European Central Banks boosts support for financial markets

By Nick Beams
5 June 2020

The European Central Bank has ramped up its emergency bond-buying program—introduced in mid-March to counter the meltdown in financial markets as a result of the COVID-19 pandemic—to €1.35 trillion.

The decision to lift purchases under the Pandemic Emergency Purchase Program (PEPP) by €600 billion, from an initial amount of €750 billion, was warmly welcomed by financial markets. The euro reached its highest level against the US dollar since March and stock markets rose on the back of the decision as the ECB brought its policy response closer into line with that of the US Federal Reserve

Reflecting the favourable response to the decision to make still more money available through the PEPP, one London-based investment fund manager told the *Wall Street Journal*: "The ECB is very well known to be behind the curve, acting only at five minutes to midnight, but now they are ahead of the curve."

In her review of the state of the euro zone economy delivered at the start of a news conference yesterday at which she announced the new move, ECB president Christine Lagarde said the latest data confirmed that the region "is experiencing an unprecedented contraction" and there had been an "abrupt drop" in economic activity as a result of the pandemic.

She said while real-time indicators showed some signs of a "bottoming-out" in the plunge "the improvement so far has been tepid compared with the speed at which indicators plummeted in the preceding two months."

In her words, as in the rest of the world, there is no prospect of V-shaped recovery—a scenario widely promoted at the start of the pandemic.

Lagarde said June macro projections were for growth declining at "an unprecedented pace" in the second quarter before a rebound in the second half of the year. Overall annual euro area GDP was expected to fall by 8.7 percent in 2020 before rebounding in 2021. But Lagarde did not rule out an even deeper downturn and cautioned that "the overall scale and speed of the rebound remains highly uncertain."

Press conferences following the meetings of the ECB's governing council always have a certain air of unreality about them because of the central bank's single mandate which is to maintain price stability and a level of inflation around 2 percent.

This means that decisions which have really nothing to do with price levels, and are directed to providing a boost to financial markets, have to be justified in official statements as if they did.

This type of shadow play was particularly in evidence at yesterday's press conference because it was the first to be held after a decision by the German constitutional court on May 5 that called into question whether the Bundesbank, the German central bank, could continue to take part in the ECB's bond buying program.

The decision reflected opposition in some sections of the German financial and political establishment to what they regard as ECB operations to bailout southern European countries and finance their governments' budget deficits.

Lagarde was questioned about the decision of the German constitutional court a number of times during the press conference. In reply to one of those questions, she noted that the European Court of Justice had ruled that the ECB's actions have been in line with its mandate.

"[A]ll of us, take note of the judgement passed by the Karlsruhe constitutional court, which is directed at two parties; the German government and the German parliament. We are confident that a good solution will be found… which will in no way comprise the independence of the ECB, primacy of European law and decision by the European Court of Justice."

However, the fact that the question continues to be raised means this is by no means a settled issue.

One questioner pointed out that when the PEPP was first announced in March the word "inflation" did not appear in the statement and asked whether its inclusion in the announcement to expand it was in part aimed at providing the explicit rationale being insisted on by the German constitutional court.

In a number of answers about the operations of the PEPP Lagarde made clear that euro zone financial system was facing a severe crisis in the middle of March. She said its introduction on March 18 had "prevented the downward spirals to financial markets and reduced any tail risks at the time without which we would have been in a seriously different situation in terms of both growth and inflation outlook."

She said it had been decided to increase the size of PEPP because financial conditions in the euro area had become "significantly tighter" in a situation where the economy needed easier conditions.

Commenting on reports that not all members of the governing council had been prepared to support an increase in the PEPP, Lagarde said "there was a unanimous view" that action had to be taken.

The latest ECB decision is significant, not only because the size of the intervention—an increase to €1.35 trillion in new asset purchases on top of the more than €2 trillion it already holds—but the broadening scope of those purchases.

Lagarde pointed out that the ECB had included a "significant amount of corporate bonds—almost €46 billion worth under the PEPP program up to May 29—and that it had decided to shift a large share of our purchases to commercial paper."

This indicates that, like its counterpart in the US, the ECB, the world's second most important central bank, has become the chief backstop and prop for all areas of the financial system—from long-term government debt to corporate debt and short-term commercial paper.
