MOODY'S ANALYTICS

ANALYSIS
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Bravo to the ECB

Introduction

The ECB will do whatever it takes to contain borrowing costs—this is especially relevant for the southern European countries—to allow euro zone governments to spend as much as they want on their fiscal response to the COVID-19 crisis.

In an unscheduled move, the European Central Bank late Wednesday evening launched a massive quantitative easing package (the Pandemic Emergency Purchase Programme) worth €750 billion. This came on top of the €120 billion announced last week. While the general aim of the programme is to support the free-falling euro zone economy, it is clear the move came mainly as a response to Wednesday's sharp widening of bond spreads across the euro zone. The message is clear. The ECB will do whatever it takes to contain borrowing costs—this is especially relevant for the southern European countries—to allow euro zone governments to spend as much as they want on their fiscal response to the COVID-19 crisis.

The PEPP is expected to continue until at least the end of the year, and will consist of public and private asset purchases. A major feature of the package is that purchases will now be expanded to commercial paper—a short-term debt instrument issued by corporations—which is a first for the ECB.

Most important, though, is that the size of the package is monumental. Adding it to the bank's previously announced QE commitments, the ECB now is set to buy as much as €1.05 trillion of assets until the end of the year. This would mean an average of €116 billion purchases per month, considerably larger than any monthly purchases in any previous ECB programme. For comparison, from 2015 to 2018 the ECB's monthly QE purchases averaged €60 billion.

Another key feature of the package is that it is flexible. Not only is the timing of the purchases left open-ended, meaning the ECB could frontload all of it if it wanted to, but the bank also made clear that it will be flexible about its capital key, which is the benchmark for the purchase allocation across member states. This means the ECB could now focus on purchases of Italian bonds to ensure a reduction of spreads. Also of note is that the bank will start buying Greek debt for the first time in history.

The ECB didn't abandon its self-imposed '33% issuer limit' rule yet. This rule constrains the maximum share of an issuer's outstanding securities that the ECB can buy to 33%. This may be a problem, because the central bank is close to exceeding its issuer limit for several countries, notably Germany and the Netherlands. But two main considerations are at play. First, governments are now likely to issue a lot of extra debt because of the COVID-19 crisis, which will raise the pool of eligible assets for the ECB to buy. Second, the bank made clear that it is ready to abandon any self-imposed limits in coming weeks if it deems necessary, and the language on 'flexibility' was strong. Thus, our view is that the ECB won't hesitate to raise or even outright abandon the issuer limit rule if it faces a roadblock.

In short, the ECB's action on Wednesday was historic and showed that the bank finally came to terms with the magnitude of the crisis. The key takeaway is that it is allowing governments to go big on their fiscal responses, which we believe is mandatory if it wants to prevent the euro zone economy from plunging into the abyss. More important, we think the ECB wouldn't hesitate to go even bigger if necessary, confirming our view that monetary policy has not reached its limits just yet.