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ECB meeting: now, fiscal policy has to play its part

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- ***ECB action:*** *At its meeting on 12 March, the ECB disappointed market expectations by not cutting rates in the wake of the coronavirus spread. The bank delivered additional unconventional monetary easing thorough a* ***temporary boost to its QE programme****, which will see a set of additional net asset purchases worth EUR 120Bn this year. Such purchases will be mainly skewed towards the private sector. In addition, the ECB will temporarily be conducting additional LTROs to provide immediate support to the Eurozone financial system while the ECB's banking supervision will provide temporary capital and operational relief in reaction to the coronavirus outbreak. Finally, the ECB supports the EBA decision to postpone the 2020 stress test so that banks can focus on business. Importantly,* ***Ms Lagarde made a strongly worded request for "ambitious and coordinated fiscal policy", as the response to the coronavirus-induced crisis should be fiscal first and foremost. Indeed, European countries are announcing significant stimulus plans that should buy time while the epidemic is being contained.*** *Once the epidemic has been contained, measures to stimulate aggregate demand would be needed to ensure a significant growth rebound.*
- ***Investment implications****: Central banks' recent actions have failed to support the markets, which have recorded heavily losses. Also, the Fed decision to pump additional liquidity into the system failed to drive a rebound. While it is too early to call the bottom, a trigger is needed which we think would need to be a massive and coordinated fiscal reaction, along with drastic virus containment measures. Until something concrete materialises, market volatility will continue to be very high. However, at least, CB action should avoid a credit crunch, but pressure on spread products is likely to remain. We expect an* ***increasing divergence between the valuation of issuers with solid balance sheets and other, weaker issuers****. The enhanced QE programme is supportive of euro IG credit in the overall credit space. However, it is still too early for an aggressive move into risky assets.*
- ***Beyond the short term****: The initial supply shock related to the epidemic is giving rise to a demand shock of increasing magnitude and the global economy could plunge into a recession as severe as that experienced in 2008-09. However, macroeconomic stabilisation measures are reasonable simple to design and are not the sole responsibility of monetary policy. Governments have become aware of the seriousness of the situation and, in exceptional circumstances, the Stability and Growth Pact provides for a temporary relaxation of budgetary rules. However,* ***for fiscal policy to be truly effective, it has to be accompanied by persistently accommodative monetary policy****. Ultimately, the countries in crisis will emerge with higher stocks of public debt and the ECB balance sheet should grow significantly. For countries to remain solvent, interest rates will have to remain low.*

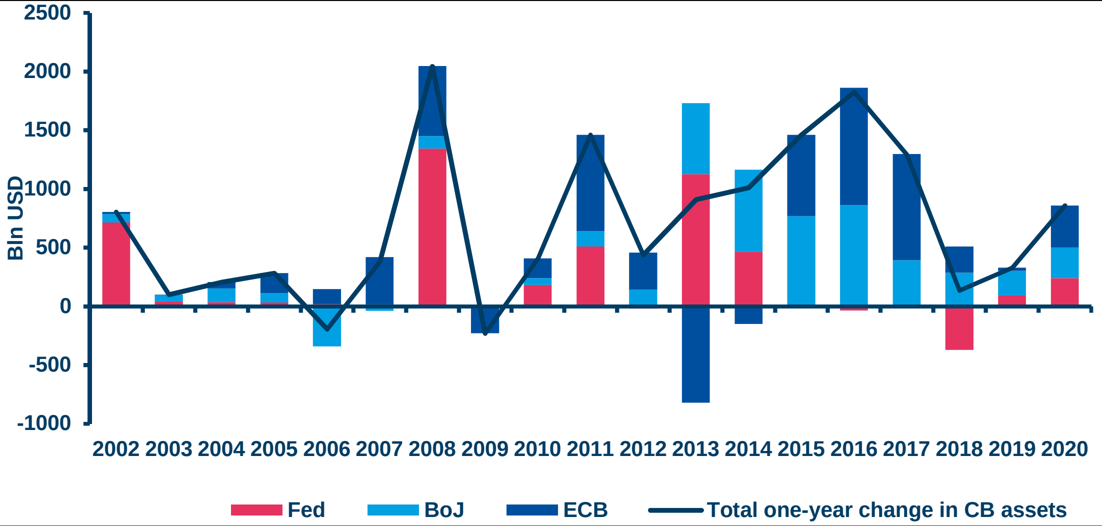
"New measures announced by the ECB are mainly focused on liquidity-enhancing facilities and do not include a rate cut".

Please recap the new measures announced by the ECB on 12 March. Do you believe they will be sufficient to support the Eurozone economy this year?

At its meeting the ECB, unveiled a series of new accommodative measures to help the Eurozone economy weather the economic fallout of the coronavirus spread. **The measures mainly focus on liquidity-enhancing facilities and do not include a rate cut.** The decision was unanimous. Forward guidance reiterates that rates "*will remain at their present or lower levels until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within our projection horizon".* The ability of the ECB to cut rates further is limited (and potentially useless, given already negative yields), with over 50% of the euro fixed income debt already trading at negative yields.

In order to support liquidity in the system, the ECB decided to **boost its QE programme** via a temporary set of additional net asset purchases worth EUR 120Bn. Such purchases will be added until year-end on top of those already scheduled (EUR 20Bn per month) and will be mainly skewed towards the private sector. The programme will take full advantage of the flexibility allowed within the current framework – ie, there is no monthly pre-determined amount set.

One-year change in central bank assets, USD Bn (Amundi forecasts for 2020)



Source: Amundi Research, Datastream. Data as of 12 March 2020.

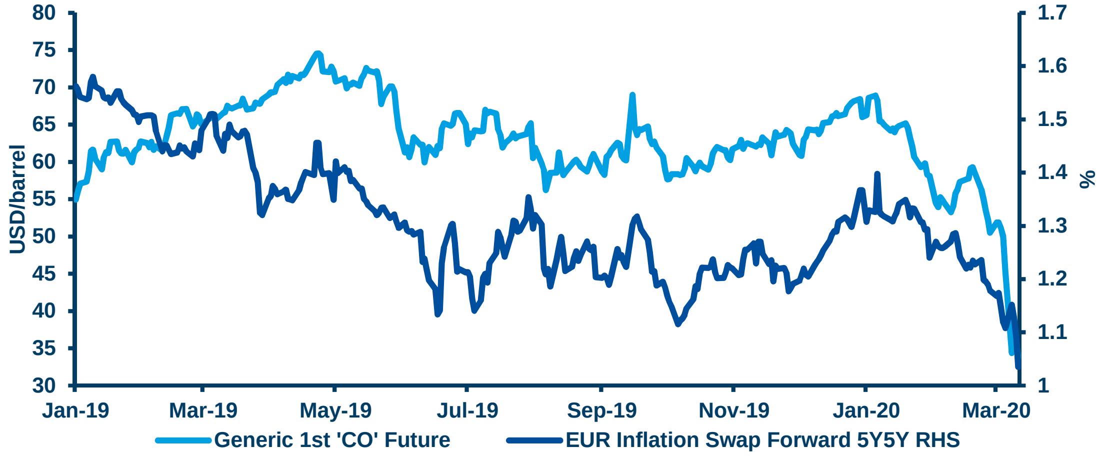
Moreover, the ECB announced new **liquidity tools and long-term loans,** at full allotment and preferential rates to support refinancing for small and medium-sized enterprises (SMEs). In detail:

- the ECB will be temporarily conducting additional longer-term refinancing operations (LTROs) to provide immediate liquidity support to the Eurozone financial system;
- the ECB's banking supervision will provide temporary capital and operational relief in reaction to the coronavirus outbreak; and
- the ECB is supporting the decision by the European Banking Authority (EBA) to postpone the 2020 stress test so that banks can focus on business.

"Ms Lagarde stated that "ambitious and coordinated fiscal policy" is required, as the response to such crisis should be fiscal first and foremost".

Importantly, ECB President Christine Lagarde stated that "**ambitious and coordinated fiscal policy"** is required, as the response to such a crisis should be **fiscal first and foremost**.
On the economic outlook, the **coronavirus strongly impairs the Eurozone growth outlook, with risks clearly pointing to the downside.** The virus spread is a major shock at a time when the economy was already going through a bout of weakness. Easy financial conditions, fiscal stimulus, and containment and recovery from the pandemic should help the economy regain traction. Inflation trends remain a concern, especially in light of the huge oil price drop, as the five-year forward euro inflation swap has dropped below 1%. The ECB believes it is very likely that inflation will be lower than its most updated forecasts.

Oil and inflation expectations



Source: Amundi, Bloomberg. Data as of 12 March 2020.

What can national governments and the European Commission do on the fiscal side to help the Eurozone economy rebound once the epidemic has receded? Have you seen any evidence yet of some fiscal loosening?

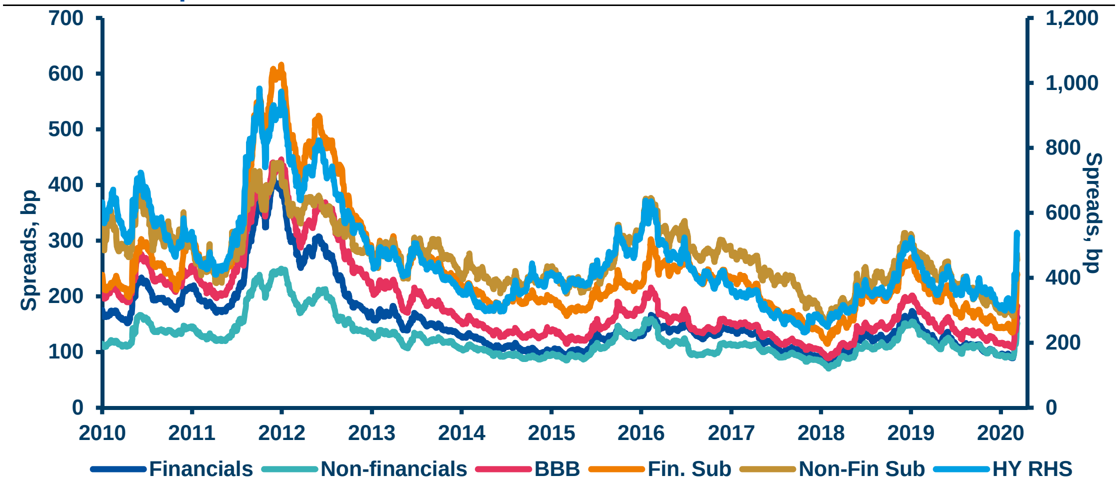
"Fiscal action is a prerequisite for an economic rebound to materialise once the epidemic has receded".

Fiscal action is a prerequisite for an economic rebound to materialise once the epidemic has receded. The good news is that European countries are announcing – one after the other – significant stabilisation plans. The United Kingdom and Italy were the first to communicate. France is also committed to doing whatever is necessary without worrying about the budgetary costs involved, even without specifying the amounts. All eyes are now on Germany and what it chooses to do. **Fiscal and budgetary policies will buy time.** Once the epidemic has been contained, a few measures to stimulate aggregate demand are likely to be needed to ensure a significant growth rebound. **Tightening too early could prevent a rebound**.

Investment implications

Risk assets, which were already very weak before the ECB meeting, reacted in a strongly negative manner, with large peripheral and credit spreads widening, and the euro returning to new session lows against the dollar and the Swiss franc, as the ECB has disappointed expectations with no change to the issue/issuer limit, to the capital key rule, and with additional QE below expectations.

Euro credit spreads



Source: Amundi, Bloomberg. Data as of 12 March 2020.

There has clearly been an ample degree of monetary accommodation, but the ECB appears to be sitting on the side lines, awaiting a coordinated fiscal effort.

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Ms Lagarde is now putting pressure on governments to act and has said she is open to taking further action soon after the new fiscal measures have been implemented. In such a context, central banks will do whatever they can to avoid a liquidity crunch. But, the ability of CBs to boost growth is limited, due to the specific context (this is both a demand and supply shock) and to the already accommodative monetary policy stances. The ECB can provide cheap credit to banks, but **the challenge will be to avoid a tightening in financing conditions in an environment of rising risks. Cheap credit to banks and lower capital constraints are not enough.** In an environment in which global growth is at risk and CBs are injecting liquidity, **we expect an increasing divergence between the valuation of issuers with solid balance sheets and other, weaker issuers**. This programme remains favourable to euro IG credit in the overall credit space. However, it is still too early for an aggressive move into risky assets, as a catalyst is needed to reduce volatility.

Monetary and fiscal policy beyond the short term

Do you expect CBs to move even further on the unconventional front?

Not necessarily, as the role and impact of fiscal policy should not be underestimated. The epidemic crisis has gone from being localised and temporary to being global and to lasting for a much longer period than initially expected. The initial supply shock gave rise to a demand shock whose magnitude is increasing on a daily basis, with historic prevention measures put in place. **There is now a risk that the global economy could plunge into a recession as severe as that seen in 2008-09**. However, **the roots of the current crisis are very different from the 2008-09 Great Financial Crisis or the Eurozone sovereign debt crisis of 2011-12: it is a real economy crisis first and foremost and does not originate from the financial sector.** Admittedly, the fall in economic activity may temporarily be even more pronounced. However, macroeconomic stabilisation measures are straightforward to design and are not the sole responsibility of monetary policy. Governments have become aware of the seriousness of the situation following the coronavirus spread, as evidenced by the conclusions of the special European Council held on 10 March, with the Heads of State firmly committing to taking the necessary measures to ensure that the short-term economic shock – which is inevitable and could be severe – does not undermine the medium-term growth potential of economies. To do so, they need to free up fiscal resources in order to guarantee access to health care, help companies in difficulty to avoid a cascade of bankruptcies, and compensate employees who will be forced into temporary unemployment. In exceptional circumstances, the Stability and Growth Pact (SGP) provides for a temporary relaxation of the budgetary rules **and there is in practice no limit to what governments can do in the short term, at least if the shock is temporary**. The statements made by French President Emmanuel Macron on 11 March are clear in this regard (e.g., temporary easing in corporate taxation, compensation for temporary unemployment, and an increase to healthcare spending). **However, this does not mean that the ECB has no role to play. For fiscal policy to be truly effective, it has to be accompanied by persistently accommodative monetary policy,** which so far has been the case. Since the sovereign debt crisis, the ECB has equipped itself with many unconventional tools. **Provided that governments announce substantial and credible plans, Ms Lagarde made it clear that the ECB could do more.** The ECB will have to do everything it can to prevent the current crisis from leading to a solvency crisis. The expansion of the ECB balance sheet has no limits when it comes to maintaining financial stability. If governments act in line with their commitments, the ECB will guarantee lower-cost financing, which would ultimately allow economies to weather the storm by limiting losses. **The budgetary bill will be high** – probably around EUR 200Bn at the EU level, which is the same amount as the stimulation plan proposed in November 2008 by the European Commission. Decisions will be taken at the country level. In the event of an uncontrolled rise in Eurozone interest rates (e.g., if QE is not sufficient), a weakened state may resort to a financial assistance programme via the ESM or activate the ECB's Outright Monetary Transactions programme. The tools are sufficient in the context of a temporary shock, lasting a few months. It is only in the case of a very long-lasting shock that other monetary policy options should be considered (e.g., equity purchases, ‘currency helicopter’).

“For fiscal policy to be truly effective, it needs to be accompanied by persistently accommodative monetary policy”.

What could be the long-term consequences of these moves?

Ultimately, the countries in crisis will emerge with significantly higher stocks of public debt and the ECB's balance sheet will grow significantly. For countries to remain solvent, interest rates will have to remain low – that is, below nominal GDP growth. Sooner or later the problem of debt sustainability will return to the forefront in countries where potential growth is low. On the other hand, the size of a CB's balance sheet is not in itself a problem. The ECB has fallen into a 'QE trap' from which it will be even more difficult to emerge without threatening the solvency of some states. This could pose a problem in the medium to long term, especially if inflation resurfaces. **In the longer term, this crisis should lead governments to rethink Europe's budgetary and fiscal architecture**. It is typically while dealing with situations of this magnitude that the EU would need to equip itself with a significant stabilisation budget. The need to create a European financing instrument could also come back on the table.

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Definitions

- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Breakeven Inflation:** Breakeven inflation is the difference between the nominal yield on a fixed-rate investment and the real yield on an inflation-linked investment of similar maturity and credit quality.
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **LTRO:** The long-term refinancing operations (LTROs) are Eurosystem operations that provide financing to credit institutions for a predefined period. They offer long-term funding at attractive conditions to banks to further ease private sector credit conditions and stimulate bank lending to the real economy.
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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