ECB eases policy to support financial and credit market conditions

- **With the near-term growth outlook deteriorating sharply, the ECB stuck to its commitment of announcing another stimulus package in line with expectations**
- **The PEPP size was increased by EUR 500 bn and the duration of purchases was extended to March-2022 from June-2021. The ECB also committed to reinvesting maturing securities under PEPP up to December-2023 from a previous guidance of December-2022**
- **The focus remained on supporting credit markets as additional TLTROs and PELTROs were introduced while the conditions set under TLTROs were re-calibrated**
- **On the economic outlook, mild upward revision was made to the growth projection for 2020 reflecting a strong showing in Q32020 but concerns were expressed about the outlook in Q42020 and Q12021. The central bank assumes that herd immunity will only build-up by end-2021. Hence, the need to provide adequate support in the interim period**
- **The inflation trajectory is expected to remain flat over 2020-2023 warranting an accommodative framework for a sustained period of time**
- **However, we expect the ECB to be in 'auto-pilot' mode for most of H12021 with balance sheet expansion likely to continue in line with guidance provided. The outlook for H22021 will remain contingent on the manner in which the vaccine is rolled out and the pandemic pans out**
- **Market response was limited as the recent round of easing was priced in. We reiterate that in the near-term, the EUR/USD trajectory will be driven by the 'Brexit' outcome**
- **We see a flat trading trajectory in EUR sovereign yields in the near-term but an adverse 'Brexit' outcome could result in some near-term softness**

Reviewing the monetary stimulus package: Given the weakening trend seen in Euro-zone growth prospects in Q42020 and the guidance provided in the policy meeting in October, the European Central Bank (ECB) moved forward to deliver another stimulus package. Key announcements made were:

- **PEPP:** The size of the Pandemic Emergency Purchases Program (PEPP) was increased by EUR 500 bn from EUR 1350 bn to EUR 1850 bn. The duration of the program was extended from June-2021 to March-2022. The ECB also emphasized that the quantum used can be lower or can be increased depending on how economic conditions evolve. The ECB Governor also explained that the decision in terms of quantum and duration was taken to build-in the possibility of 'herd immunity' taking place by end-2021.

- **Credit easing measures:** On expected lines, the ECB re-calibrated the terms that it offers on TLTROs. Three additional TLTROs were announced over the June-December-2021 period. The amount that counterparties are allowed to borrow was raised from 50% of their eligible stock to 55% of the eligible stock that was extended up to June-2022. In addition to the TLTRO announcement, the ECB also announced four additional pandemic emergency longer-term refinancing operations (PELTROs) that will be conducted in 2021.

- **Asset purchases:** The traditional open-ended asset purchases (QE) program was kept unchanged at EUR 20 bn per month while the additional envelope of EUR 120 bn introduced earlier in 2020 was maintained.

- **Forward guidance:** Policy rates were kept unchanged along with the guidance that it will remain at current or lower levels until the inflation objective has been reached. The guidance on the open ended asset purchases program was also kept unchanged.

- **Reinvestments:** The ECB has extended the duration to which it plans to reinvest maturing securities under the PEPP program from end-2022 to end-2023. It will also continue to reinvest maturing securities under its asset purchases program for an indefinite period of time till the inflation objectives have been reached.

On balance, the main rationale provided for the easing package was to ensure that financial conditions and credit market conditions remain favourable that will continue to support the recovery. In the press conference, the ECB President was quick to emphasize that the program has been undertaken to support both the private sector and the public sector respectively. We estimate that the ECB will infuse around EUR 30 bn to EUR 40 bn per month up to at least H12021 taking in to account both the PEPP and the traditional asset purchases program that are at work. The infusion via the PEPP program could start to moderate going in to H22021 if the recovery shows broad-based signs of taking hold.

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Economic conditions: risks cannot be ignored: In the policy, the central bank continued to emphasize that the manner in which the economy evolves will remain contingent on the pandemic.

- **On growth:** For one, the ECB acknowledged that the rebound has been much sharper in Q32020 than was previously assumed. However, concerns continued to be expressed on the growth outlook for Q42020 with a possible sequential contraction expected as well as on the outlook for Q12021. A recovery was expected to kick-in once the vaccine is distributed but the process of mass vaccination might take a fair bit of time as the logistics of mass distribution and the willingness of people to take the vaccine needs to be examined carefully. The ECB also emphasized the divergence in performance between the manufacturing sector that is benefiting from a global re-stocking cycle and service sector that has taken a hit from social distancing norms that are being employed. **While risks to near-term growth was acknowledged, the ECB did make a mild upward revision to the balance of risks to growth outlook from 'clearly tilted to the downside' in the October policy meeting to 'tilted to the downside' in the December policy meeting reflecting progress on the vaccines.**

  In terms of the growth profile provided, upward revision was made to the 2020 projections taking in to account a strong showing in Q32020. The growth rebound in 2021 was lowered by a degree to take in to account the time it might take for herd immunity to build-up. A continuation of the momentum was projected going in to 2022-2023. We expect a much sharper pace of growth going in to 2021 that could start to kick-in from Q22021 onwards as gradual distribution of the vaccine helps in increasing mobility and driving service sector activity higher in the process.

Chart 1: Review of ECB's projections

ECB EZ GDP Projections (% YoY)				
	2020	2021	2022	2023
Mar-20	0.8	1.3	1.4	NA
Jun-20	-8.7	5.2	3.3	NA
Sep-20	-8.0	5.0	3.2	NA
Dec-20	-7.3	3.9	4.2	2.1
ECB EZ Inflation Projections (% YoY)				
	2020	2021	2022	2023
Mar-20	1.1	1.4	1.6	NA
Jun-20	0.3	0.8	1.3	NA
Sep-20	0.3	1.0	1.3	NA
Dec-20	0.2	1.0	1.1	1.4

Source: ECB & ICICI Bank Research

- **On inflation:** The ECB expects a fairly flat CPI inflation profile over the forecast horizon with a terminal forecast of 1.4% by 2023. We suspect that the trajectory has been premised on the Euro-zone exhibiting negative output gaps up to at least 2023-2024 given the structural damage that COVID-19 is expected to have on the economy. With the inflation profile remaining flat, ECB will maintain an accommodative framework for a considerable period of time.

- **On the exchange rate:** The ECB maintained its line that it is continuing 'to monitor developments in the exchange rate with regard to the possible implications to the medium-term inflation outlook'. However, this was an unchanged assessment form the previous policy meeting. The language does not suggest that the central bank is worried about the level or will want to take any action to reverse the trend. One reason for this is that the upward move in the EUR/USD pair is part of an overall anti-USD sentiment in the global market subsequently not warranting sharp corrective action from the central bank.

- **On fiscal policy:** Given that progress has been made with regards to passing the EU recovery fund, the ECB expects fiscal policy to work as an important medium-term support.

Outlook: All done for now: As the ECB has launched another stimulus package in response to COVID-19, we think that it has provided a more than adequate policy response for the time being. We expect ECB policy to be in 'auto-pilot' mode over H12021 with balance sheet expansion expected to continue. The manner in which the pandemic evolves and the speed at which the vaccines help in creating 'herd immunity' will work to influence the incremental direction of European monetary policy in H22021. We see a recovery taking hold in 2021 driven by policy stimulus and a pick-up in pent-up demand. Hence, the prospect of further monetary accommodation by the ECB remains fairly low.

Market impact: The impact on the market was fairly limited as investors had priced in the monetary stimulus package that was delivered. We maintain that the next main trigger for the EUR and GBP is likely to be the outcome of 'Brexit'. Talks are scheduled to conclude by 13-December-2020. If a deal is agreed upon between EU and UK policymakers, we see a further acceleration in the EUR/USD pair to the 1.22 level and the GBP/USD pair moving to the 1.35-1.40 range in the near-term. On the other hand, a 'No-deal' outcome could see the GBP/USD pair crashing to the 1.25-1.30 range while the EUR/USD pair might move to the 1.17-1.20 range in the near-term. Markets are positioned for the UK-EU to reach a deal.

With ECB committing to maintaining the size of stimulus, we see a fairly flat trajectory in EUR sovereign yields with a possible softening bias in the near-term in case of an adverse 'Brexit' outcome.

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