# ECB sets the stage for more accommodation in 2020

- **The ECB maintained status quo on its accommodative framework on expected lines. The guidance provided was 'dovish'**
- **The central bank made a strong emphasis on the downside risks to growth given the recent partial lockdowns that have been imposed across the region. A disinflationary environment is expected to remain in place until early 2021**
- **We have also lowered our 2020 GDP expectations reflecting the recent imposition of the lockdowns. However, the magnitude of contraction in Q42020 is unlikely to be as severe as that witnessed in Q22020 as industrial growth is likely to continue. Service sector activity is where the majority of the disruption will likely take place**
- **The ECB indicated that it is 'recalibrating its policy options to support the recovery' suggesting that it could resort to using several instruments to support the economy**
- **Hence, we maintain our call of a further increase in the size of the Pandemic Emergency Purchases Program (PEPP) from EUR 1350 bn to EUR 1850 bn - EUR 1900 bn in the December policy meeting**
- **Some possible revisions in TLTROs (III) is also possible but we rule out the possibility of further policy rate cuts**
- **Concerns about European growth along with more accommodation could mean that the EUR/USD pair and sovereign bond yields trade with a downside bias in the near-term**

**A review:** The ECB maintained status quo on its accommodative framework—policy rates, respective asset purchases program and forward guidance-- that was on expected lines. However, the messaging provided was fairly dovish with the central bank using this policy meeting to set the stage for an increase in the quantum of stimulus in the very near future. Of course, the assessment provided has a lot to do with the recent surge in COVID-19 cases which has subsequently resulted in several major European nations resorting to lockdowns.

**Downside risks to growth were identified:** The post policy statement and the press conference of the Governor was fairly dovish on several fronts:

- Near-term risks to growth outlook were identified from the pick-up in virus and lockdowns that have been imposed for November. References were made to the weakening trend visible in several high frequency indicators.
- There was an acknowledgement that the pace of rebound was fairly spectacular with half of the output lost in Q2 recovered in Q3 but there could be further downside risks to GDP projections in Q4.
- An uneven pace of recovery was identified with manufacturing sector production holding up but service sector activity falling considerably and these trends are likely to get even more exaggerated in Q42020.
- CPI was expected to remain in negative territory up to the Q12021 reflecting several factors including tax cuts, exchange rate appreciation, fall in commodity prices and weak demand but recover in the medium-term to longer-term towards the 2% mark.

**More easing options are being considered:** The guidance provided was that the ECB will 'recalibrate its instruments, as appropriate to respond to the unfolding situation and to ensure that financial conditions remain favourable to support the economic recovery'. **In short, the central bank is preparing for more accommodation and is carefully examining all of its options that are on the table.** Given the reference provided to 'instruments', it would suggest that the ECB could consider introducing a range of measures in response to the recent softening in growth momentum that is to be expected in Q42020.

**We maintain our expectations:**

- **We have lowered our GDP expectations for Q42020, although the magnitude of contraction could be lower than that witnessed during the lockdown episodes that were seen during Q2.** A key reason for this is that industrial production and essential services are likely to continue in Q4 that was not the case in Q2. On the other hand, the downward revisions reflect the fact that service sector activity will slow quite dramatically that is a trend that is fairly visible in the high frequency indicators that were released over September-October. We see a contraction of -8.4% YoY in 2020 as against previous expectations of -7.1% YoY contraction reflecting the new round of partial lockdowns that will be implemented in November.

Shivom Chakravarti
shivom.chakravart@icicibank.com
Phone number: 022-4008-6273

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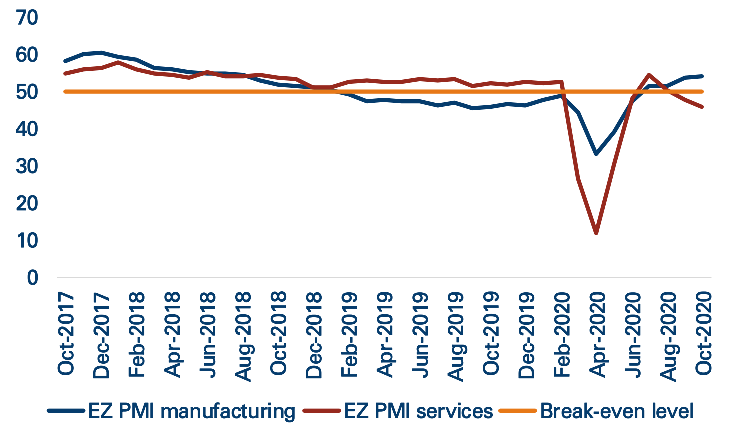
- We maintain that the ECB will increase the size of its Pandemic Emergency Purchases Program from the current size of EUR 1350 bn to EUR 1850bn-EUR 1900 bn in the December policy meeting. We also expect that the purchases under this scheme to be extended in to at least December-2021 from the June-2021 that is currently been indicated. The increase in purchases is likely to be justified by making downward revisions to its growth and inflation projections in the December policy meeting.
- There could also be additional support provided via improving the terms under the TLTRO (III) given concerns were expressed about the tightening in credit conditions in the policy statement. The current interest rate offering of TLTROs is a spread of 50 bps below the deposit rate that could be reduced further.
- We do not anticipate further rate cuts given that taking the policy rate in to further negative territory is unlikely to stimulate the economy but could instead work as an additional headwind for the banking sector.

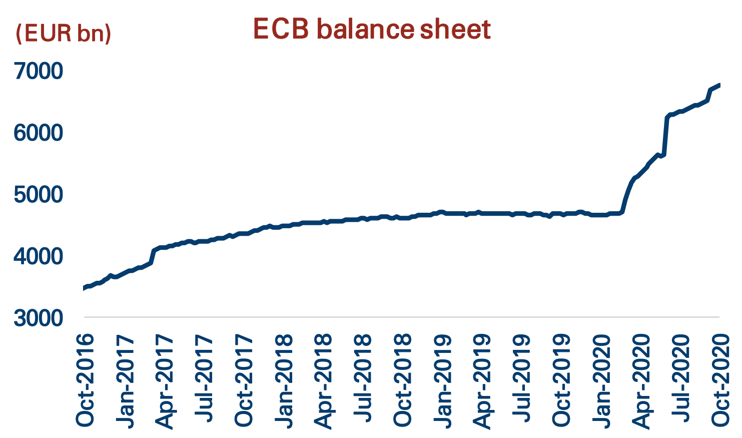
**European assets: More underperformance in store:** We maintain our range of 1.15-1.18 for the EUR/USD pair with more downside likely in the near-term reflecting ongoing concerns about the state of the economy. We have lowered our Q42020 GDP projections. Some response to the outcome of the US elections is also on the cards. We think that EUR bond yields will trade lower and continue to decouple from US yields that get even more exaggerated in case of a 'Democratic Sweep' scenario.

**Chart 1: Divergence in performance between manufacturing and services in intensifying**




Source: Bloomberg & ICICI Bank Research

**Chart 2: ECB balance sheet is expected to expand further**




Source: Bloomberg & ICICI Bank Research

**Appendix: Review of ECB accommodative framework:**

- Policy rates have not been changed in 2020. The marginal refinancing operations rate remains at 0%, interest rates on marginal lending facility remains at 0.25% and the interest rate on the deposit facility remains at -0.50%. These rates will remain in place until inflation converges sufficiently to close to but below 2%.
- The Pandemic Emergency Purchases Program (PEPP) has a total envelope of EUR 1350 bn was introduced in 2020. They are conducted in a flexible manner across asset classes and jurisdictions. They will remain in place at least until June-2021 and maturing proceeds under this scheme will be reinvested at least until end of 2022.
- The open-ended asset purchases program was introduced in 2019 and remain in place. Monthly purchases are to the tune of EUR 20. An additional temporary envelope of EUR 120 bn was created in 2020 in response to the pandemic. These purchases will remain in place for as long as necessary to reinforce the accommodative impact of policy rates and will end just before interest rate increases are considered. Reinvestment of maturing proceeds will continue for an extended period of time for as long as necessary.
- The TLTRO (III) program as well as the non-targeted pandemic emergency longer-term refinancing operations (PELTROs) that was introduced in May-2020 remain in operation.

ICICI Bank Global Markets

ICICI Bank: ICICI Bank Towers, Bandra Kurla Complex, Mumbai- 400 051. Phone: (+91-22) 2653-1414

| Economics Research Group | | | |
|---|---|---|---|
| **Economics Research** | | | |
| Shivom Chakravarti | Senior Economist—Global markets | (+91-22) 4008-1414 (ext 6273) | shivom.chakravarti@icicibank.com |
| Anushri Bansal | Senior Economist—Domestic markets | (+91-22) 4008-1414 (ext 6220) | anushri.bansal@icicibank.com |
| Sumedha Dasgupta | Economist | (+91-22) 2653-1414 (ext. 7243) | sumedha.dasgupta@icicibank.com |
| Aniket Gaikwad | Research Analyst | (+91-22) 2653-1414 (ext. 8161) | aniket.gaikwad@icicibank.com |
| Kaushal Aryan | Research Analyst | (+91-22) 2653-1414 (ext. 7249) | kaushalkumar.aryan@icicibank.com |
| Asha Sasikumar | Research Analyst | (+91-22) 2653-1414 (ext. 7249) | asha.sasikumar@icicibank.com |
| Jyoti Sharma | Research Analyst | (+91-22) 2653-1414 (ext. 7249) | sharma.jyoti@icicibank.com |
| Tanisha Ladha | Research Analyst | (+91-22) 2653-1414 (ext. 7309) | tanisha.ladha@icicibank.com |
| Nihal Kumar | Research Analyst | (+91-22) 2653-1414 (ext. 7309) | nihal.kumar@icicibank.com |

| **Treasury Desks** | | | |
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