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ECB preview: Ready to do more

Following 'normal' crisis patterns, the actions of the last few weeks should call for a 'taking stock' ECB meeting this week. But the current crisis is far from normal

Source: Shutterstock

Who needs a regularly scheduled European Central Bank meeting, when the action these days seems to take place during spontaneous video or telephone conference calls. After the last regular meeting, which already offered ample liquidity and an increase in quantitative easing, the ECB decided on its €750 billion Pandemic Emergency Purchase Programme (PEPP) and several significant tweaks to its collateral framework. Heading into this week's meeting, ECB members will try to take stock of all these measures but also get a better grip of the severity of the economic situation. According to media reports, ECB President Christine Lagarde last week warned EU leaders that the eurozone economy could shrink by 15% this year. Whether this is the ECB's base case or the outcome of a risk scenario is unclear to us.

The ECB's current main worries

Currently, it looks as if the ECB is following three main goals: i) avoid a vicious circle of downgrades of sovereigns and companies and consequently problems in the banking sector; ii) prevent sovereign spreads from widening further; and iii) support the economy. The avoidance of a vicious circle, in particular, seems to have the ECB's main attention, with last week's decision to include junk bonds as collateral. Despite some market disappointment about last week's EU leaders' call, the PEPP and the waiver to the issuer limit are currently still sufficient to tackle unwarranted increases in government bond yields, if supported by strong communication, but more to this later. As regards the ECB's efforts to support the eurozone economy, the latest readings of confidence indicators were dreadful and gave a first impression of how severe the contraction could be. Also, the drop in oil prices will significantly lower the ECB's inflation projections. However, as this is anything but a 'normal' crisis, additional monetary stimulus at the current juncture could be the allegorical attempt to catch a falling knife.

What the ECB could still do

While we cannot fully rule it out, we don't expect the ECB to decide on additional measures this week. This does not mean that the ECB is done. In fact, given the depth of the contraction, low inflation and falling inflation expectations and the risk of a further widening of government yield spreads, we would expect the ECB to step up its PEPP. If old patterns hold, the June meeting with a fresh round of economic projections, would be the right moment to announce such an increase. The increase of PEPP could follow the principles of the latest collateral easing, including purchases of fallen angels. It also would seem logical that the ECB adds bonds of these 'fallen angels' to its purchase programme. The ECB could even go beyond this and consider buying bonds of banks.

Strong communication this week - priceless

For this week's meeting, strong communication to do 'whatever it takes' by reiterating that the ECB stands ready to increase and extend the PEPP at any time could be sufficient to bridge the gap until the June meeting. However, remember that particularly regarding communication, the March meeting did not really stand out. Christine Lagarde's faux pas on yield spreads and the (no personal) need for 'whatever it takes' added some bruises to the ECB's reputation as almighty crisis manager. The measures taken since the March meeting have restored this reputation. A strong and convincing message from Lagarde on Thursday could therefore save the ECB from taking even bolder steps, at least for now.

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