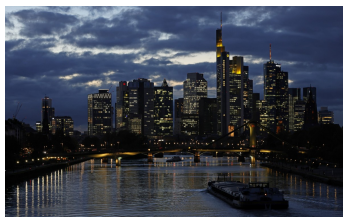


## From the ECB to yours: the outlook for banks

The European Central Bank is promising action next month to help counter the ravages of Covid-19. While we examine what more it could do, we also have a comprehensive report on all aspects of banking as we move into 2022. We're certain: the delayed impact of the coronavirus crisis is about to make itself felt. Here are our top stories this week

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The pandemic brought banks a renewed sense of purpose in 2020: providing liquidity to the real economy. Helped along by accommodative monetary and...

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#### **ECB: We do pre-commit and will go big in December**

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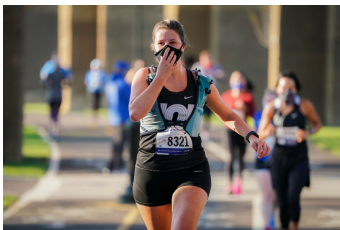
By Bert Colijn



## Already slowing eurozone growth now points to double-dip recession

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## United States

### The US economy races ahead but for how much longer?

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### US Presidential election G10 FX scorecard

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## Exploring the depth of Asia's unconventional central bank easing

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# Banks Outlook 2021: The delayed impact of Covid-19 will make itself felt

The pandemic brought banks a renewed sense of purpose in 2020: providing liquidity to the real economy. Helped along by accommodative monetary and government policies, banks have indeed played their part in the crisis response. Going into 2021, the delayed impact of the pandemic will make itself felt



## □ Loan demand: weak, weaker, weakest?

In 2021, the recessionary environment will weigh on **bank loan demand of corporates**, as investment projects are shelved and businesses are struggling to survive. Borrowing rates are supportive, but cannot fall much further, and bond markets are an attractive alternative for larger corporates in many eurozone countries. Businesses seeking alternative sources of liquidity, once government-supplied liquidity has dried up, may stimulate demand for bank loans, but only to a limited extent. With southern European economies on average hit more strongly by lockdowns, having a higher share of Small and Medium-Sized Enterprises and consumer credit portfolios in those countries, and taking into account pre-corona trends, we expect bank loan demand to weaken mostly in southern Europe. Find that section [here](#).

## □ Margins: under increasing pressure

The clouded outlook for loan volumes is complemented by an ever-increasing **pressure on**

**margins**, as eurozone banks continue to suffer from the negative rates environment in 2021. The 10-year EUR swap rate is hovering around -25bp, painting a dark picture of the European rates outlook with markets expecting short rates to stay, on average, at negative levels for the next decade. What is more, the yield curve has flattened considerably in the past few years, detrimental to banks deriving part of their income from maturity transformation.

The particular vulnerability of banks to negative rates depends on their loan book composition, including duration and funding mix. Deposits are no longer the safe and efficient means to generate interest income on maturity transformation that they once were. In fact, given difficulties imposing negative rates on deposits, a strong dependence on deposit funding may be turning into a weakness rather than a strength. Find that [here](#).

## □ Non-performing loans: silence before the storm?

Helped by extensive government support measures and payment holidays, many businesses have been surviving in 2020. Default rates and NPL ratios have been deceptively quiet this year. Support measures are not forever though. **A sharp increase in non-performing loans is a question of 'when, not if'**, but will hit some countries more than others. Factors driving those differences include the sectoral composition of corporate loan books, the share of SMEs in those loan books, and the size of legacy NPL portfolios. Taken together, a worrying picture emerges. Covid-19 may deal another blow to those countries and banking sectors that are worst positioned to deal with it. Find that article [here](#).

## □ Consolidation: a change in tune

Weak demand and digesting losses may drive banks into each other's arms. But even before Covid-19, several banking markets were already overbanked. 2020 will likely mark a year of change for bank consolidation in Europe with another hit to bank profitability in the form of Covid-19 and a change in tone from supervisors. This is likely to result in **more consolidation**.

We think domestic deals will continue to take the lead and consider in-market transactions to be more likely in certain areas. Cross-border deals are more likely to involve large banks that target new markets. Motivation could include increasing economies of scale, synergies, geographical and product diversification, acquiring better digital capabilities, or improving the asset and liability match by merging with a complementing entity. An important consideration for cross border mergers will probably continue to be the hunt for greater size and customer base, especially since banks are facing ever tougher competition from big-tech platforms. Cross-border deals have been hindered partly by a reluctance of domestic authorities. The tone may be changing though, with the ECB now seemingly pushing harder towards bank consolidation. More on that [here](#).

## □ Bank bond supply: I'm good, thank you

Covid-19 has sharply reduced **bank bond issuance** this year. The fall in covered bond and preferred senior supply is a direct consequence of banks relying more on the ECB's TLTRO funding. Only subordinated supply has kept its head above water thanks to the ECB's measures and a rise in lending growth for some banks. With the global economy projected to recover from its severe growth relapse in 2021, bank supply is likely to follow a similar pace as we have seen this year. More on that [here](#).

## □ Regulation: where were we?

Regulators have responded strongly to the Covid-19 pandemic in an effort to mitigate the impact of the crisis on households, corporates and banks. All these measures have guided banks well through the first storms of the Covid-19 crisis. To what extent banks will be able to rely on these **temporary provisions in 2021**, pretty much depends on how the coronavirus situation evolves. If renewed lockdowns and economic pressures are indeed the direction we are heading, governments and central banks will likely continue to do their utmost to navigate the crisis. That may include extending measures that were put in place temporarily to optimise the conditions for banks to deal with the Covid-19 crisis and the postponement of important measures such the Basel-III reforms. Read more [here](#).

## □ Sustainability: next steps towards climate neutrality

The Covid-19 pandemic is underscoring and reinforcing the importance of **sustainability**. Bank sustainable bond issuance held its ground in 2020, quite an achievement given the general reduction in bank bond issuance. Sustainability is likely to remain a key topic in 2021 for banks in many different ways, ranging from disclosure requirements to the impact of the taxonomy regulation in the field of green loan and bond market developments, just to name a few. The follow-up developments in light of the European Green Deal will keep financial market participants engaged and so should the ECB's monetary policy review, which could include a pivot towards green lending. Bond markets will remain a vital reflection of this. Click [here](#) for more on that.

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Snap | 29 October 2020

## ECB: We do pre-commit and will go big in December

European Central Bank President Christine Lagarde could not have repeated the main message of today's meeting more often: there will be additional stimulus in December, the only question is what this stimulus will look like and how much it will be



Christine Lagarde

### No jumping just yet

After last night's lockdown announcements in Germany and France, the European Central Bank's base-case scenario has definitely become outdated. This is why there was a small chance it could have surprised markets today by preempting additional easing in December. Some argued that the March experience could force the bank to jump ahead of the curve. Not yet. The ECB today tried a balancing act, de facto announcing new actions in December. Let's hope that the economic situation will allow the ECB to wait until then.

### Lagarde does pre-commit

ECB president Christine Lagarde could not have repeated the main message of today's meeting more often: there will be additional stimulus, the only question is what this stimulus will look like. Forget about Mario Draghi's 'we never pre-commit'. Today, Lagarde introduced her own 'we will recalibrate all instruments' at the December meeting. There was no conditionality, apart from the



reference to using different instruments.

The fact itself that new ECB action will come was not contested at all. According to Lagarde not even within the ECB. While according to her there was no discussion today on any policy action, the ECB unanimously agreed on the need to act in December. The reasons for this determination are clear: a weakening of the eurozone economy which, due to the latest lockdown announcements, will almost unavoidably turn into a double-dip recession.

## Get ready for December

Going into the December meeting, the challenge for the ECB will be to find the right answer and the right instruments to support the eurozone economy and hence restore inflation (expectations). Back in March, the emergency response PEPP programme was started to tackle a possible new eurozone crisis with widening government yield spreads, aka restoring the transmission channel of monetary policy. A widening of spreads, however, is not, yet, a problem. Therefore, the ECB will probably also look into options of how to support banks and, through the banking sector, companies running at the edge of bankruptcy. The latter won't be easy given that the sectors hit most by the lockdowns are normally sectors with many small enterprises and self-employed people. As much as the ECB would like to do 'whatever it takes', it looks as if the biggest chunk of crisis-fighting will continue to have to come from governments.

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*Christine Lagarde surprised with more dovishness and determination than expected*

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Interestingly, Christine Lagarde said that the ECB would look into all instruments and the mix of all instruments. This leaves the door open for another rate cut, but given the adverse effects of negative interest rates, this is in our view still an unlikely option. We think the most likely outcome of the December meeting is still an increase of asset purchases, via both the PSPP but also the PEPP programme, by some 500bn euro and more, possibly even more tailor-made support for banks and bank lending by for example including Fallen Angels in the asset purchases or extending the most favourable interest rate of -1% by more than the current twelve months. The digital euro, which could actually help in the current situation as it would allow helicopter money, will not come in time.

All in all, today's ECB meeting follows a good old ECB tradition to first assess all the facts and jump the gun. Still, Christine Lagarde surprised with more dovishness and determination than expected, posing the only question if the ECB agrees on the need to act in December, why didn't they act already today? Here is the answer: Had the ECB meeting taken place not one day but one week after the lockdown announcements in France and Germany, the outcome of the meeting would probably have been different.

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Snap | 30 October 2020

## Eurozone GDP receives double-digit boost ahead of another downturn

A whopping 12.7% rebound in GDP in the third quarter is a bittersweet result with new lockdowns just being announced. That makes a double-dip unavoidable. Meanwhile, the latest inflation data vindicates the ECB's dovishness



Source: Shutterstock

The eurozone recorded a very strong rebound after the deep lockdown in the third quarter, much better than expected.

Third-quarter growth in the bloc was even stronger than what we saw in the US – 12.7 vs 7.4% non-annualised – but American GDP didn't plummet as much either during the lockdowns. The strong rebound was led by France, Spain and Italy – the countries that experienced the harshest lockdowns. Clearly, this 3Q growth figure largely reflects a mechanical rebound.

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*The strong 3Q GDP figure will not make much of an impression as a new downturn is almost certainly upon us. With inflation remaining very weak and GDP set to fall again in 4Q, the ECB has started to work on a new monetary stimulus package*

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The current level of economic output is far more interesting than the growth rate. At -4.3%, below the peak in GDP of 4Q19, the rebound has still left a very significant gap to close. At levels of output, much below pre-Covid-19 levels and with new restrictive measures on the economy, concerns about second-round effects are growing. This means that the focus will now turn to how adequate fiscal responses will be to counter the long-term effects of new partial lockdowns.

The latest inflation data provides reasons to be concerned. Inflation was stable at -0.3%, but the slide in services inflation continues is worrying. While one-offs continue to influence the headline and core inflation rate, the October data for inflation still shows deflationary pressures at work. With new lockdowns, the outlook for inflation for the start of the new year will be weakening too, largely justifying the ECB's very dovish tone at yesterday's press conference.

The strong 3Q GDP figure will not make much of an impression as a new downturn is almost certainly upon us. With inflation remaining very weak and GDP set to fall again in 4Q, the ECB has started to work on a new package of monetary stimulus.

Not what you'd usually expect when an economy just grew by 12.7%, but this is the reality of a Covid economy.

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Snap | 29 October 2020

## Already slowing eurozone growth now points to double-dip recession

October economic sentiment reveals an economy already slowing ahead of more significant lockdown measures. Expect the dreaded double-dip for 4Q GDP



French President, Emmanuel Macron, announced new lockdown measures on Wednesday evening

Tomorrow is 3Q GDP day for the eurozone and we're in for a huge growth figure. The reception will be bittersweet at best though, as last night's announced lockdowns in France and Germany all but seal the deal on a negative growth rate for 4Q. October sentiment data shows that the start of the quarter already came in soft.

The Economic Sentiment Indicator was more or less stable in October. It fell slightly from 91.1 to 90.9, which was the first decline since April. It was impacted by the end of the rebound from the first lockdown and the second wave of the coronavirus. Still, the eurozone economy experienced a relatively modest impact from new restrictive measures over the month as recent days have seen the more severe measures introduced. That makes a much larger drop in November likely.

The manufacturing sector continues to be a bright spot. Industry sentiment increased significantly from -11.4 to -9.6 as order books continue to improve. Businesses indicated a significant improvement in the recent production trend, which leads to believe that industrial production could surprise on the upside for the September/October period. As countries have so far shied

away from restricting manufacturing production as part of new lockdown measures, industry could continue to outperform in November as well.

Services confidence decreased moderately in October, from -11.2 to -11.8. The decline reflects the expected impact of new restrictive measures as expectations for future demand decreased sharply. Recent demand was improving slowly when the survey was taken, indicating a slow start to the quarter while businesses brace for what's to come.

## Author

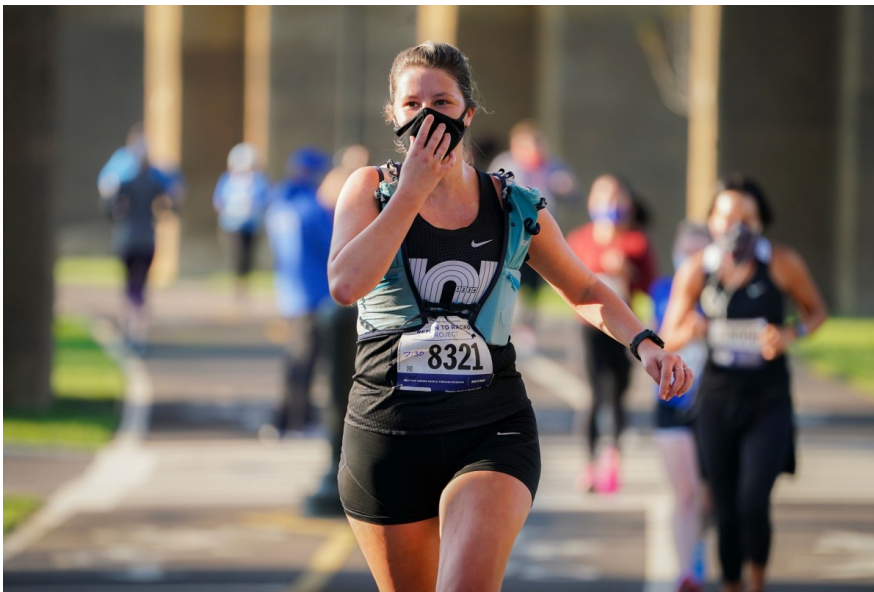
### **Bert Colijn**

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# The US economy races ahead but for how much longer?

A record US annualised growth rate of 33.1% in 3Q20 as pent-up demand post lockdowns and surging government transfer payments to households fuelled spending. However, rising Covid cases, consumer anxiety, squeezed incomes and election worries create massive uncertainty for 4Q activity. We tentatively suggest 2% growth, but we can't rule out a drop



Like this masked runner in New York, the US economy roared ahead in 3Q but for how much longer?

# 33.1%

 GDP growth in 3Q 2020

Better than expected

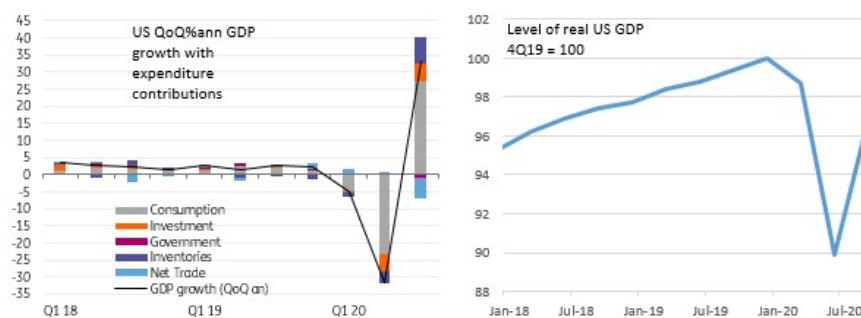
## A record rebound

The US economy expanded at a record 33.1% annualised rate in the third quarter, slightly better

than the 32% consensus forecast. The post-lockdown rebound was led by a 40.7% gain in consumer spending where durable good consumption jumped 82%. It is important to remember that this wasn't purely a post-lockdown spending splurge, but massive government transfers (the \$1200 cheque, expanded unemployment benefits and the \$600/week additional Federal payment) supported sentiment and boosted spending.

There was a 59% gain in residential investment as record-low mortgage rates helped trigger a wave of housing transactions and a big 6.6 percentage point contribution to headline growth from inventories being rebuilt following factory shutdowns in 2Q. Net exports subtracted 3.1% from headline growth as consumer demand sucked in imports while government spending subtracted 0.7pp as the CARES stimulus faded.

## US GDP growth and output levels



Source: Macrobond, ING

## Covid fears, election uncertainty and squeezed incomes

Even after today's record growth figure, we need to remember that output is still 3.5% below that of the end of the fourth quarter 2019 and there are 10 million fewer Americans in work than in February. There is a long way to go until the economy has fully healed and there could be more economic pain ahead.

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*There is a long way to go until the economy has fully healed and there could be more economic pain ahead*

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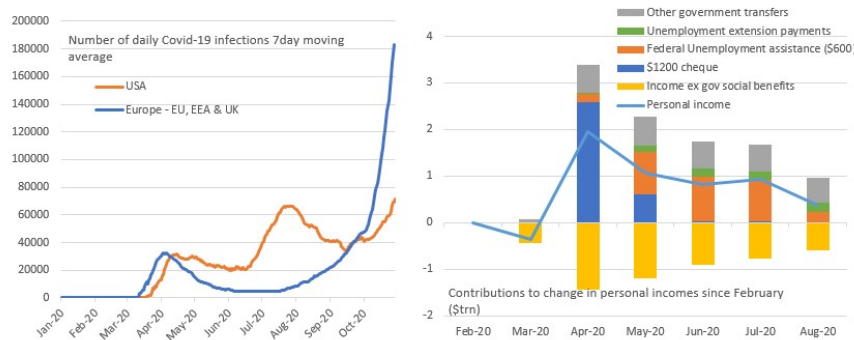
The number of new Covid-19 cases is rising sharply with the potential for social gatherings around Halloween and Thanksgiving accelerating this process. Should hospitalisation rates continue to rise and healthcare systems start to struggle this may necessitate the return of containment measures, such as we are seeing in Europe. This would inevitably be economically damaging and result in more job losses.

Even if we don't see such action, health fears could mean consumers disengage with the economy – not go to shops, restaurants and gyms – and activity weaken in any case.

If next week's election fails to deliver a clear result and we instead get acrimony, legal battles and protests, anxiety levels could rise amongst households and businesses, compounding the problems

for financial markets and the real economy. Political animosity would also weaken the prospect of a near-term fiscal stimulus that could prevent the very real chances that household income growth moves into negative territory in November and/or December.

## Covid and falling unemployment benefits



Source: Macrobond, ING

Income from employment and assets remains below the levels of February while the support from incomes from the \$1,200 government cheque has passed and the \$600/week Federal payment has been tapered to \$400 (and to \$300 in many instances). We also need to remember that millions more have now exhausted their 26 weeks of state unemployment benefits.

With politicians so far failing to agree on a new stimulus plan, there is the risk that uprated benefits soon no longer fully offset to the decline in employment incomes, especially if rising Covid cases lead to a weaker economy and mounting job losses.

## A double dip?

We continue to hear encouraging words on the prospect of an approved Covid-19 vaccine in coming months, but the timeframe to roll out a vaccination program means a return to pre-Covid consumer behaviour norms is a long way off. Given the potential health and economic impact of a European style spike in Covid and the prospect of weaker income growth, the risks are increasingly skewed to a sub 2% GDP growth reading for 4Q 2020. If aggressive containment measures are introduced in December it will likely be negative.

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## US Presidential election G10 FX scorecard

Our US election G10 FX scorecard is here to gauge the impact of various election scenarios on G10 FX. In our view, the 'Blue Wave' scenario would lead to weaker USD and outperformance of NOK and AUD. We're also giving you an augmented scorecard for those wishing to penalise European FX due to the Covid situation in the region



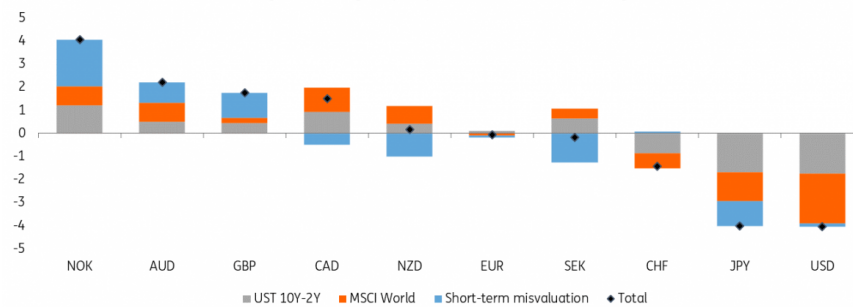
To gauge the impact of the US presidential elections on G10 FX immediately after the event, we have built a G10 FX scorecard, as you can see below. It consists of three factors:

1. Currencies sensitivity to risk;
2. The shape of the UST yield curve (2s10s); and
3. The level of the short-term mis-valuation (based on our short-term financial fair value model).

In our view, these factors should be the key drivers of FX markets post US elections.

## US Election G10 FX scorecard

G10 FX US Presidential Election Scorecard. Higher score = higher upside potential in Biden landslide victory scenario and vice-versa



Source: ING

Calculated as z-scores on 6-month daily (% change) correlations. Each currency's performance is calculated vs USD, for USD the US Dollar Index (DXY) was used. Misvaluations are vs USD and based on ING's short-term fair value model. For USD, a weighted average (using DXY weights) was used.

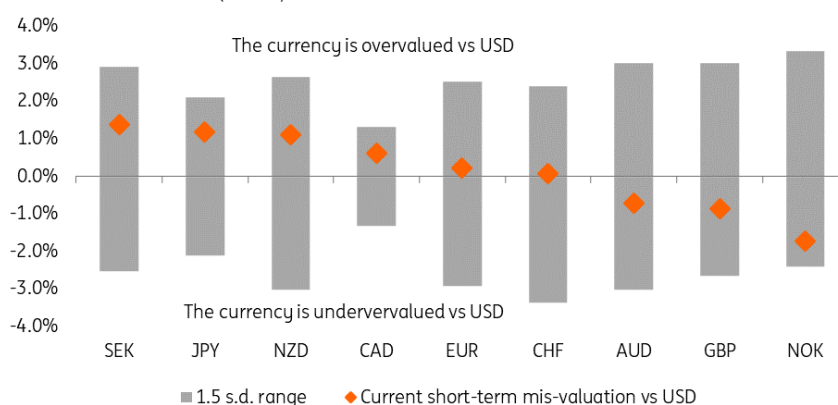
### 1 Blue Wave

In the case of the most positive outcome for markets, the 'Blue Wave', the expectations of larger US fiscal stimulus delivered by the Democrats and the return to the rules-based system for international relations should be initially positive for global risk appetite and lead to a steeper UST yield curve. Hence, the focus on the correlation of G10 FX with global stock markets (MSCI World Index) and UST 2s10s – and the currencies that will benefit. Here NOK, AUD, NZD and CAD all stand out.

The third factor, the mis-valuation, shows to what extent the G10 currencies currently trade out of sync with their short-term fundamentals. This factor captures the scope for a justified correction based on fundamentals – ie, those higher beta currencies that are undervalued have more scope to rally vs those which are rich in the case of a market positive outcome. Here, both NOK and AUD stand out (we show the level of G10 FX short-term mis-valuation in the chart below) and score better than NZD, CAD or SEK.

## G10 FX short-term mis-valuations

Deviation of G10 crosses (vs USD) from their short-term financial fair value



Source: ING

Misvaluations are vs USD and based on ING's short-term fair value model. For USD, a weighted average (using DXY weights) was used.

As the scorecard shows, higher beta, undervalued NOK and AUD should benefit the most from the Blue wave outcome, while USD and the safe-haven JPY should turn into the underperformers.

## 2 Biden wins, but Republicans retain the senate

A Biden victory, with Republicans retaining the Senate, would likely manifest itself into a weaker USD (largely due to the expectations of less unpredictable US international policies and the lower possibility of further trade wars) yet the reduced odds of a larger fiscal stimulus would be less positive for global risk sentiment and would reduce the extent to which the UST curve can steepen. Hence, the lower degree of outperformance of the likes of NOK and AUD vs the Blue wave scenario. But still, the conclusions from the G10 FX scorecard would hold, in terms of differentiation. USD would be the laggard and cyclical currencies would benefit.

## 3 Trump wins

A President Trump win would catch markets off-guard and likely put an end to expectations of USD weakness in 2021. The rebound in USD would be felt across the entire G10 FX segment, would see the reverse of the price action expected in the case of a Biden victory with activity currencies suffering from the extension of protectionism. The under-priced risk of the return of the trade war agenda for another four years would unlikely lead, at least initially, to materially higher global equity markets. The dollar would benefit, though with the Fed now targeting average inflation (and thus its stance should be skewed to the behind-the-curve approach) this should provide less support to USD than was the case during the first Trump mandate.

## 4 Contested result

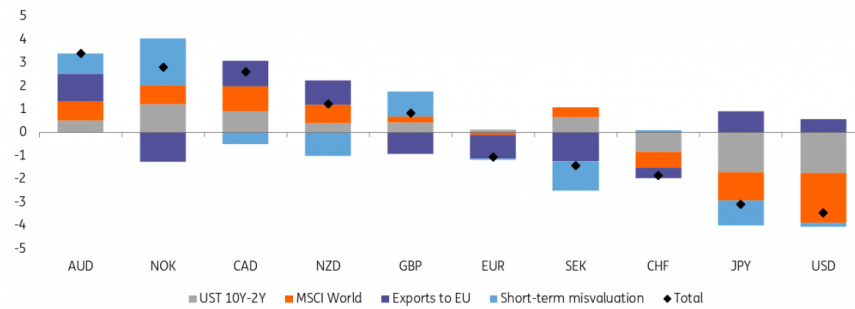
The price action should be similar in terms of the direction to a Trump victory as it would likely disappoint current market expectations, though the hit to cyclical currencies would likely be larger given the dent to risk appetite. Any prolonged uncertainty about the US Presidential election outcome would be negative for risk assets, lead to lower equity markets, flatter UST and core global curves and benefit safe havens. JPY and USD would lead in gains, followed by CHF.

## What about the Covid 19 situation in Europe?

For investors concerned about the further deterioration in the Covid situation in Europe and even more eurozone economic underperformance vs the US and Asia, we also present an augmented version of the scorecard above, which penalises European currencies (given their exposure to the EZ economy – we use the export channel to the EU as % of total exports as the factor to differentiate). As evident in the augmented scorecard below, AUD looks like a better way to express a positive US election outcome market view when compared to NOK – as NOK (as well as other European FX) falls down the pecking order due to its exposure to the European economy.

## Augmented US Election G10 FX scorecard

Augmented G10 FX US Election Scorecard. Higher score = higher upside potential in Biden landslide victory scenario and vice-versa



Source: ING

See Figure 1 for calculation details. Exports to the EU are calculated as a % of the country's total exports.

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Article | 27 October 2020

## Exploring the depth of Asia's unconventional central bank easing

“Unorthodox” monetary policy is becoming so mainstream now, that what was once considered the edgy domain of some developed markets, is now even being dabbled in by some emerging market central banks including the Philippines, Indonesia, India and Korea with some trying to get away with “lite” versions of both QE and even direct monetary financing



Source: Shutterstock

## Asia Pacific – unorthodox policy by country

	Philippine central bank	Indonesia central bank	Reserve Bank of India	Bank of Korea
What has happened?	BSP unloaded a hefty monetary response with a flurry of conventional easing – 175bp of rate cuts and 200bp reduction in reserve requirements. As a result, PHP 1.9 trillion was released into the system.	BI has carried out its fair share of conventional easing, with rates slashed by 100 bp and reserve requirements reduced for both dollar and specific IDR-denominated accounts in first-quarter. But Indonesia is constrained by a vulnerable currency- the rupiah.	India's central bank action has been a mix of both conventional and unconventional measures. The RBI cut policy interest rates by a total of 115 bp and banks' cash reserve ratio by 100bp from March to May.	The Bank of Korea leapt in to help with a quick 50bp rate cut in March followed by another 25bp of easing in May. This is still where policy rates stand today, at 0.50% - still above zero, and indicating some slight additional room for further orthodox easing should it be required.
Quantitative Easing	<b>FULL</b> - The central bank has bought up government securities with no volume limits or target tenors. To date, we estimate, it has bought up roughly PHP 1.1 trillion worth of bonds & given the heft of their holdings relative to the outstanding total (20%).	<b>FULL</b> - At the onset of the pandemic, BI received provisional authority to expand its scope to purchases of long-term securities in the primary market via "perpu" or presidential declaration to assist the govt. manage the impact of Covid. Currently, BI's monetary operations have totalled roughly IDR 658 trillion, worth roughly 4.2% of GDP.	<b>LITE</b> - When hefty rate cuts failed to revive growth and CPI started to rise towards the year-end, the RBI resorted to buying long tenor govt bonds and selling short ones to drive market yields lower. Given the long-term nature of this operation (1 to 3-years), assets created remain on the RBI's balance sheet until the maturity of TLTRO. As of August, the outstanding balance on this account was INR 2.5 trillion (1.2% of GDP).	<b>LITE</b> - The Bank has been keen to enter the unorthodox club with talk of "Korean-style QE". At its 9 April meeting, it announced the adoption of an unlimited liquidity support facility. This was to use a weekly repo purchase facility to supply an "unlimited" amount of liquidity at set interest rates for a period of 3 months. The new measures were also linked to the implementation of the government's financial support package.
Deficit financing	<b>LITE</b> - The Bank's charter allows short-term cash advances to the govt, capped at PHP 810 bn. Given the cash crunch faced by authorities in October, the Bank agreed to purchase PHP 540 bn worth of 3-month paper directly from the government. As time goes by, it looks like BSP may be willing to move on to full-on deficit financing.	<b>FULL</b> - Indonesia's central bank has also recently entered into a "burden-sharing" agreement with the govt, as the Bank carries out full deficit financing. Despite subsequent pronouncements highlighting the independence of BI, investors remain wary of future burden-sharing agreements in the coming months with BI tagged as standby financier of the deficit.	<b>LITE</b> - Under Governor Das, the RBI has been generous in helping the govt to fund a wide budget deficit. The main channel here is the RBI's dividend payment and transfer of excess reserves to the government. The Bank also boosted its Ways and Means Advance limits for central and state governments. This isn't a source of deficit financing per se – just a mean to tide over short-term (usually up to 3 months) mismatch of government's receipts and spending.	
Where do we go from here?	Despite, pledging the use of unconventional policies was "time-bound" and will be phased out, authorities have secured legislation to extend and upsize the budget for cash advances, setting the precedent for more cash advances between monetary and fiscal authorities.	The Bank appears ready to resort to unconventional measures to support the govt's recovery efforts. Bank officials have repeatedly declared independence from fiscal authorities but we expect the Bank to carry out more deficit financing activities in 2021 and also use QE measures to ensure adequate liquidity in the system.	The RBI balance sheet doesn't provide sufficient grounds for thinking about outright QE or deficit monetisation. Total assets/GDP ratio of 27% is small compared to many developed market central banks pursuing full QE. We look for signs of significant balance sheet expansion to indicate policy has switched from its current lite measures to full QE or deficit financing.	Despite the Governor raising the possibility of purchasing corporate bonds or commercial paper as an expansion of this exercise, the Korean-style QE program concluded at the end of July, having supplied around KRW19tr. With market rates having stabilised, the liquidity benefits of this program are not required. Nor does the Governor seem keen to embark on mainstream QE.

Source: ING

## Once impassable, now prevalent

Across the world, the Covid-19 pandemic has turned life on its head. Things once considered impossible (majority home working) have proved eminently achievable. Fiscal policymakers have also ripped up the rule books – better to risk a rating downgrade than to let the economy implode – and deficits are ballooning. Again, seemingly without major ramifications.

*Monetary policies are beginning to push in directions that less than a year ago would have seemed absolutely unthinkable including in the Asia Pacific region*

And on the monetary policy side too, there are changes. Zero real interest rates were once seen as an impassable line in the sand for most emerging market economies. But this, or even negative real rates are now the norm for many. And for others, policy rates are now also nearing the absolute zero lower bound.

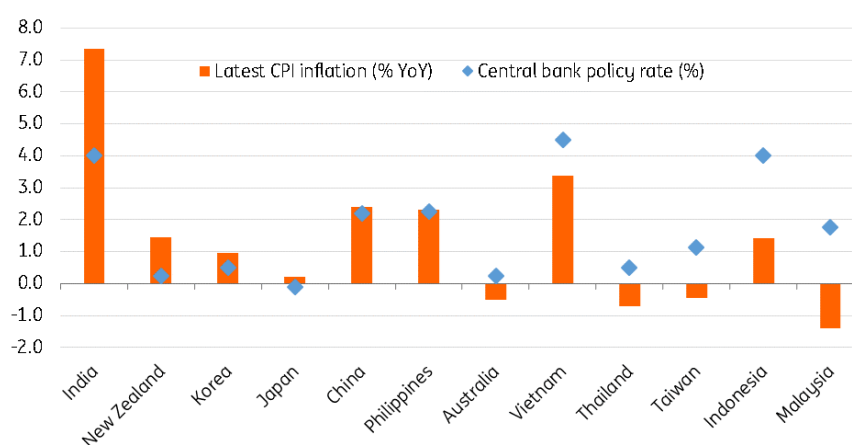


Even this doesn't seem enough for some, and at the margin, policies are beginning to push in directions that less than a year ago would have seemed absolutely unthinkable including in the Asia Pacific region. Some central bank actions are beginning to look a bit like quantitative easing ([see also this broader EM note from June](#)), and even in some cases, direct monetary financing.

Markets seem to be paying little attention as previous norms are broken, but as normality resumes, their tolerance for such policies may lessen or even reverse.

### QE in emerging markets: Unconventional risks

## Asia: Central bank policy rate and inflation rate (%)



Source: CEIC, ING

Note: Countries in ascending order of real interest rates defined as nominal rate minus inflation rate.

## Unorthodox policies – a primer

Given the limitations of rate policy in achieving desirable economic outcomes in terms of either economic growth, full employment or low positive inflation targets, a number of developed market central banks in recent years have tried to squeeze a little more juice from the dried up husks of their policy arrays.

Such policies have typically involved some form of balance sheet expansion, with quantitative easing the main policy of choice. In very simple terms, quantitative easing was an active expansion of the central banks' balance sheet, using created money balances (central banks directly control the supply of "cash" money) which were exchanged in the secondary market for financial assets – usually longer-term national government bonds.

As time has passed, issues of asset credit quality have been superseded by the needs of market liquidity, and such purchases have expanded to include mortgage-backed securities, corporate paper, exchange-traded funds, and municipal/local government securities and others.

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*In the end, it turns out that QE has been pretty ineffective at even enabling modest inflation targets to be met. Any inflationary*

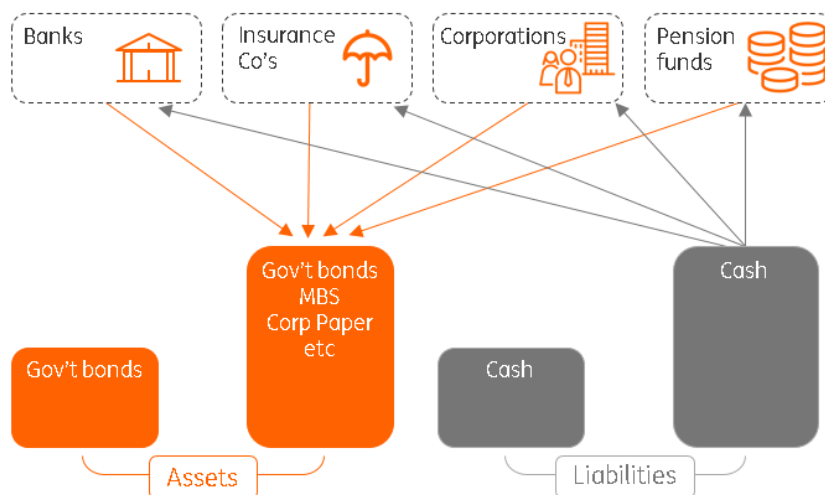


*impact of QE is largely confined to financial asset markets.*

The aspect of QE that made it a novel policy tool, was the fact that the purchases were done with created money. This was “money printing” in terms of old school attitudes, and had previously been avoided, other than what was necessary to keep pace with the nominal growth of the economy and to prevent money velocity bottlenecks. A little “seignorage” has always been regarded as acceptable, but anything beyond this was viewed as recklessly inflationary policy.

In the end, it turns out that QE has been pretty ineffective at even enabling modest inflation targets to be met, with any inflationary impact being largely confined to financial asset markets, and with only very limited real macroeconomic effects. And perhaps for that reason, central banks have become emboldened to push their policies further and further, tweaking them into new variants such as the recent demand for yield curve control.

## Central bank balance sheet expansion via Quantitative easing



Source: ING

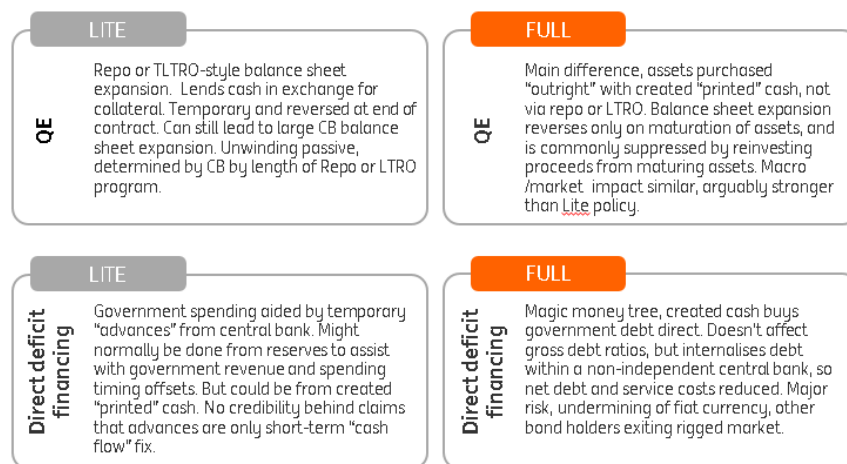
## How does it work?

Nonetheless, at its heart, the policy simply creates cash on the liability side of the central banks' ledgers and then exchanges it for assets held by others, boosting the cash balances of those from whom they purchase assets, and in turn the asset side of their own balance sheets. The reduced availability of “low risk” financial assets outside the central bank - the portfolio balance effect - pushes up their price, and by extension, encourages the purchase of riskier assets, equities, high yield credit etc, supporting these markets too.

Not all developed market central banks were initially ready to take the plunge and undertake quantitative easing. For years, the European central bank limited itself to a form of QE-lite, expanding their balance sheet, but only temporarily through long-term refinancing operations (LTROs), which were time-limited. This essentially created a limit to the duration of the stimulus and built-in its reversal, perhaps lessening its impact.

Such LTRO and targeted (T)LTRO approaches could be viewed more as a counter to poor market liquidity than an overt attempt at domestic demand management, which full quantitative easing, it could be argued, tries to be.

## QE vs. Deficit financing



Source: ING

## And, direct deficit financing

In reality, full QE also has only a finite impact on the central bank balance sheet, except for perpetuums, eventually, outright purchases of fixed income assets mature, and cash will return to the central bank. To overcome this shortcoming, proceeds of maturing assets have often been re-invested, maintaining the balance sheet expansion until such time as it was viewed it was no longer needed, and hence providing an even stronger signal of expansionary intent to market participants.

So far, no developed central bank has embarked on direct monetary deficit financing, though give it time... This is an even more overt form of money printing and simply pays for government borrowing directly in primary markets with printed money. At this point, the central bank abandons any pretence of independence and simply becomes a tool of the government, printing cash to pay for the government's deficit spending. Monetary policy becomes indistinguishable from fiscal policy.

Currently, this feels like a step too far even for most developed market central banks. But with their fiscal options more limited, even in these unusual times, some emerging market central banks seem to be trying to make up for their limited fiscal leeway by leaning in the direction of such direct monetary financing, in particular, via temporary "advances" to government.

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*Some emerging market central banks seem to be trying to make up for their more limited fiscal leeway by leaning in the direction of direct deficit financing in particular, via temporary "advances" to government*

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What looks like a temporary advance today, may end up lingering long past any reasonable concept of short-term cash flow management which is how these measures are currently described. And although such direct financing doesn't directly lower gross government deficits or their debt pile relative to GDP, it does internalise it, by turning the central bank into the monetary arm of the government, and in turn, lowering the net deficit / net debt to GDP ratios.

In the current market climate, where almost anything seems possible, central banks in Asia seem to be getting away with at least "lite" versions of both QE, and in some cases, direct monetary deficit financing.

## Asia Pacific – unorthodox policy by country

We now take a closer look at this and consider whether these policies remain acceptably "lite" or have crossed the threshold posing a risk should we ever return to a situation where markets become more choosy about where they place their funds.

### 1 Philippine central bank: Getting rather busy

The Philippine central bank delivered a hefty monetary response to the pandemic, deploying a flurry of conventional easing - 175 basis points of rate cuts and 200 bps reduction in reserve requirements) and has since ventured into unconventional policies.

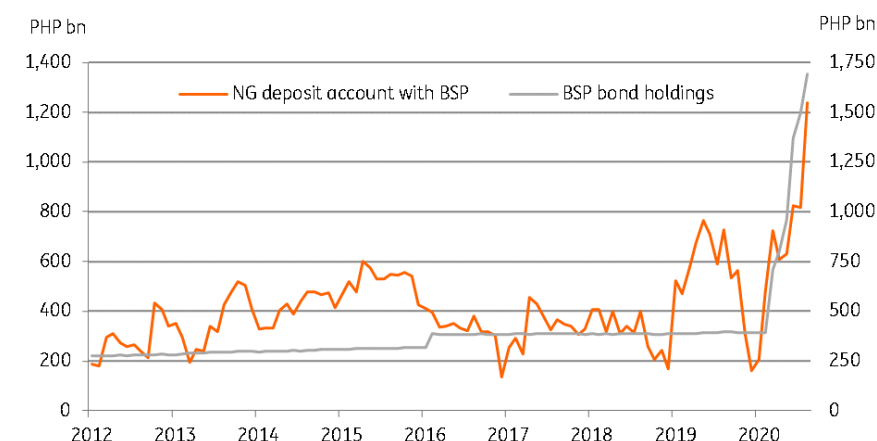
As a result of its easing measures, Bangko Sentral ng Pilipinas' released roughly 1.9 trillion Philippine pesos into the system to calm financial markets with the central bank carrying out both direct deficit financing and quantitative easing.

### BSP - Quantitative easing (Full)

The Philippine central bank has engaged in quantitative easing measures, buying up government securities from the secondary market with no volume limits or target tenors. To date, we estimate that BSP has bought up roughly PHP 1.1 trillion (5.6% of GDP) worth of bonds from the market and given the heft of their holdings relative to the outstanding total (20%).

We believe BSP will likely hold on to these bonds until maturity for fear of rattling financial markets.

## BSP balance sheet



Source: CEIC, ING

## BSP - Deficit financing (Lite)

Early on in the pandemic, the central bank initially agreed to a government cash advance via a PHP 300 bn six-month repurchase agreement in March, which has since been settled. The Bank's charter allows it to conduct short-term cash advances to the national government, capped at PHP 540 bn or 2.7% of GDP. Given the cash crunch faced by fiscal authorities in October, the Bank agreed to purchase PHP 540 bn worth of three-month paper directly from the national government with central bank Governor Benjamin Diokno indicating he remained open to additional support in the future.

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*BSP may be willing to move on to full-on deficit financing.*

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Meanwhile, recent legislation has granted authority for the central bank to upsize cash advances to the government to PHP 810 bn or 4.1% of GDP while also extending the repurchase agreements for up to two years. As time goes by, it looks like BSP may be willing to move on to full-on deficit financing with finance minister Dominguez indicating that BSP will likely be called upon to do more in terms of debt financing in 2021.

## ? BSP - Where do we go from here?

BSP Governor Diokno has pledged that the use of unconventional policies was “time-bound” and that measures would gradually be phased out once economic conditions improve. Despite these pronouncements, we note that the authorities have handily secured legislation to extend and even upsize the budget for cash advances, setting the precedent for additional cash advances between monetary and fiscal authorities in the future.

With the economy in deep recession, BSP has chosen to go almost all-in with full-fledged quantitative easing measures alongside lite-deficit financing agreements.

## Indonesia's central bank: Going all in

Indonesia's central bank has carried out its fair share of conventional monetary easing, cutting policy rates by a total of 100 bps while also reducing reserve requirements for both dollar and specific IDR-denominated accounts in 1Q. Growth momentum has understandably fallen sharply with Indonesia recording one of the highest Covid-19 rates of infection in the region with 2Q GDP falling into contraction.

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*Indonesia's central bank appears to be constrained by a vulnerable currency*

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Despite the need to help bolster GDP via additional policy easing, the central bank appears to be constrained by a vulnerable currency with Indonesia rupiah down 5.5% for the year, weighed down by substantial foreign selling in the local bond market in 1Q. Being constrained from easing monetary policy via conventional measures, BI has not shied away from enacting unconventional measures to help bolster the economic recovery from the pandemic.

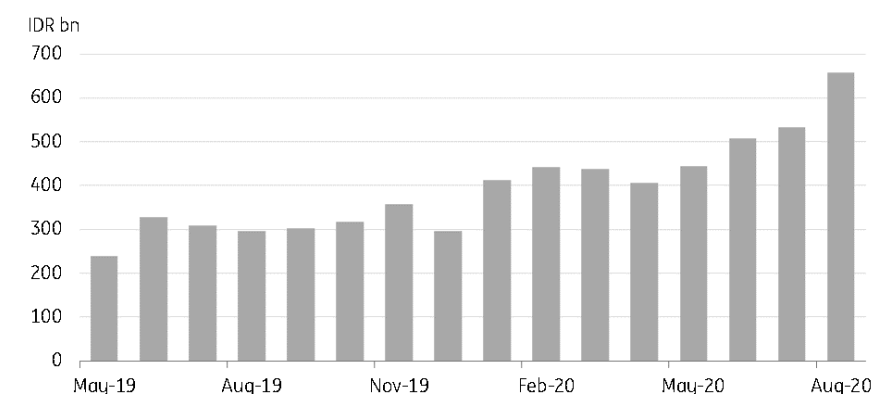
### BI - Quantitative easing (Full)

Prior to the pandemic, the central bank had been conducting repurchase agreements to help manage liquidity conditions since 2008 with the central bank limited to taking on short-term securities from the secondary market.

At the onset of the pandemic, BI received provisional authority to expand its scope to purchases of long-term securities in the primary market via “perpu” or presidential declaration “in order to assist the Government manage the impact of Covid-19 ”. BI was granted authority to purchase long-term primary market securities only as a “last resort” should the market be unable to absorb debt sales by the government to cap upward pressure on yields given heightened uncertainty. The perpu also granted the central bank the authority to purchase longer-dated securities in the secondary market also to help preserve financial market stability and to ensure adequate liquidity in the financial system.

Currently, BI's monetary operations have totalled roughly IDR 658 trillion, worth roughly 4.2% of GDP.

## Indonesia's central bank monetary operations



Source: CEIC, ING

### BI - Deficit financing (Full)

Indonesia's central bank has also recently entered into a “burden-sharing” agreement with the national government, as the central bank goes head-long into deficit financing.

Market anxiety spiked as soon as reports on the rumoured deal circulated with concerns about central bank independence weighing on sentiment. BI finalised the IDR 575 trillion (3.6% of GDP) agreement with fiscal authorities in early July with the central bank agreeing to buy up IDR 397.5 trillion at the policy rate to fund Covid-19 relief efforts.

The Bank also agreed to act as the standby buyer for primary market debt worth IDR177 trillion with the central bank shouldering the cost which is pegged at BI 3-month repo rates less 1 percentage point with the proceeds used to recapitalise distressed small and medium-sized enterprises. For the private placement worth IDR 397.5 trillion, BI would return the bond yield to the government in full.

Investors had initially absorbed the “burden-sharing” agreement after authorities justified such manoeuvres as necessary given the crisis while vowing that the agreement was a “one-off” deal. In August, jitters re-emerged during the passage of the 2021 national budget with fiscal authorities citing BI as standby financier for the deficit all the way through to 2022. Despite subsequent pronouncements (even from President Jokowi) highlighting the independence of BI, investors remain wary of future burden-sharing agreements in the coming months with BI tagged as standby financier of the deficit.

### ? BI - Where do we go from here?

With the economy in recession, Indonesia's central bank appears ready and willing to resort to additional unconventional measures to support the government's recovery efforts.

Bank officials have repeatedly declared independence from fiscal authorities but we do expect the central bank to carry out additional deficit financing activities in 2021 while also employing quantitative easing measures to ensure adequate liquidity in the financial system.

## Reserve Bank of India: Nowhere near full QE

Prevailing fiscal policy constraints in helping the economy turn the Covid-19 tide saw the Reserve Bank of India taking the lead in providing stimulus during this pandemic. Indeed, a significant portion of the 10.5% of GDP “total stimulus package” announced by the government on May 2020 comprised monetary measures.

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*RBI's unconventional policy falls on the lite side of both quantitative easing and deficit financing, though it's more of the former than latter.*

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Like many other Asian central banks, India's central bank action has been a mix of both conventional and unconventional measures. The RBI cut policy interest rates by a total of 115 basis points and banks' cash reserve ratio by 100bp from March to May. This came on top of the 135bp of rate cuts in 2019, more than most Asian central bank eased in 2020. The more unconventional measures have taken the form of liquidity support via LTRO, TLTRO, variable repo operations, enhanced marginal standing facilities, financing window for non-bank finance companies, and increases in the “Ways and Means Advances” to the government.

We think RBI unconventional policy falls on the lite side of both QE and deficit financing, though it's more of the former than latter.

### RBI - Quantitative easing (Lite )

Unconventional policy came into play well before the pandemic hit. The economy was already on a downward path in 2019. As hefty policy rate cuts of last year failed to revive growth and inflation started to accelerate towards the year-end, the RBI resorted to ‘Operation Twist’ – buying long tenor government bonds and selling short ones to drive market yields lower, a form of yield curve control that the US Fed pioneered in the 1960s and re-used following the global financial crisis. The move helped to curb upward pressure on longer-term yields, making it one of the preferred policies this year – the RBI has had four rounds of this Operation since April, swapping a total of INR 100 billion or 0.05% of FY19-20 GDP from short-term to long-term bonds each time, without any net impact on its balance sheet.

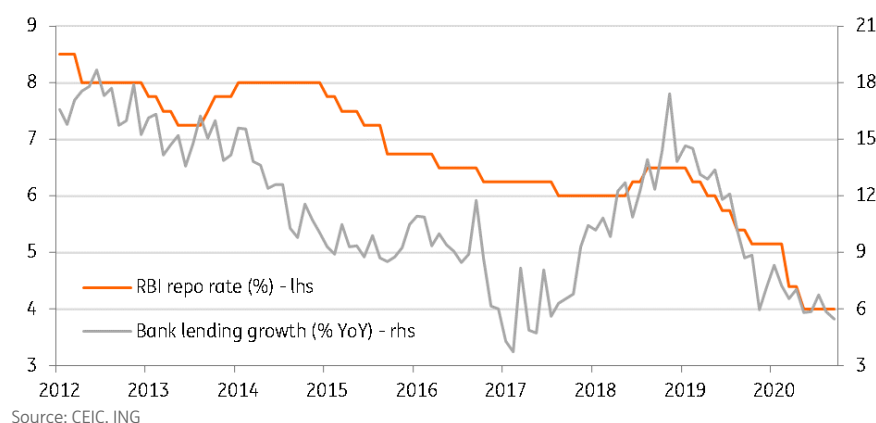
In its first policy meeting of 2020 held in February, the RBI injected about INR 1 trillion (0.5% of GDP) of liquidity through 1 to 3-years repo operations (LTROs) and also eased bad loan norms for small borrowers and reserve requirements for select lending. As the nation-wide lockdown forced the economy to a grinding halt by late March, the RBI delivered 75bp of repo and 90bp of reverse repo rate cuts and also lowered the cash reserve ratio by 100bp. That was not all. It launched INR 1 trillion of TLTRO for tenors from 1 to 3-years at a floating rate linked to the policy repo rate (4.40% at the time) and INR 1 trillion of variable repo operations. In mid-April came another TLTRO 2.0 for INR 500 billion and a financing window for NBFCs for INR 500 billion.

While the RBI continued to pile up liquidity support via unconventional measures, including another INR 1 trillion of on-tap TLTRO announced in the latest policy meeting earlier this month, the market response to the TLTRO operations has been rather tepid. So is their balance sheet impact. Given the



long-term nature of this operation (1 to 3-years), the assets created remain on the RBI's balance sheet (classified as loans and advances to banks) until the maturity of TLTRO. As of August, the outstanding balance on this account was INR 2.5 trillion (1.2% of GDP).

## Lower policy rate failed to stimulate lending



## RBI - Deficit financing (Lite)

As the RBI embarked on an aggressive easing and the government launched a record INR 12 trillion borrowing programme for the year, noise grew about outright QE or even buying government bonds directly from the primary market. While former RBI policymakers warned against such policies on the grounds of their potentially inflationary consequences, Governor Shaktikanta Das hasn't shown any particular inclination towards them either.

However, under Governor Das, the RBI has been generous in helping the government to fund a wide budget deficit. The main channel here is the RBI's dividend payment and transfer of excess reserves to the government. The government's increased demand on the RBI for these funds was a controversial topic just recently, raising questions about the central bank's independence under the current regime. Indeed, this payment jumped to a record INR 1.76 trillion in FY2018-19 (July-June, the RBI's accounting year), 64% higher than what the government had budgeted for the year and over a three-fold increase from the INR 500 billion paid in the previous year. The transfer for FY2019-20 has slowed sharply though to INR 571 billion, and it is projected to be around that level too in the current year.

The central bank also boosted its Ways and Means Advance limits for central and state governments. This isn't a source of deficit financing per se – just a mean to tide over short-term (usually up to three months) mismatch of government's receipts and spending. The RBI lifted its WMA limit to INR 2 trillion for the first half of current financial year and to INR 1.25 trillion for the second half from INR 75 billion and INR 35 billion corresponding periods of the last year. Being for short-term use, WMA's are generally underutilised and aren't a source of RBI balance sheet expansion.

Both the dividend transfer and WMAs may be viewed as creeping monetisation of the deficit, as the RBI's former deputy governor, Viral Acharya, pointed out recently. He also questioned the RBI's independence under the current regime before he quit in early 2019.

## ? RBI - Where do we go from here?

The RBI balance sheet doesn't provide sufficient grounds for thinking about outright QE or deficit monetisation.

The balance sheet expanded by 30% over the last financial year ended in June 2020. While this may align with the aggressive monetary expansion over this period, the expansion is mainly explained by the revaluation of gold and reserves, foreign investment, and loans and advances on the assets side, and currency and deposits on the liabilities side. A surge in demand for cash during the Covid-19 lockdown underlines increased currency circulation. As excess liquidity from monetary expansion countered by weak demand, funds flew back to the RBI as deposits via reverse repos. About a 50% jump in the foreign investment assets reflects the reinvestment of swelling FX reserves. Lastly, a 42% rise in domestic investment and loans and advances results from huge liquidity operations.

Moreover, the total assets/GDP ratio of 27% is very small compared to many developed market central banks pursuing full QE. We would look for signs of significant balance sheet expansion from here as indicating that policy has switched from its current lite measures to full QE or deficit financing. The RBI seems to be a long way from that at present. And with stagflation risk is lingering on horizon, we don't believe this is likely either. Indeed, monetary policy has probably reached about as far as it can go, and more of the same is our baseline view until the economy recovers the entire loss of output caused by Covid-19.

## 4 Bank of Korea : Temporarily dabbles with QE-Lite

As one of the more developed markets in the Asia Pacific region, it is arguable that adoption of unorthodox monetary policies by the Bank of Korea would represent a smaller departure from normality than it would for some of the less developed markets considered earlier.

Yet despite this, the Bank of Korea's journey into these uncharted zones has been timid, and "talked up" rather than delivering any genuine move into unorthodox policy. Such moves have also been very short-lived, with policy currently looking distinctly orthodox.

### Bank of Korea - Quantitative Easing (Lite)

The Bank of Korea was a reluctant easer during 2019, beginning to cut its 7-day reverse repo rate target from 1.75% in July, reversing some of the tightening that it had resumed towards the end of 2018. The July 25bp rate cut was followed by a further 25bp of easing in October, taking the policy rate to 1.25%, which was where most analysts anticipated the rate cycle would end.

Covid-19 spurred the Korean government into action early in 2020, with Korea one of the first countries in Asia to record substantial numbers of cases after the outbreak in China. The BoK leapt in to help with a quick 50bp rate cut in March and followed up with a further 25bp of easing in May.

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*Korea's central bank has been keen to claim entry to the unorthodox club with talk of Korean-style QE.*

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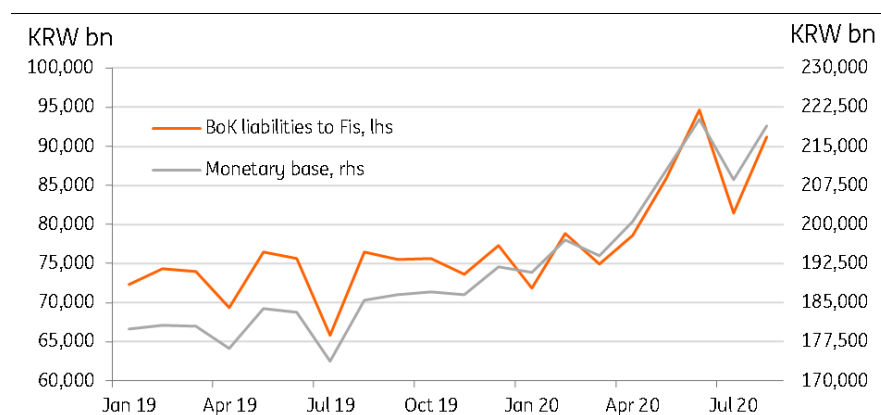
This is still where policy rates stand today, at 0.50% - still above zero, and indicating some slight additional room for further orthodox easing should it be required. But despite apparently having more room for additional orthodox policy, the central bank has been keen to claim entry to the unorthodox club with talk of “Korean-style QE”.

This Korean-style QE has taken the following form. At its April 9 meeting, the Bank announced the adoption of an unlimited liquidity support facility. This was to use a weekly repo purchase facility to supply an “unlimited” amount of liquidity at set interest rates for a period of three months. The new measures were also linked to the implementation of the government's financial support package.

To make this work, the BoK expanded the range of institutions that could take part in these liquidity exercises, and also broadened the range of eligible securities.

Describing their measures at the time as “Korean-style” QE, the policy does look to have allayed concerns about market liquidity, which had seen 10-year government bond yields spiking higher during March. But importantly, the measures were temporary, limited to three-month repos, and rather than balance sheet expansion through money printing, look like little more than liquidity management. The fact that they were “unlimited” hints that there may have been some willingness to print to ensure sufficient liquidity was extended. But this would, in any case, have been a temporary phenomenon, and seems a very long way from QE as we understand it.

## Monetary base and Bank of Korea liabilities to financial institutions



Source: CEIC, ING

### ? Bank of Korea - Where do we go from here?

Despite Bank of Korea Governor Lee Ju-Yeol raising the possibility of purchasing corporate bonds or commercial paper as an expansion of this exercise, the Korean-style QE program concluded at the end of July, having supplied around KRW19tr. Though it has been kept on ice and could be resumed if needed.

With market rates having stabilised, the liquidity benefits of this program are not currently needed. Nor does it appear that Governor Lee is keen to embark on more mainstream QE directions, describing these in a recent speech as “premature”. All told, this experience seems like a departure from the BoK’s usually conservative approach to policy, and one that it did not feel entirely

comfortable with. We doubt that they will return to similar measures any time soon.

## Why markets don't seem in a hurry to penalise

Across the Asia Pacific region, as the Covid-19 pandemic has raged, the stresses and strains on governments' abilities to fight the economic damage caused by the virus with traditional monetary and fiscal policy has been strained. And this strain has been more evident for emerging market governments, always keeping one eye on the rating agencies and market support, than it has for the richer, more developed economies.

*We see more evidence for a creeping support for government fiscal policies from central banks in the Asia Pacific region.*

It is perhaps not surprising, therefore, that we see more evidence for creeping support for government fiscal policies from central banks in the less developed markets of the Asia Pacific region than we do from the richer, more developed economies. With the exception of some big talk from Korea, the action has been largely at the other end of the spectrum, India, Indonesia and the Philippines.

Recovery in these latter economies is likely to remain slow, and pressure on governments fiscal balances to remain substantial. So we don't rule out a further creep over time in the direction of both full QE, as well as towards more direct monetary support measures for fiscal policy. And at some point in the future, maybe when markets are no longer being accommodated to such a large extent globally as is currently the case, this could prove very troubling to these markets.

For now, however, so long as these countries can use such policies to keep economic growth from outright collapse, markets seem to be in no hurry to penalise them.

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