3 December 2020

ECB Preview

Recalibrating, not easing

- The ECB is set to recalibrate its monetary policy instruments at next week's meeting and the question is which tools it will use. Recent comments have focused on more PEPP and TLTROs as the main tools, but we expect the ECB to tweak its more technical parameters, such as tiering and collateral rules, as well.
- **PEPP.** We expect the ECB to add another EUR400bn to the current PEPP envelope running at least until end-2021. The ECB may also increase the APP purchase rate, but this is less powerful than the PEPP and it is not as important for the overall ECB monetary policy stance unless the purchase rate is increased significantly to, e.g., more than EUR40bn/month. The ECB will not commit to a monthly target under the PEPP.
- **TLTRO/PELTROs.** Extend the discount window to the entire duration of the liquidity operation (3y). Provide four additional TLTRO liquidity operations until Q1 22 (quarterly basis) and expand the eligibility pool. PELTROs to continue into end-2021 on a monthly basis.
- **Tiering.** Increase the tiering multiplier to 10x the reserve requirement.
- **Collateral.** Extending the 7 April grandfathering of the collateral eligibility rules until end-2022.
- **No rate cut.** Still no rate cut, but repeating the option to cut if needed.

No bazooka – more of the same

We do not expect material changes to the ECB's overall monetary policy approach at next week's meeting. That means that the ECB will continue to ensure favourable conditions and backstop any potential tightening that may arise but will not actively ease the overall monetary policy stance. Recent comments from across the governing council have focussed on recalibration of its already implemented instruments rather than new measures. As we discussed in *ECB Research: Recalibrating - not reinventing - the toolbox*, 12 November 2020, the ECB's toolbox is not suitable for solving the problem at hand (the demand side of the economy in lockdown), hence its crucial job is to 'buy time' while supporting the fiscal policy stance. This piece serves as policy reflections ahead of next week's meeting (for more details on each instrument, see the link above).

Recent remarks from various governing council members showed a remarkable agreement on a recalibration of PEPP and TLTROs and we received only very few comments on technical tweaks to the tiering and collateral rules. Nevertheless, we expect the tiering multiplier to be increased to 10x the reserve requirement (from 6), as excess liquidity has increased markedly as a result of the ECB's bond buying and liquidity operations and is also set to increase at least through 2021. An increase in the tiering multiplier should be seen in light of mitigating some of the negative side effects of banks' profitability. Furthermore, we expect the grandfathering of the collateral rules as announced on 7 April, which essentially is a backstop in case of downgrades into non-investment grade, to be extended to end-2022 from its current expiry date in September 2021.

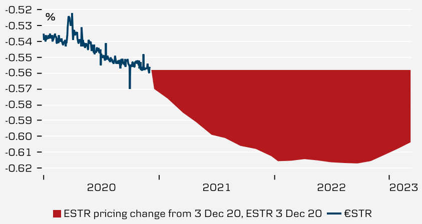
10 December 2020 (CET)

13:45 ECB decision
14:30 Press conference

Euro area Financial Conditions Index

Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.
Source: Bloomberg, Macrobond Financial, Danske Bank

Markets no longer point to a full 10bp rate cut by the ECB



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Source: Macrobond Financial, Danske Bank

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Easing of TLTRO terms

Since late October, when the ECB's Bank Lending Survey pointed to an expected tightening of credit conditions in Q4, the ECB's governing council members have been quite vocal on the bank lending transmission. As TLTRO is tailored to support favourable lending conditions, we expect the ECB to be relatively aggressive in its easing of the terms. Last week, ECB's chief economist Lane said that all parameters could be tweaked. Of those parameters, we expect (1) a prolongation of the TLTRO discount to last for the entirety of the operation's lifetime (from current June 2021), (2) no increase in the discount size from -50bp, (3) additional four operations with last allotment in March 2022 and (4) an increase in the eligibility pool. The last point is the result of notably banks in the periphery countries having utilised close to their maximum allowance. We expect the eligible TLTRO allotment to be increased to 70% (from 50%), which would allow around EUR1trn additional funding to be taken (at most), but this is significantly lower than the actual take-up would be.

With regard to the governing council members, Schnabel on Tuesday said that 'three years is already quite long', while being open to extending the discount. On Wednesday, Kazaks (Latvia) was much more aggressive, saying that 'you can consider extending them from three to five years'.

PEPP, APP or both

As the ECB's two bond-buying programmes are different in nature, how the ECB assesses the economic and inflationary outlook is set to decide which programme (or both) would be scaled up. As the PEPP was established to address market fragmentation in response to the COVID-19 crisis and later also got the mandate to bring inflation back to its pre-COVID-19 path, a PEPP scale-up is a 'done deal' as we are not out of the COVID-19 crisis. It is more uncertain if the ECB will scale up its APP programme at the same time. It is already much smaller with EUR20bn/ month +EUR120bn envelope (that will expire at the end of the year), hence the decision to recalibrate the APP will be determined by whether the ECB can already now assess the more permanent impact from COVID-19 on the economic and inflation outlook, to bridge the 'normal' inflation gap to its target. This is uncertain at this stage, but eventually the APP is set to become the more prominent bond-buying scheme.

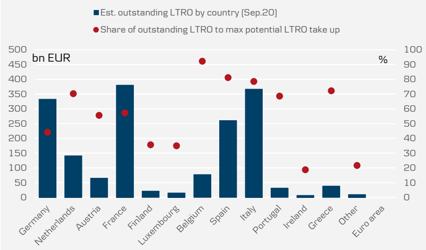
This differentiation may have implications for the implementation aspect, as so far we have seen that the PEPP focuses on public sector bonds, while the APP is implementing around 25% of private bond purchases. Furthermore, the PEPP's flexibility has allowed the ECB to shift purchases across time, duration, jurisdiction and asset class, which (for now) is not possible under the APP. In other words, we do not expect a migration of the programmes or that APP will have the same flexibility and limits as the PEPP.

We therefore expect the PEPP to be increased by EUR400bn as discussed in the toolbox discussion piece (link above), by applying the provided elasticities from the ECB. We also expect the envelope to be available until end-2021. The ECB might increase the APP to EUR30/40bn per month, but this is not a given. The most recent consensus survey (from Bloomberg) points to EUR500bn additional PEPP until end-2021.

No rate cut

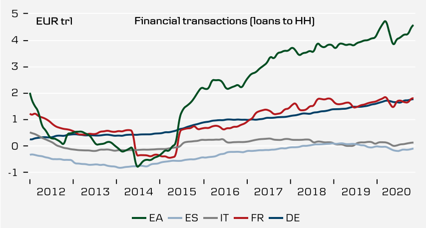
The ECB included a reference to the exchange rate in the first sentence of the ECB decision in October, which was the first time it had done this, which to us means that the ECB is vigilant on the FX implications for the economic outlook and implications for inflation.

TLTRO take-up in share



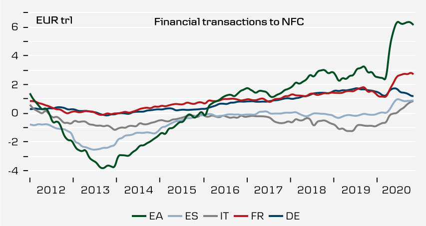
Source: ECB, Danske Bank

Loans to households have rebounded since the first TLTRO in 2014...



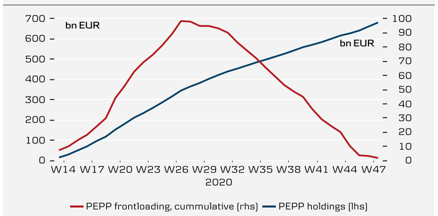
Source: ECB, Macrobond Financial, Danske Bank

... similar to loans to non-financial-corporations



Source: ECB, Macrobond Financial, Danske Bank

PEPP well ahead of schedule



Source: ECB, Macrobond Financial, Danske Bank

However, we only assign a 5-10% probability of the ECB actually cutting rates next week, as the effect of a single rate cut would be low and transitory. Should the ECB decide that it is willing to cut the deposit rate over several months, we believe it would have an impact but as the deposit rate is already at -50bp, the room for manoeuvre is rather limited. Most recently, ECB chief economist Lane said in a WSJ interview that rate cuts are better in calm environments than in turmoil and that rate cuts could be in scope if this situation is deemed more than just temporary. Markets are currently pricing in a 1bp rate cut at the December meeting (chart on front page).

New staff projections not 'gloomy' enough to warrant a big package

At the October meeting, Lagarde stressed that the euro area economy is losing momentum faster than expected and that recent hard data, survey results and high frequency indicators point to a significant softening of economic activity in Q4. The September ECB projections foresaw Q4 GDP growth at 3.1% q/q. In light of new lockdowns across many euro area countries, this estimate now seems too optimistic and we look for a contraction of -1.4% q/q. All in all, this would suggest a further downward revision in the ECB's growth forecasts for 2020 and 2021, but at the same time the Q3 GDP rebound was much stronger than expected by many economists, including the ECB (12.6% q/q versus 8.4% q/q). Comments from governing council members have since suggested that the new staff projections would not differ much from the latest EU Commission forecast released in early November. These suggest GDP growth projections would be taken down 0.8pp in 2021 and 0.2pp in 2022. As these seem largely cosmetic changes in light of the significant uncertainty in the economic outlook and as positive vaccine news has since brightened the prospects again, we do not think the message from the new staff projections will be 'gloomy' enough to warrant a big package.

The inflation outlook arguably continues to create trouble for the ECB. Core inflation fell to a new all-time low of 0.2% in September and has since remained subdued. Dissecting the drivers for the downtrend in core inflation over the last months very much shows the impact from discounting campaigns and lower prices in travel, hospitality and tourism services, which account for the majority of the fall. The low core inflation prints will certainly not cheer the ECB, but as long as a broad-based weakening trend is not visible, we think the ECB will look through the near-term low inflation pressures.

The October ECB minutes suggested that inflation was expected to be in negative territory for longer than had been foreseen in the September staff projections and we hence look for a 0.1pp downward revision for core and headline inflation in 2021. Still, the inflation outlook should keep an upward profile. The drag from energy prices should slowly abate and the reversal of Germany's temporary VAT cut will be an important factor lifting core inflation. However, the dynamics in service prices remain more ambiguous and some form of normalisation in tourism and hospitality-related sectors is probably required, before service price inflation can get back to its pre-coronavirus highs. For more on our current thinking on euro inflation, see also *Research Euro Area - Measuring the euro area inflation pulse*, 9 November 2020.

Implications for markets – difficult to surprise

As the ECB's governing council members have been quite vocal in recent weeks, to some degree pre-announcing the chosen instruments, we believe that anything but a recalibration of PEPP and TLTROs would come as a surprise. We further believe that a rate cut would be a major surprise to markets. As the PEPP increase will be seen in light of the end date

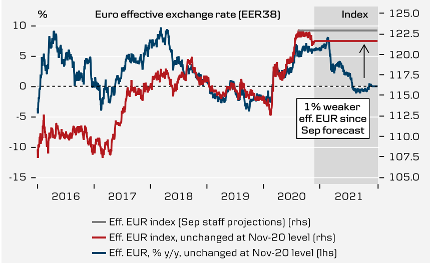
Downward revisions largely 'cosmetic'

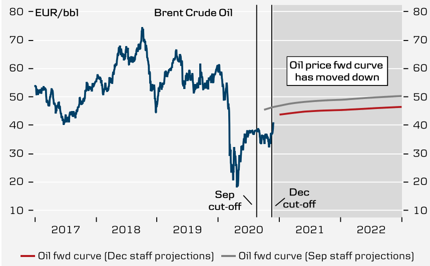
ECB projections December 2020	2020		2021		2022	
GDP growth	-7.4% (-8.0%)	↗	4.2% (5.0%)	↘	3.0% (3.2%)	↘
HICP inflation	0.2% (0.3%)	↘	0.9% (1.0%)	↘	1.3% (1.3%)	→
Core inflation	0.7% (0.8%)	↘	0.8% (0.9%)	↘	1.1% (1.1%)	→

Parenthesis are the old ECB projections (from September 2020)

Source: ECB, Danske Bank

Technical forecast assumptions little changed since September



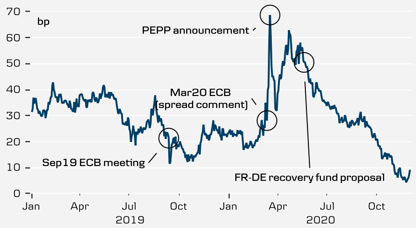


Note: Past performance is not a reliable indicator of current or future results.
Source: ECB, Macrobond Financial, Danske Bank

and overall volume, we believe that the ECB would have to announce AND commit to buying at least EUR100-120bn/month for this to be a dovish surprise. Announcing a large envelope and still calling for flexible and discretionary implementation will not lead to a dovish market reaction. An increase in the APP will give support to credit and covered bonds, as the CBPP3/CSPP shares have historically been higher in this programme. The technical tweaks, such as a tiering multiplier increase, may give a short bout of volatility in the front end, but similar to the 2019 decision, we expect markets to normalise quickly. Finally, the TLTRO announcement may be where we get a surprise, notably if the terms are very generous, by either long discount or increase in discount. This would lead to lower rates and a tighter spread reaction in rates markets.

Looking ahead, we do not expect the ECB's overall approach to its monetary policy stance to change and we expect the rates drivers of low volatility, tight spreads and low yields to prevail in the near term.

10y GDP euro area weighted yield spread to EONIA



Note: Past performance is not a reliable indicator of current or future results.
Source: Macrobond Financial, Danske Bank

ECB to have little impact on EUR/USD

We expect little change from the ECB at the next meeting. In turn, EUR/USD optimism is running high and will likely continue to do so as we head into Q1. A Brexit deal may be announced soon, vaccines are moving towards being rolled out and global economic data as well as market sentiment continue to improve, albeit at a slower pace than in Q3. Near term, we continue to expect EUR/USD to be quite well supported. The ECB may (or may not) mention there is a link between currency moves and the inflation outlook but we do not expect the ECB to be able to materially change the FX trajectory. In turn, global factors will remain key and they should continue to improve. We continue to see EUR/USD at 1.16 in 12 months' time but the tapering of optimism in the cross is very unlikely to arrive before Q1. We recommend clients with USD income to continue hedging such linearly.

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Expected updates

None.

Date of first publication

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