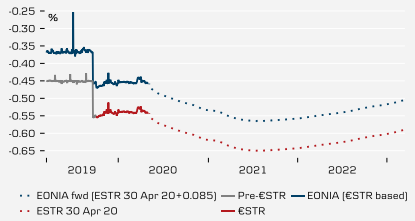
30 April 2020

Flash ECB Research

No PEPP increase, no rate cut but then again

- The ECB decided not to change the modalities of either the PEPP or the APP in size, composition or similar.
- However, the ECB made a pseudo rate cut for banks in the period between June this year and June next year by lowering the TLTRO rate by 25bp in the period.
- Further, the ECB plans to start conducting seven unconditional liquidity operations this year (PELTROs) at the MRO rate minus 25bp, with maturity in Q3 21.
- We expect the ECB to step up its PEPP by another EUR250bn and extend the APP at the June meeting. In our view, EONIA should continue to trade off the deposit rate.

ECB pricing continues to point to a rate cut



Source: Danske Bank

Max TLTRO allotment by country

(bn EUR)	TOTAL
Germany	755
Netherlands	202
Austria	118
France	665
Finland	61
Luxembourg	44
Belgium	84
Spain	321
Italy	468
Portugal	47
Ireland	39
Greece	54
Other	48
Euro area	2928

Source: Danske Bank

More is coming

Our overall take on the ECB meeting is that, with the severity and duration of the COVID-19 economic crisis, the ECB will continue to stand ready to act to mitigate the effect of the economic slump. As we discussed in *ECB Preview: The only game in town*, 24 April, we did not see a need to scale up the PEPP programme now, while we highlighted a potential sweetening of the TLTROs. Furthermore, President Christine Lagarde was very clear in her communication on adjusting the PEPP in size and composition should it be necessary. With the increased issuance coming and the expected scope of this crisis, we expect the ECB to continue its APP beyond the end of 2020, at a monthly purchase of EUR20bn at least until September 2021. At the same time, we expect it to announce an increase and extension of the PEPP for another EUR250bn until Q1 20 next year. We expect the announcement to come at the June meeting but we also highlight that the ECB could wait for the September meeting.

With the new PELTROs and TLTRO sweetened terms, the banks' relevant policy rate to take funding will increasingly be -1% but so far only in the period between June 2020 and June 2021. Therefore, the ECB has essentially made a synthetic interest rate cut in the 1Y period mentioned above. Banks will be able to take up to almost EUR3trn at the TLTRO operations. However, we do not expect such a high take up but look for a total EUR1.2-1.7trn. Importantly, with the ECB's increase in the eligibility pool to 50% (already decided at the March meeting), the ECB will allow in particular Italian and Spanish banks to increase their take up. These jurisdictions have been closest to the maximum take up.

With the sweetened TLTRO terms, which now offer liquidity at the deposit rate -50bp (25bp reduction compared with March decision) and increased collateral rules/sweetened terms, the ECB has raised the incentive for euro area banks to increase the risk appetite and support any financial fragmentation. This also means that if euro area banks' risk departments allow banks to take more risk, banks have an incentive to buy, for example, BTPs rather than the ECB. In our view, this reduces the risk of a PEPP increase. However, we expect the ECB ultimately to lift the envelope.

Synthetic rate cut for banks but not markets

Despite the synthetic rate cut by the ECB for the period June 2020 to June 2021, we did not see front EONIA contracts repricing on the back of the announcement. This is due to markets continuing to trade off the marginal euro rate level (EONIA).

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Looking ahead, we do not believe this will change in the current setup, nor do we believe that the ECB will deliver a 'conventional' rate cut by lowering the deposit rate.

Liquidity left, right and centre – PELTROs

With the new PELTRO (Pandemic Emergency Longer-term Refinancing Operations), the ECB will offer seven operations until year-end, all of which mature in Q3 21 at the MRO-25bp on a fixed rate full allotment basis. As banks have a greater incentive to fill their TLTRO allowances, we believe the PELTRO is not likely to be used to the same extent as the TLTRO but it serves as an important backstop to a potential funding squeeze.

With the increased liquidity facilities and subsequent rising excess liquidity, we see a higher probability of the ECB ultimately needing to address the tiering multiplier. So far, the ECB has not revealed is reaction function for changing the multiplier.

Current ECB liquidity facilities

Operation	Frequency	Rate
MFL	Daily	0
MRO	Weekly	0
PELTRO	7 operations until year-end	MRO-25
LTRO	Weekly until Jun 2020	Depo
TLTRO	Quarterly	Depo subject to benchmark, until June 2020
TLTRO	Quarterly	Depo-50 (-1% if benchmark) June 2020-June 2021

Source: Danske Bank

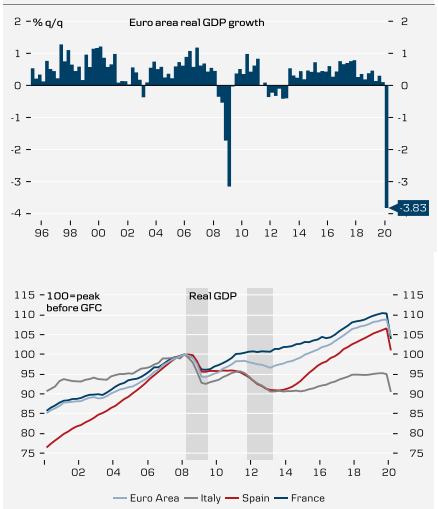
Euro area economy seen contracting between -5% and -12% in 2020

President Lagarde acknowledged that the euro area is facing a recession of unprecedented scale and speed, including a profound deterioration in labour market conditions.

The 'great lockdown recession' is already the deepest recession ever recorded for the euro area, with an unprecedented decline in GDP of -3.8% q/q in Q1, with worse still to come in Q2 in our view. ECB staff scenarios point to a GDP contraction between -5% and -12% in 2020, with the extent of the contraction/recovery depending on the duration of the containment measures, how far supply capacity and domestic demand are permanently affected and the success of policies in mitigating the adverse impact on incomes and employment. Lagarde mentioned a scenario analysis that the ECB will share tomorrow on its website.

The negative impact on the euro area inflation outlook has been more muted so far, due to a surge in food prices and an upward bias for core inflation, resulting from imputations of services prices. Although the medium-term implications of the coronavirus pandemic for inflation are uncertain due to opposing supply and demand shock effects, disinflationary forces are likely to accumulate as the crisis progresses. In this light, **we believe today's ECB measures to boost credit growth are an important step to support the economic 'restart' once lockdown measures are lifted**. We – and the ECB – still look for a rebound of the economy in H2 20 but we believe it will take some time before pre-crisis GDP levels are reached, especially in Italy, where GDP has fallen to the lowest since 2000 in level terms.

Sharpest economic slowdown ever recorded in the euro area



Source: Eurostat, Macrobond Financial, Danske Bank

FX – EURUSD

One may interpret the ECB's actions as to some extent providing a 'shadow cut', which in turn could weigh on spot EUR/USD. However, in our view, relative interest rates are a very marginal and often confounding factor as a driver of spot, so we see this as less important for FX. EUR/USD is currently supported mildly towards 1.09-1.11, say, by a combination of stabilising global sentiment, an uptick in the usual reflation trades and tapering of broad USD momentum. We do not expect this to be able to change materially the long-term trajectory of a weak EUR but it may nonetheless provide some support.

ECB has made attempts to remedy the market volatility of which European institutions have generally themselves proved a source but EUR is set to be haunted by this 'break up' risk for some time still. That said, EUR/USD is now trading on the low side of recent ranges and one may be cautiously hopeful that the negative institutional risk premium does not build further near term.

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Piet P. H. Christiansen, Chief Analyst, Aila Mihr, Senior Analyst, and Lars Sparresø Merklin, Senior Analyst.

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Ad hoc.

Date of first publication

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