ECB Watch

AIB Treasury Economic Research Unit

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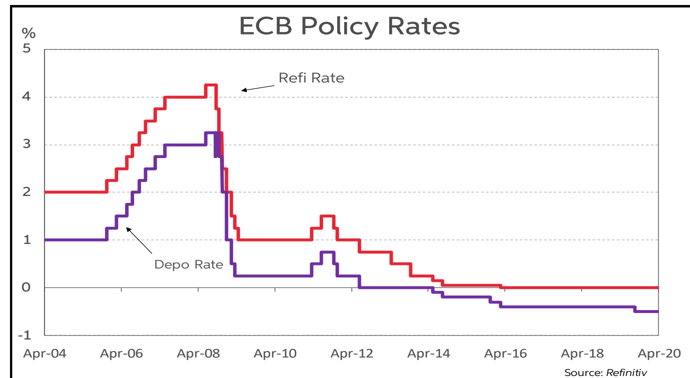
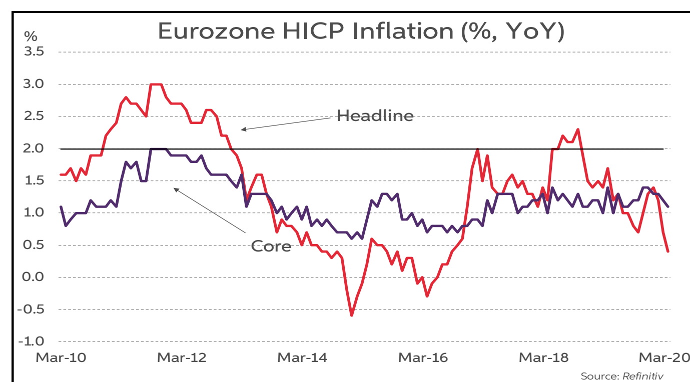
ECB announces further liquidity supports for the economy

The ECB today refrained from making any changes to its key benchmark interest rates or to its bond purchase programmes. The depo rate was left unchanged at -0.5% and the refi at 0%. However, the Governing Council did announce some additional liquidity measures to aid the flow of credit to the private sector amid the on-going shock to the Eurozone economy arising from the Covid-19 pandemic.



The measures announced included a further easing of the ECB's targeted long term lending operation, known as TLTRO III. The main aspect of this was a 25bps reduction in the interest rate applied on these operations from June 2020 to June 2021 to 50bps below the average interest rate on the main refinancing operations.

The ECB also announced a new series of non-targeted pandemic longer term refinancing operations—PELTROs. The aim of these operations is to support liquidity and funding conditions in the Eurozone and in turn help to preserve the "smooth provision" of credit to the real economy.



In terms of its quantitative easing package, it made no changes to its standard Asset Purchase Programme (APP) monthly pace of €20bn or the additional €120bn temporary envelope. Likewise, it did not alter its Pandemic Emergency Purchase Programme (PEPP), which currently has a €750bn envelope. **President Lagarde emphasised though that the ECB was prepared to adjust the size and the composition of the PEPP by as much as necessary and for as long as needed.**

In its assessment of the economic outlook, the very first line of the meeting statement referenced that the Eurozone was facing into an economic contraction of a magnitude and speed that are unprecedented in peacetime. President Lagarde elaborated further by outlining that growth scenarios prepared by the ECB suggest GDP could fall by between 5% and 12% this year. In line with expectations elsewhere, it anticipates the negative impact will be most severe in the second quarter of the year.

The key determinant of the magnitude of this decline would be the "duration" of the containment measures and the success of economic policies to mitigate the economic fallout from the Covid-19 pandemic. The central bank expects to see a recovery in economic activity as these containment measures are gradually lifted. Although, it noted that the speed and scale of this improvement was still "highly uncertain".

Overall, the ECB retains an easing bias as the Eurozone economy faces into a very difficult and uncertain outlook. It continued to emphasise today that it stands ready to adjust all of its instruments, as appropriate, to ensure it achieves its price stability objective. The market expects that the ECB will increase the size of its PEPP at some stage this year. It also anticipates that official Eurozone rates will remain low for an extended period of time and could be cut by a further 10bps by end 2020. A 10bps rise in the ECB deposit rate from its current level of –0.5% is not priced in until 2024.

Market reaction to today's ECB meeting was mainly confined to Italian bonds. Italian spreads widened slightly following the meeting suggesting some disappointment on bond markets that the central bank did not announce any expansion to its QE package. Meanwhile, there was no impact on the euro from the meeting outcome.

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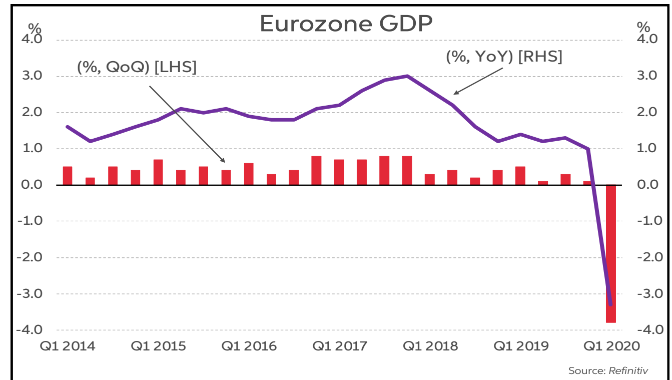
Coronavirus pushes Eurozone into recession

Eurozone GDP contracted by 3.8% in the opening quarter of 2020, leaving the year-on-year growth rate at –3.3%. This represents the region's worst quarterly performance on record and reflects the sudden halt to activity due to the imposition of lockdowns to halt the spread of Covid-19 from March. Notably, France, Italy and Spain, who have been badly impacted by the virus, saw GDP declines of 5.8%, 4.7% and 5.2%, respectively.



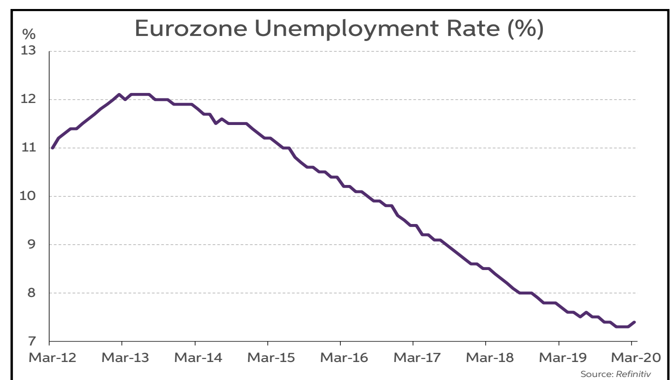
The available data for Q1 that predate the virus outbreak suggest the economy was performing solidly. In January/February, retail sales and industrial production were by 0.9% and 0.8% on Q4 levels, respectively.

Survey data, however, deteriorated from March. The composite PMI plummeted to a record low of 29.7 from 51.6 as economies locked down. Services have borne the brunt of the impact, as evidenced by the plunge in the sector's index to 26.4 in March, from 52. At the same time, the output subcomponent of the manufacturing PMI fell to 38.5 from 48.7. The German Ifo, French INSEE and Italian ISTAT measures of business confidence also dropped sharply. On the demand side, consumer confidence collapsed in March.

With regard to the labour market, the unemployment rate only edged up from 7.3% to 7.4% in March, reflecting the impact of furloughing schemes introduced by governments across the region. However, the jobless rate will spike higher when these schemes are unwound - it is anticipated that the Covid-19 recession will result in a sharp fall in employment.

The negative demand shock from Covid-19 will likely weigh heavily on inflation this year too. The collapse in oil prices has been reflected in Eurozone headline HICP decelerating to just 0.4% in April, from an already muted 0.7% in March. The core rate (ex-food & energy) has also begun to ease, edging down to 1.1% in April from 1.2%. This is well below the ECB's target of close to, but just below, 2%.

Turning to Q2, the limited amount of data available have been consistent with a severe economic downturn. Ongoing lockdowns have seen the composite PMI drop further to an unprecedented 13.5 in April from 29.7, while the headline EC economic sentiment index has also declined to an over 10-year low. Both of the surveys suggest that industrial activity, while very weak, is holding up somewhat better than in the services sector, which has collapsed on the back of the Covid-19 lockdowns.



The near-term outlook for the Eurozone is extremely downbeat. Covid-19 represents both a demand and a supply shock. Efforts to contain its spread will continue to weigh heavily on consumption. Consumer spending will also be hit by the decline in household income linked to rising unemployment. Threatened supply chains and reduced demand for goods and services pose significant threats to firms and provide a challenging backdrop for investment. The outbreak will also delay indefinitely the expected recovery in global trade, another headwind for the export orientated economy. Positively, sizeable government spending plans to counteract the outbreak have been announced across the bloc and ECB action has prevented peripheral bond yields from soaring. However political tensions have re-emerged as the old debate over the creation of a common Eurozone debt instrument has returned. This in turn has seen financial conditions tighten somewhat.

The latest IMF forecasts, which assume a 12-week lockdown and a gradual easing of restrictions thereafter, are for a contraction of Eurozone GDP of 7.5% in 2020. A number of countries have now begun to exit from lockdowns, or have outlined their plans to do so in the coming weeks. However, restrictions will be removed only very gradually and could be re-introduced if cases begin to rise again. More generally, there is a real risk of a second, smaller outbreak at some stage. The IMF see growth rebounding by 4.7% in 2021 assuming the virus has abated next year.

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