‘Hand me the mop’, the ECB tackles the supply tsunami

The ECB underscored its willingness to be the Eurozone’s lender of last resort last week - as the €1.35tn PEPP envelope removed all lingering doubts. We think, the ECB will be successful in reducing financial fragmentation, but not in preventing a gentle rise in interest rates

(L-R) German Minister of Finance Olaf Scholz, President of European Central Bank Christine Lagarde, European Commissioner in charge of Economy Paolo Gentiloni and French Economy Minister Bruno Le Maire

Source: Shutterstock

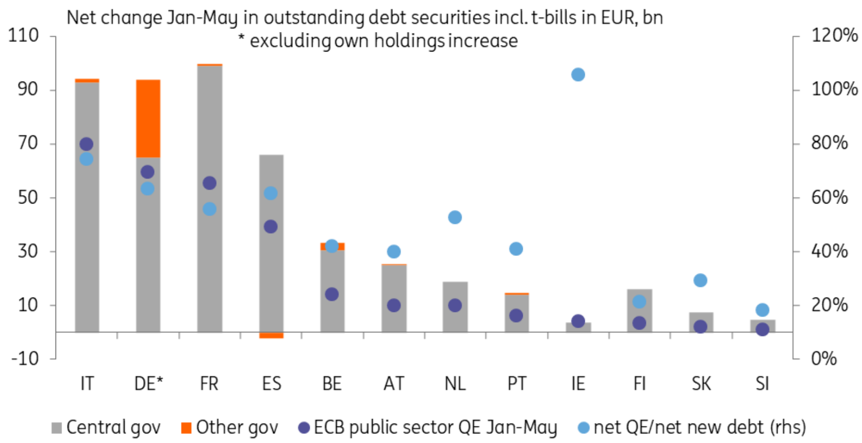
The ECB to buy more than €1.8tn until mid-2021

The European central bank's recent announcements mean that the central bank's net asset purchases until mid-2021 will amount to over €1.8tn, assuming a constant €20bn/m asset purchase programme. A good part thereof will be conducted in public sector debt markets. If we assume a share of 80% as has been the case in recent months, that will add up to more than €1.4tn.

The latest pandemic emergency purchase programme (PEPP) and asset purchase programme details underscore the magnitude of the ECB purchases already conducted, especially if set against the backdrop of what has been issued by countries in bond and bills to date.

In Italy, the ECB buying amounts to 75% of the net debt increase. For Germany, it is still 63% taking into account that the regional states also increased their debt by a sizeable amount.

The ECB already absorbed a good part of this year's sovereign issuance



Source: ECB, Bloomberg, ING

Governments aren't hiding the significance of this outsized support.

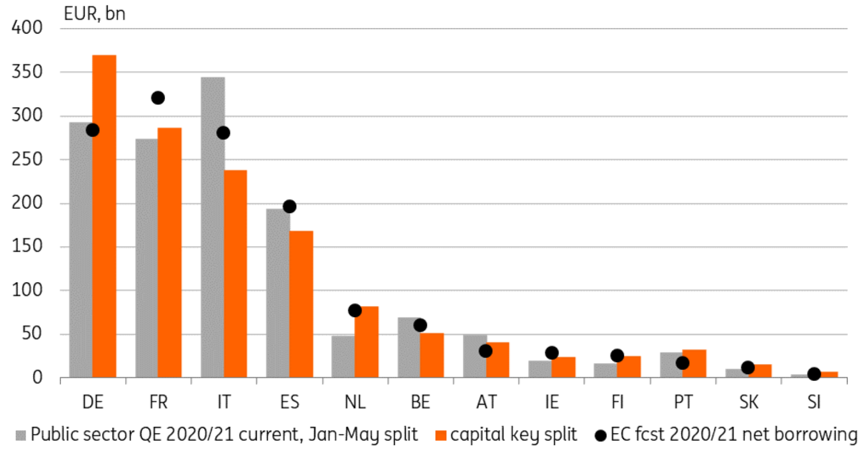
After the PEPP increase, Austria's debt agency head proclaimed that demand matched supply again. Recall that the ECB had estimated that the crisis would create €1.0-1.5tn in additional financing needs for eurozone governments. Given that the ECB's economic baseline scenario has moved closer to the initial worst-case scenario, we might be looking towards the upper end of that range.

The European Commission (EC) made its own forecast in early May, breaking it down onto the country level, although their underlying assumptions now look outdated and too optimistic. It forecasted a net new borrowing of €942bn in 2020 and €425bn in 2021 for general governments (i.e. including state and regional levels). The chart below sets the EC forecast for this year and next against the current ECB's buying trajectory, assuming that APP continues unchanged and 80% of QE purchases are directed at the public sector.

Here we also show two splits: one keeping in line with what has been observed this year and the other if the ECB were to strictly adhere to the capital key. In practice, the split will probably lie somewhere between the two.

Here, the takeaway already should be that the ECB now stands ready to entirely absorb the first year's extra funding of most countries, if not even already a part of next year's. But with current EC forecasts likely to be towards the lower end and also the envisaged issuance of €750bn for the new EU recovery fund not taken into account yet, it does not need to be the end of what the ECB is willing to do on the buying front.

ECB public sector purchases versus anticipated government new borrowing 2020/2021



Source: European Commission, ECB, ING

Individual country funding plans - still playing catch up

The individual countries' funding plans for central governments are playing catchup with the financing needs arising from new measures announced to tackle the crisis. Of course, the issuance of new debt is spread over different instruments, thus also spreading the impact on government funding levels. Ramping up the issuance of Treasury bills has allowed debt management agencies to quickly cover the initial spike in funding needs for instance.

In the end, however, the heavy lifting will have to be done in the EUR government bond markets. And eventually, outstanding bills are likely to be termed out under the cover of the extended refinancing period of PEPP until at least the end of 2022.

Eurozone issuance estimates for 2020 versus last year (ex bills, €bn)

	2020			2019			Difference		
	Gross	Redem	Net	Gross	Redem	Net	Gross	Redem	Net
Germany	212	164	48	159	148	11	53	16	37
Netherlands	35	30	5	21	30	-8	14	0	14
Finland	14	13	1	9	5	4	5	8	-3
Luxembourg	3	2	1	2	0	2	1	2	-1
Austria	23	15	8	20	26	-6	3	-11	14
Belgium	45	19	26	30	24	5	15	-5	20
France	255	131	124	243	129	114	12	2	10
Slovenia	8	2	6	2	1	1	6	0	6
Slovakia	10	3	7	3	2	1	7	1	6
Ireland	22	17	5	14	13	1	8	4	4
Spain	186	84	102	113	92	21	73	-8	81
Portugal	23	8	15	15	8	7	8	0	8
Italy	320	202	118	238	199	39	82	4	78
Greece	8	1	7	10	9	1	-2	-7	6
Total:	1163	691	473	878	685	193	285	5	280

Source: Debt Agencies, ING

The current funding plans of debt agencies already show that gross bond issuance is on track to total €1.2tn which translates into a net issuance of close to €0.5tn. Compared to 2019 that is already €0.3tn higher. While the largest adjustments will likely have been made by now - Austria and Spain were the latest to announce their funding revisions - more are still in the pipeline potentially already in the coming weeks.

Germany is likely to accommodate the latest stimulus package in its upcoming Q3 funding plan.

With the cost of the €130bn package calculated at €90bn at the federal level for this year, untapped appropriations of €60bn in the current budget imply that at least €30bn of extra funding will have to be pencilled in until the end of the year. The Netherlands recently extended its stimulus package for three months at a cost of €13bn, which should also find its way into the next quarterly funding plan update. France could also be in for another update after the finance minister announced that the deficit would be €50bn larger than forecast in April.

The ECB will dampen the impact of higher debt on interest rates

We have written on previous occasions that we expected ECB intervention to be the dominant factor in setting the path for core interest rates.

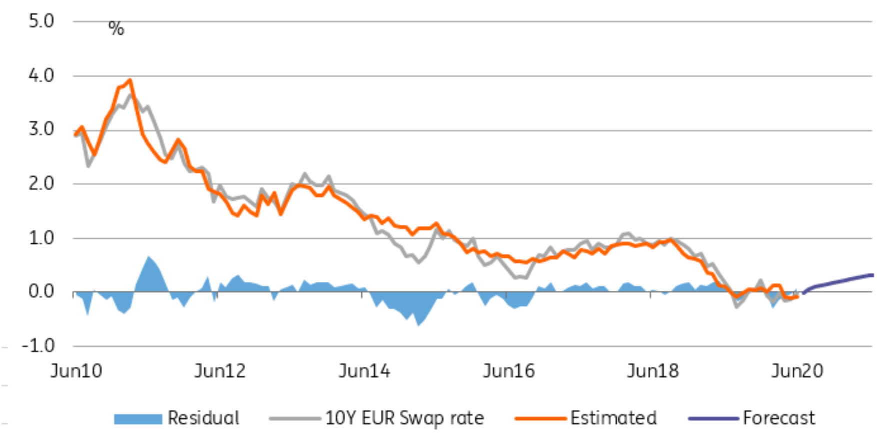
We include in that category the yield on core government bonds such as Germany, France or the Netherlands, but also EUR swaps whether using Eonia, €STR or Euribor as underlying benchmarks. Now that we have more certainty as to both the path of ECB policy, we detailed the main implications in our ECB wrap-up, and about borrowings needs, we can more easily quantify the impact on interest rates.

> *Our model foresees only a modest rise in interest rates despite the debt tsunami that has to be financed over the coming years*

By and large, our intuition proved correct. Our model foresees only a modest rise in interest rates despite the debt tsunami that has to be financed over the coming years. Focusing here on EUR swaps against 6-month Euribor, we see 10-year rates rising to 0.15% by the end of 2020, and to 0.35% by end-2021.

A similar path can be inferred for other core interest rates in our view.

EUR rates to rise only slowly



Source: Bloomberg, ING

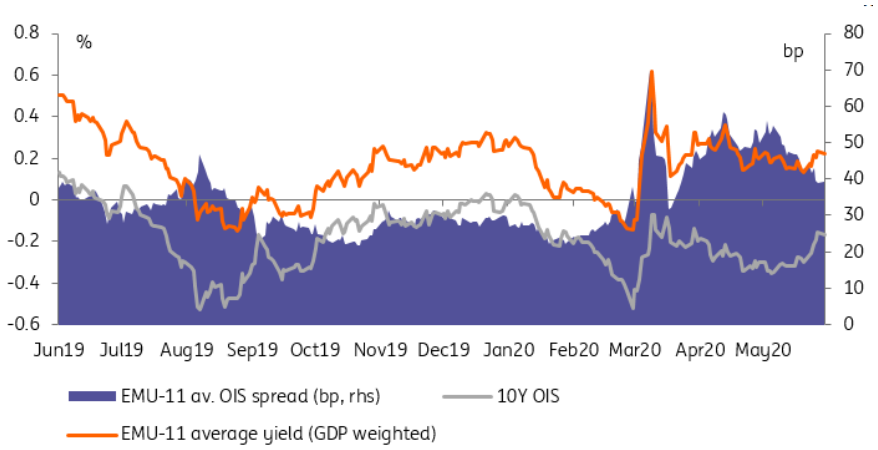
Average EGB yields to rise but fragmentation to ease

Both Christine Lagarde and chief economist Philip Lane highlighted last week the average GDP-weighted yield on European government bonds as an indicator of tightening or easing financial conditions. This is probably too restrictive a criteria to be the be-all the end-all of monetary policy targets but it highlights how central the cost of government finances is to the ECB's decision. It also highlights its determination in keeping market interest rates low.

Our analysis suggests the measures taken last week should be successful in absorbing most government net supply, and in smoothing the path of interest rates.

We doubt it will prevent a rise altogether.

Higher yields outright but lower realtive to OIS



Source: Bloomberg, Eurostat, ING

An important distinction has to be made between average EGB yield and average yield spread to OIS. The former is a reflection of government borrowing costs, the latter is an indicator of financial fragmentation and a by-product of tighter of sovereign spreads.

We think it will be very difficult for the ECB to achieve both lower average yields and average OIS spreads. Since the latter reflects an improvement in financial fragmentation, we expect the ECB would have to live with slightly higher yields, if they come with tighter sovereign spreads.

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