Policy Manoeuvres in the Dark

77 – 1 February 2021

Key points

- There is some talk of taking the deposit rate further down in some quarters of the European Central Bank (ECB), to try to stem the recent appreciation of the euro. We argue that the growth differential, fuelled by the divergent performance on vaccination, will actually favour the dollar, especially if more political volatility materializes in Europe.

Some members of the ECB Governing Council are clearly worried by the euro appreciation, to the point of talking up the possibility of cutting the deposit rate further, an instrument which had largely been ignored in the recent policy discussions focused on the PEPP/TLTRO duet providing support to the economy by making fiscal policy financially possible and helping banks. We continue to think that we are very close to the "reversal rate", i.e. the point beyond which cutting rates does more harm than good, especially since the ECB's capacity to mitigate the impact of such policy on banks is limited. We are also surprised by the prominence of the exchange rate issue. As of last Friday, the euro has appreciated by less than 3% relative to the ECB forecast for 2021 published on December 10th, which would hardly move the needle for inflation and growth.

In our opinion the pendulum has already swung back on the exchange rate. While we will see volatility as Biden will have to compromise to get his fiscal policy push through, there are many reasons to think the US economy will significantly outperform Europe in 2021, and the push higher in US long-term interest rates should ultimately re-create foreign interest in dollar-denominated assets. Beyond the role of fiscal policy – and the fact that the US economy was in any case more resilient before the Covid winter wave struck – the gap on the sanitary front is also widening. The US is not doing as well as the UK on vaccination, but it is still vastly outperforming Europe.

This goes beyond the exchange rate, or even purely macroeconomic considerations. We are concerned that "lockdown fatigue", exacerbated by mounting criticism on Brussels' handling of vaccination procurement, could fuel populist movements which so far did not fare that well in Europe since the start of the pandemic. Early elections can still be avoided in Italy if another coalition contract is found between PD, M5S and Italia Viva. If this base case does not materialize, we will have an important test for Europe in the first half of 2021. The US was the main source of "political volatility" these last few months. Hopefully, Europe will manage to avoid taking up that role now.

The return of the rate cut talk

In December the ECB could consider that it had “the job done” for the whole of 2021, and a bit beyond, with the announcement of an extension of its Pandemic Emergency Purchase Programme (PEPP) and the new round of Targeted Long Term Refinancing Operations (TLTROs), together with a pledge to recalibrate PEPP if need be. While the central bank maintained its customary message on the possibility to use “*all instruments*”, there was no doubt in the market that the “PEPP/TLTRO” duet was in practice the only stars of the show**. Dutch central bank Governor Klaas Knot’s point on the ECB still having the capacity to cut its deposit rate in an interview to Bloomberg last week came as a complete surprise.**

Klaas Knot elaborated by stating that “*we have explored the effective lower bound, but we haven’t found it yet”*. What followed added to the confusion. Shortly after Knot’s interview, Bloomberg reported on “ECB sources” according to which some “officials” were worried that the market was under-pricing the possibility of more depo cuts. Conversely, Reuters came up with its own sources at the central bank signalling that odds of another decline in the policy rate were low and that the conversation on another rate cut triggered by Knot at the last Council meeting had been “marginal”. A member of the Governing Council finally intervened publicly on Friday (Gabriel Makhlouf, Governor of the Irish central bank), but while the headlines (“Rate cut isn’t warranted at this point”) were somewhat reassuring, the details of his own interview to Bloomberg still pointed to an ongoing debate in Frankfurt *(“we haven’t ruled out using any of our options, including a rate cut. And when we get together in March, we’ll make a call”).* The discussion may not be as marginal as what the Reuters’s story hinted at.

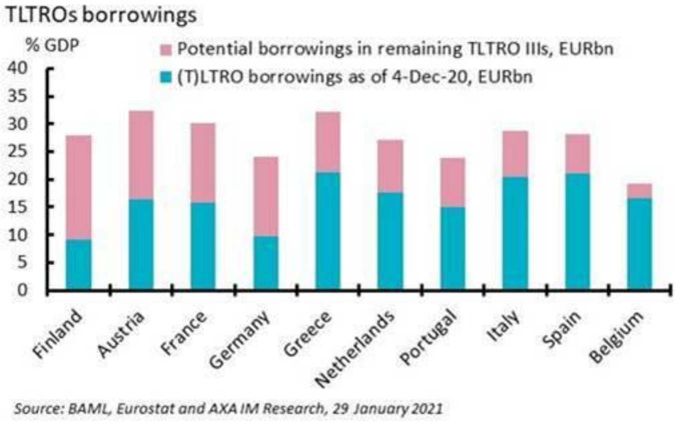
We are quite surprised that this comes to the surface again now. True, deposit rate action is the main tool for the ECB to deal with currency appreciation, and the euro is indeed expensive. Using the broad-measure of the trade-weighted foreign exchange index, it is currently hovering at about 0.5/0.6 standard deviation above its long-term average, and the rise in 2020 has been significant (see Exhibit 1). Still, as of last Friday night the exchange rate was only 2.8% above the level for 2021 assumed by the ECB’s projections in December. Based on previous vintages of the ECB’s alternative scenarios to its forecast, such appreciation against the dollar would reduce inflation and GDP growth by c.0.1% after 2 years, an unwelcome development but quite second-order compared to the magnitude of the macro shocks the central bank is currently dealing with. We fail to see what the urgency is of discussing the issue at this stage. Actually, the pressure on the euro was more acute in December than in January. In our view, the “market debate” over the last few weeks has been more focused on the possibility of seeing the dollar re-strengthening. The rise in long- US interest rates triggered by the more expansionary fiscal policy pursued by Joe Biden could potentially attract non-resident investors to dollar-denominated assets in the coming months, in a context of low hedging costs.

More fundamentally, we believe interest rates in the Euro area are actually quite close to the “effective lower bound” when taking on board the little space which remains to mitigate the adverse consequence of negative rates for the banking sector. The ECB can play on two cursors to help the banks deal with the “tax” on their excess reserves. First, the Governing Council can rebalance the loss for banks on their asset side by subsidizing their funding costs on lending to the private sector. Second, the ECB can exempt a higher proportion of excess reserves from the payment of the negative rate (i.e. “tiering”).

The generosity of TLTROs is crucial there. Since the (negative) interest rate at which the best-performing banks in terms of lending can access long-term funding from the ECB is automatically linked to the deposit rate, a higher “tax” triggered by a further decline in the ECB’s policy rate would be at least partly offset by a further fall in banks’ funding costs. **The “only” problem is that banks are not equal in terms of access to the TLTROs.** Potential additional borrowing in Italy and Spain is very low compared with core countries (see Exhibit 2). More generally, the capacity for banks to quality as “best performers” and deliver on the ECB’s conditions in terms of maintaining lending to the private sector to get the most favourable funding conditions in the TLTRO is now lower given the decline in credit demand reflected in the last ECB Bank Lending Survey. The other mitigation instrument – raising the threshold below which excess reserves are not hit by the deposit rate – is also quite blunt. Cash-rich banks are in core, not in the periphery. Few Italian and Spanish banks would benefit from more generous tiering.

Exhibit 1 – The euro is expensive, but it's not new

Exhibit 2 – not much left for the peripheral banks



At the very least the conversation on pushing the deposit rate further into negative territory should be had in conjunction with a general re-think of the TLTRO framework. The ECB in December chose not to go very far on extending the borrowing allowance (to 55% of eligible loans), thus restricting the take-up of TLTROs. Those in the Governing Council arguing for cutting the rate should accept to take another look at this allowance, and not focus on tiering only.

Another issue is that while the ECB can help to mitigate the impact of negative interest rates for the banking sector, it can't do much for the rest of the financial system. In the context of a discussion of the right calibration of the PEPP, the "minutes" of the Governing Council December meeting report *"the argument was made that a further lowering of yields from their already highly accommodative levels could be expected to have only marginal effects on growth and inflation, while increasing the risks of unintended side effects, in particular for financial stability"*. Indeed. We fully agree with this view, which is precisely why making the fiscal push possible is the most efficient transmission channel of monetary policy in these circumstances. But what is true for the potential effects of PEPP on yields should also apply to the aftermaths of another depo cut. The level of long-term yields may be capped by the central bank by bond purchases, but its lower bound is driven by the market's expectation of how low the ECB will put its deposit rate. In other words, moving the deposit rate has ramifications all along the curve. This can trigger a continuous search for more duration (or risk, or both) on the asset side of non-bank financial institutions, putting them in a potentially difficult position when interest rates finally normalize. We suspect those on the Governing Council who would contemplate another rate cut are also those who were the most uncomfortable with the latest extension in PEPP**. Still, if the central bank is worried about doing too much on the quantitative easing side of its policy framework, this should extend to its interest rate stance.**

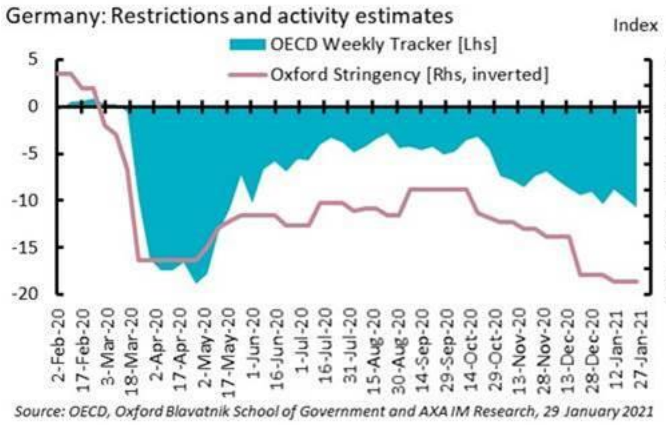
This sudden return of the deposit cut option may reflect some discomfort at the Governing Council with some "dovishness deficit" of the ECB relative to the Federal Reserve. Some of the strength of the European currency could come from the Fed's embrace of "average inflation targeting" and its tolerance of future inflation overshooting, a step which the ECB has so far refused to take as explicitly. Toying with rate cuts today could "offset" a less iron-clad commitment to keep interest rates low in the future and keep the exchange rate down. We don't think however that the ECB can address the market effect of the potential future divergence in the policy stance across the Atlantic with tweaking the *current* rate differential. We think that the Governing Council has to address a long-term strategic problem, and this is one of the points the ongoing review should deal with.

On balance we think a majority of the Governing Council will continue to resist the temptation of another cut, given an unfavourable "balance of risk" of such a move.

Continental spleen

The ECB can take comfort in the latest dataflow which confirms the Euro area economies are dealing better with the pandemic. France was the latest country coming out with much better than expected GDP data for Q4. The 1.3% quarter-on-quarter fall stood at -1.3%. Such a quantum would be considered as extremely concerning in any normal circumstances, but INSEE's economists themselves were expecting a 4% decline. The resilience of the Euro area economy to the winter pandemic wave cannot be explained by less stringent restrictions. We illustrate this with the example of Germany in Exhibit 3. According to the Oxford stringency index, the current lockdown in Germany is stricter than during the first wave, but economic activity – here proxied by the OECD's weekly indicator – fell much less. There is a fairly strong correlation between the *changes* in the stringency index and economic activity, but with a "level shift" between the first and second wave. Businesses and consumers have managed to adapt themselves to some extent to the new set-up. However**, if the macro shock is now shallower, it may last longer than expected, specifically in continental Europe, given the continued disappointment on the vaccination programme.**

Exhibit 3 – The economy is dealing better with the restrictions



European continental countries are doing reasonably well in curbing the propagation of the virus and in most cases pressure on the healthcare system is falling (see Exhibit 4), France being an exception with hospitalisations still rising, but reaching collective immunity is elusive, judging by **the persistently low pace of vaccination, which is still at between one fifth and one fourth of what is being observed in the US and the UK** (see Exhibit 5). We have already made the point in Macrocast that the issue does not lie so much in the slow pace in itself but rather in the absence of acceleration. The Southern countries were doing initially well, at least better than Germany and France, but they have now stalled. Logistical bottlenecks are starting to hit. Some regions in France and Spain have already had to drastically revise their schedule for February. The daily flow on new injections has started to plateau in the UK, but the country is the only one at this stage on track to get to collective immunity by the middle of the year, albeit by taking some shortcuts such as delaying the second injection and relying heavily on a vaccine with comparatively low efficacy.

Exhibit 4 – Pressure on health system falling in most cases

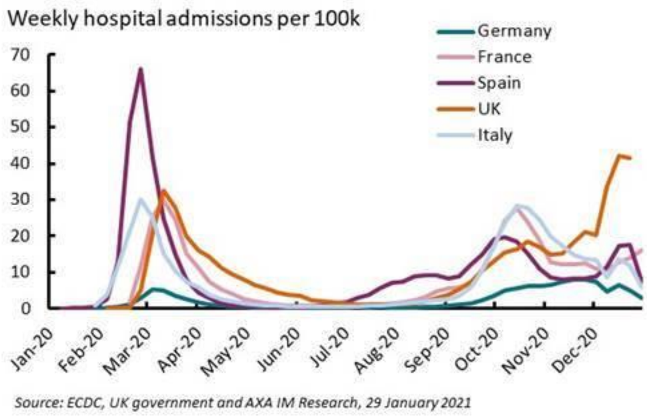
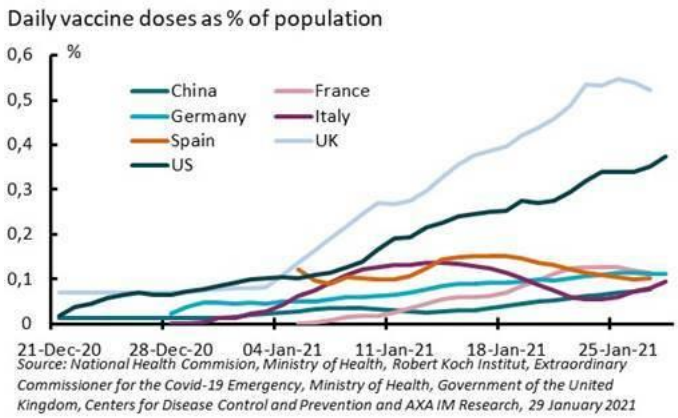


Exhibit 5 – wrong direction for vaccinations on the continent



The setback on vaccination is all the more problematic that the prevalence of more contagious variants raises the bar for the percentage of the population that needs to be vaccinated to provide collective immunity. This threshold – ignoring the share of the population which has already developed immunity after being infected – depends on the ratio between the virus' natural reproduction rate (R0) and the vaccine's efficacy. If R0 rises by

0.6 – as seems to be the case with the British variant – then another 7% of the population needs to be vaccinated. If then the average vaccine efficacy illustratively drops from 90% to 80% (for instance if the “vaccine mix” moves towards the least efficient ones), then the “vaccination threshold” would have to increase by another 10% (to exceed 90%).

In principle, faced with a stubborn wave and delays on the vaccination programmes, governments would opt for prolonging the lockdowns and making them more stringent. However, they are balancing this with the population’s capacity to accept and comply with these measures which, according to the polls, is falling. France is trying a middle-way, by focusing on curfews and restricting further activity in the major retail centres but eschewing for now a return to the tough lockdown conditions of the first wave. Italy is relaxing some of the measures in a few regions.

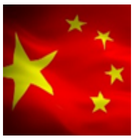
Thorny political ramifications

With “lockdown fatigue” setting in and criticism at the European Commission’s handling of vaccine procurement rising, we have some ingredients for “political accidents” – especially if Eurosceptic movements can draw on the vaccination bottlenecks to raise their profile further.

Focus continues to be on Italy – even though the recent riots in the Netherlands should act as a reminder that political stress is not the monopoly of peripheral countries. Since the efforts at cobbling together enough support from small centrist parties have failed, the coalition survival now depends largely on the capacity of the Democratic Party (PD) and 5 Star (M5S) to reach a new arrangement with Renzi’s Italia Viva party (IV). Beyond the power struggle, as we have already discussed in Macrocast the substance of the confrontation between Renzi and the two main coalition parties revolves around Italy’s handling of the Recovery and Resilience Fund. To cut a long story short, Renzi wants the transfers and loans from Brussels to be encapsulated in a structural reform package, raising Italy’s low growth potential.

We think this is a valid concern. Since for the most part RRF funding will come too late to help during the most acute phase of the crisis, it makes sense to use it as much as possible to address the long-term issues of the economies which were the most fragile before the pandemic. It is a gamble though. **It is not obvious governments can easily push through a reformist agenda, with potentially difficult distributional consequences, while the economy and the population are still under the shock of an unprecedented recession in peacetime since the Great Depression.**

Populist movements in Italy just like in the rest of Europe fed on the growing rejection of the policy recommendations espoused by Brussels. For now, most commentators believe that Italy will be able to avoid elections to unlock its current crisis as a compromise will be found to renew the coalition. If this is wrong, a likely scenario, according to the polls, would be a victory of the opposition. Lega – which followed a “Euro critical” stance when in coalition with 5 Star – has lost a lot of momentum, but their loss is offset by the progress of Fratelli d ’Italia, whose European stance is also quite critical, even if the movement has in some cases in recent months been less hawkish on these matters than Lega.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Senate Republican resistance to \$1.9tn stimulus proposal, sets up first battle • US Q4 GDP rose by 4.0%, short of our expectation on weaker consumption to deliver -3.5% for 2020 as a whole • FOMC meeting left policy unch, Powell dismissed taper talk as premature, financial stability risks described as moderate • US retail investors add to stock market vol • Moderates push back on \$1.9tn stimulus	• US non-farm payrolls should rise in Jan after -140k, but unemp could rise from 6.7% • ISM mfg and non-mfg to continue to point to expansion • Stimulus debate, with increasing threats of using reconciliation if no bipartisan progress • Virus cases to continue to fall, vaccines at >1m/day, but states are easing restrictions
	• Q4 GDP surprised to the upside, with France shrinking by only 1.3%qoq, while Spain edged up 0.4 %qoq and Germany was broadly flat (0.1%) • German HICP jumped from -0.7 to 1.6%yoy on the back of VAT normalisation, CO2 tax, lockdown imputations and annual changes in weight • Rising tensions on vaccines, with AstraZeneca due to deliver 31mn doses in Q1 (vs. 80 mn expected)	• EA core inflation to jump to 0.8%yoy and EA Q4 GDP to drop by 1.1%qoq • German factory orders worth watching to gauge the manufacturing momentum into the new year • Italian politics to remain in the spotlight with the formation of a new government • Details of PEPP by country worth watching
	• New virus cases fell to mid-20k, vaccine pace at 2.2m/week, lockdown ext to 8 March • Unemployment edged higher to 5.0% in Nov 3m/3m, employment -88k better than feared • BoE QE criticised for explanation, green moral hazard. Hse of Lords to investigate • SNP push for 2nd referendum, PM refuses	• BoE Monetary Report. Expect downgrade of 2021 GDP from 7.25%, QE increase £75bn, avoid -ve rates and implied rate correction • Lending & house price releases to confirm strong market, but some easing • Final Jan PMIs to confirm marked slowdown in activity in Lockdown 3.0
	• Number of new cases decline by 24% on weekly basis • Dec retail sales was down by -0.3%yoy while Jan consumer confidence declines to 29.6 from 31.8 • Industrial production decreases by 1.6% mom in December, -5.8% below Dec 2019 level	• Gauging the sustainability of the new Covid cases decline • Manufacturing PMI should remain close but below expansion territory while services PMI is likely to decline further in contraction territory
	• PBoC unexpectedly withdrew liquidity, triggering wide market concerns about policy tightening • Governor Yi Gang assured no "premature" policy exit	• PMI may show a moderation of growth momentum in manufacturing production, but orders should stay robust
	• Preliminary Q4 GDP yoy at -8.4% for the Philippines, -1.3% for S.Korea, -3% for HK, +4.9% for Taiwan, -4.5% for Mexico • 2020 prelim average GDP growth -2.8% for Poland • EM central banks meetings saw policy rates unchanged across the board (Hungary, Chile, Colombia)	• Indian central government budget • CB meetings: India, Thailand, Poland, Czech • Jan PMI throughout EM likely to edge lower on the back of rising COVID cases • Jan CPI in S.Korea, Peru, Turkey, Thailand, Philippines, Taiwan, Russia, Colombia • Q4 preliminary GDP: Indonesia, Czech Rep.

Upcoming events	**US :**	Mon: ISM mfg (Jan), Mfg PMI (final, Jan); Wed: ISM non-mfg PMI (Jan), Serv PMI (final, Jan); Fri: Non-farm payrolls (Jan), Unempoyment (Jan), Avg earnings (Jan), TB (Dec)
	Euro Area:	EA, Ge, It, Fr, Sp mfg PMI (final, Jan); Tue: EA GDP (adv, Q4); Wed: EA comp PMI (final, Jan), EA HICP 'flash' est (Jan), EA Ge, Fr, It, Sp serv PMI (Jan), It HICP (prel., Jan); Thu: EA Retail sales (Dec)
	UK:	Tue: Mortgage approvals (Dec); Tue: Nationwode house price index (Jan); Wed: Comp, serv PMI (final, Jan); Thu: MPC meeting; Fri: Halifax house price index (Jan)
	Japan:	
	China:	Mon: Caixin mfg PMI (Jan); Wed: Caixin serv PMI

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