, Rabobank

On the one hand, this once again stresses the importance of fiscal measures, in addition to the monetary easing undertaken by the ECB. However, to the extent that the bank transmission channel could once again become a concern to the central bank – and given today's comments by Lagarde, **we expect the ECB to announce an easing of LTRO conditions in December.** At the same time, such concerns would only make the policy rate instrument a less likely option.

Easier LTRO conditions could come in the form of an extension of the TLTRO-III discount beyond July, and/or further cuts to the rates applied on these operations. But we note that there are only two more operations left, and the ultimate borrowing costs are dependent on banks' net lending – which in turn largely relies on borrowing and repayments by corporates. So this could also be a reason to ease the PELTRO instead, or launch a new series of LTROs; which, as some have suggested, could be tied to green goals rather than simply net lending targets.

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