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TRANSCRIPT

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Speakers:	Rebecca Pilendiram-King, Global Liquidity Solution Specialist, GTS, Bank of America Ruben Segura-Cayuela, Head of Europe Economics Research, Bank of America

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Attendance List: Rebecca Pilendiram-King
Ruben Segura-Cayuela

Title of Meeting: Bank of America 2021 Global Liquidity Speaker Series

Hosted By: Rebecca Pilendiram-King

Coordinator: Good day and welcome, everyone, to the GTS 2021 Global Liquidity Speaker Series, titled "Europe and a Look Ahead, Recovery Interest Rate and ECB" call. My name is Matthew and I am your operator today. During the presentation your lines will remain on listen only. I would like to advise all parties that this call is being recorded for replay purposes.

And with that, I'll hand it over to your host, Rebecca Pilendiram-King. Please go ahead.

Rebecca: Thank you, Matthew. Welcome, everyone, to today's Liquidity Speaker Series, and thank you for dialing in. I'm Rebecca Pilendiram-King, Global Liquidity Solutions Specialist focusing on EMEA large corporates. And I'm excited to be joined today by Ruben Segura, who is Head of Europe Economics Research at Bank of America. Welcome, Ruben, and thank you for joining us today. We very much look forward to hearing your insights.

Today we will be discussing a number of topics focusing on Europe, covering the ECB, the pandemic recovery, and the negative interest rate environment. We're going to open today with something that is current and topical, and is looking at the contrast between the European Union and the US recovery.

So, Ruben, welcome. My first question to you is, what makes the EU recovery different from that in the US? And perhaps you can give us your thoughts on the shape of the differences.

Ruben: Hello. Thanks, Rebecca, for inviting me. I think that first question is very important, and particularly because right now when reopening is happening and activity is accelerating across the world, at least the developed world, we tend to forget fundamentals. And that is something that will matter once the ECB fund growth is over, the reopening phase is over.

What is the difference between what we're seeing in the US and the European recovery? Well let me start with the numbers. We are forecasting GDP growth in the US of 7% this year, and 5.5% maxed. In Europe, in the Euro Area in particular, those numbers are 3.3% and 3.5%. And that comes after a contraction in GDP during 2020 that was doubled in the Euro Area than in the US.

What is the difference that leads to such an incomplete recovery in Europe rather to what we are seeing in the US? It's all about fiscal support. The fiscal response in the US was much more forceful. It was larger, faster, and better designed. And this is not new. You don't even need to take into account the latest fiscal package in the US. That was already the case throughout 2020.

Let me just put it in perspective. The US is supposed to go back to pre-COVID trend, which means that the US will end up being in better shape already this year than what we were expecting before COVID happened. In Europe, we will not reach the level of activity we had in 2019 until sometime in the second half of 2022, and it will take a few more quarters to get to pre-pandemic trend.

This has massive implications, and that's the bit that I would warn you to remember. Now it has implications for scars. Insufficient fiscal support means solvency issues are going to be appearing across European economies. I'm not talking about large corporates. I'm talking about SMEs in the service sector.

We did a paper where basically we showed that the number of bankruptcies after you lift all the emergency measures could be as much as twice what we saw in 2011 in the region. And it has implications for the whole reflation theme that people are pushing now.

In the US we have inflation going above target already next year. In Europe, we have inflation stuck at 1%, core inflation is stuck at 1%, at least until 2022. So if you want to convince me that reflation is happening, that inflation will be a significant theme in Europe, you need to convince me how you can get that with core stuck at such low levels.

So certainly, lots of different elements to the recovery path between the US and Europe. As I said, it's very hard to target them right now that we are reopening and activity in Europe is about to accelerate a lot, but certainly it's worth keeping them in mind for the latest part of this year and beyond.

Rebecca — Thank you, Ruben. That was really insightful. So essentially what you're focusing on there is that you believe that the fiscal response from the US has been essentially slightly more efficient than that that we've experienced in the EU. But I think we're going to delve more into that as we move into the questions.

So perhaps I can move on to my next question topic effectively. Given that we've seen a very supportive central bank in regards to monetary accommodation, how do you see this continuing over the coming months specifically?

Ruben — You're right, central banks across the developed world actually have been extremely supportive, and they've been extremely diligent dealing with the consequences of COVID. Basically the textbook way of dealing with COVID is that the public sector had to help the private sector digest the loss of income that came with slowdowns, and then the central banks had to help the public sector smooth that over time by keeping funding costs as low as possible.

And they've done an excellent job. In the case of the ECB, we were already running traditional QEs so they were buying assets at a rate of 20 billion per month. But when COVID started, that was not enough, and they came up with what we call PEPP, the Pandemic Emergency Purchase Programme. This is a program that is supposed to last until March of '22, and this is a program that has been extremely effective because of its flexibility, keeping rates low but also spreads quite low.

What I would expect from the ECB is to remain very accommodative for a very long time. Remember, inflation is, as I told you, well below target. It's been below target for a very, very long time. The ECB right now is in the process of finalizing its new framework, what we call the strategy reveal, and that will conclude sometime in the second half of this year. And that means some of the aspects of the way the ECB acts will be changed.

What I would expect from that process is for the ECB to first move to a symmetric inflation target, but more importantly to promise an inflation upshift. So to promise that they will tolerate inflation above 2% for some time to compensate for the fact that it's been well below 2% for a few years.

And that means that to make that promise credible, asset purchases will need to continue beyond March '22. I don't think PEPP will be the tool that will likely end in March '22, but traditional QE, which as I told you is still running, will likely be increased in size to compensate for the fact that PEPP is going.

So very accommodative for quite some time. But we have a bit of a mess right now with the central bank. Why? Because the central bank back in December of this year promised to "preserve favorable financing conditions," and I'm quoting them here. The problem is that they agreed on that wording but they never agreed on what they meant by that wording.

And there's a huge disagreement within the members of the governing council of the ECB on what that implies. Should we make sure that nominal yields do not move much? Should we make sure that real yields do not move much? Should we tolerate higher nominal or higher real rates? They all have a view. They all have a very different view, with about 25 different views on the matter. And that's not helping.

This has been happening since September. When you don't have a clear reaction function, that is an indication for markets to test the pain threshold, and the market tested the pain threshold of the ECB in February. That pushed them into promising to buy more assets using debt, or buy more aggressively, and this is what they have been doing since then.

But they still have not clarified what they're trying to do beyond buying more for three months. So the market is back at trusting them and will continue to do that so until the June meeting. And in fact, our rate strategies have run short real rates on the back of what we expect is a continuation of the market testing them.

My working assumption is that this market pressure forces them to do the right thing and tolerate a little movement in yields. Then that would allow them to reach all the way to the conclusion of the strategy review, and then you would get what I described.

But there is a significant risk that given the internal disagreements they don't do the right thing. And if they don't do the right thing, then the credibility of whatever outcome we get from that strategy review will be questioned. And then we would have a very significant mess. You would expect a lot of volatility when it comes to yield rates and spreads.

Rebecca: Understood. Thank you, Ruben. That commentary actually really leads me into my next question, which is to have a look at the longer term. So something I'm asked a lot by clients about is the negative interest rate environment, particularly in regards to the euro. And given that we've been living with a negative euro now for almost seven years, probably quite unbelievably, and reflecting on your comments in regards to the central bank's monetary accommodation, when do you think we might see an exit from the negative interest rate strategy? And also perhaps as a two-part, what drivers will be required essentially to achieve this?

Ruben: Never. No. Jokes aside, I think we need to differentiate between two different ways of exiting negative rates. The first one is basically to try to think when the ECB might be able to start a hiking cycle, or a reversal of the very easy monetary policy we have right now, and that's going to take a very long time.

Remember what I was telling you, we and the ECB are forecasting inflation well beyond target even by the end of 2023. The ECB will promise that inflation [indiscernible - 47:25], which means getting to 2% will be not enough to start thinking about hiking, you've heard me to stop asset purchases before you even start thinking about hiking rates. So altogether there's still a few years before we can even start thinking about thinking about hiking rates.

Now there is another option, which is the Riksbank move. Now remember that a couple of years ago—if my memory is still okay—the Riksbank did what I would call a re-flooring exercise. They had gone into negative, like the ECB did, and at some point what they told us is, look, we went into negative thinking that it would be temporary, that going into negative rates would help us going into a hiking cycle faster. But now we've realized this is not going to happen anytime soon, and we really don't like negative rates for a very long time. So what we're going to do is we are going to move those negative rates back at zero, and we promise that they're going to stay at zero for a very, very long time.

That's something that the Riksbank did. And that's something that if you do you have to make sure that when you do it you are not creating tighter monetary conditions, tighter financial conditions for the economy, because you are acknowledging first that negative rates forever are bad, but also that the economic situation is not great. That means that you can only do that when you have a significant slope in the curve, because what you do is you hike short-term rates, you re-floor short-term rates, but you flatten the whole curve, making sure that you compensate with a flatter curve the fact that you are lifting the short effect.

This is something that I thought the ECB could do back in 2018. So in 2018 I thought that maybe by 2020 we should have a re-flooring from the ECB, particularly in the context of the strategy review, which initially was meant to be concluded in 2020 but then COVID happened.

At this point, I think it's very, very hard for them to do so. There's going to be a discussion on this. There's going to be pressure on them to re-floor negative rates. But I don't think there is enough of a slope in curves for them to deliver a re-flooring of negative rates into zero without significantly tightened financing conditions. So in a way the door has been closed on that option, and we will need to wait until a proper hiking cycle of this to materialize.

Rebecca

Thanks, Ruben. So clearly at the end of the day we see a status quo for some considerable time to come. Perhaps never is a very long time, but it clearly isn't going to change, even longer term, in terms of what you've described. That was really interesting. Thanks, Ruben.

So maybe now we can kind of move on to the pandemic situation and thinking about some of the response to that. I've kind of structured this question in two parts. Firstly, delving more specifically into the EU response to the pandemic, can you outline what the EU has determined they're going to do to support the member states? And then perhaps secondly, how do you see this impacting the future landscape of the EU countries and their recovery?

Ruben

That's an important question. Let me give a bit of background. I would divide the response in three different parts. First, you have the national response, the national fiscal response, and this is what all these emergency measures—short-time working schemes, monetary, etcetera—come into play. And this is mainly the part, when I say that the fiscal effort has not been large enough, this is the part that has been short.

And then you have the European level response, which is a combination of two elements. First, there is the ECB, which we have already discussed the ECB, and then you have the famous Next Generation EU, what a lot of people know as the recovery fund.

Let me put it in perspective, to argue how this is going to affect the outlook. Back in March 2020, remember fragmentation risks were increasing very significantly, even Europe [indiscernible – 52:53], when countries were fighting for masks and protective equipment was increasing quite rapidly in certain countries.

The COVID shortage generated massive funding needs, so you needed a response from the ECB. And this is what PEPP did. Basically the PEPP tool made sure that the net funding needs created by COVID could be digested, obviously in the short run. But that was not enough. You needed something else because the ECB can help with net funding needs, but it cannot replace every single foreign investment, particularly every single foreign investment in the periphery.

So you needed something else that convinced foreign investors to stay put, and this is what the recovery fund provided you. Why? Because it was a move towards more Europe. In a moment in which Europe's indiscernible and fragmentation risk was increasing, Europe decided to cross several red lines they had never crossed. So it was a movement towards more Europe.

So what's NGEU? NGEU is a tool that will in principle mobilize up to 750 billion within six years. The first point I would make is that this might look like a lot, but when you split into six years, it's less than 1% of GDP per year. So compare that to what you've seen in the US, so size-wise, it's not huge. It's not a game changer, but its money that is meant to be used to reconstruct and I would say redirect the European economy, 35% of the money will go to green transition, 20% will go to digital transition. And it's money that will be raised at the European level, so it's common debt issuance in a very larger scale. That's one of the red lines that has been crossed.

It's money that allows for a huge maturity transformation. This money won't get repaid for a very, very long time. It incorporates from small fiscal transfers between countries, and it has a bit of a Hamiltonian aspect to it. Hamiltonian, meaning that it's something that's being converted into a permanent tool, the type of tool of the prototype we use every time we need to save some kind of shock. And there is an interesting aspect from the whole proposal of NGEU, which is the capacity of creating EU-wide taxation. So you give the EU a permanent expenditure capacity, which is a more Hamiltonian aspect to it.

So what I would try from NGEU is that macro-economically it helps, but it's not a game changer. Now, what the joint response between the ECB and the NGEU provides is time, and the countries need to use that. They have a few years to deploy those resources, but also to do the necessary reforms to actually fix some of their deficiencies or vulnerabilities that their economies suffered, and they have suffered for many, many years. So in a way, this gives you may be the last opportunity to fix some of the long-standing structural issues in a lot of these countries.

And the design of the NGEU is that to receive the money you actually have to deliver on those reforms. So at least the design, is very, very interesting, and you get the next set of conditions to actually deliver a powerful tool.

Rebecca: Thanks, Ruben. That's really interesting. Are there are any countries that you think that we should spotlight specifically in terms of how this response is evolving? And perhaps it would lead into some of the commentary you made around segmentation. With the NGEU and the recovery occasion, do you think that it's going to prevent future fragmentation of the EU whilst they navigate through the pandemic scenario and the recovery overall?

Ruben: On the second question, not in the short-term unless the ECB really does something very silly in the June meeting and in September. So while we keep that these two responses, the ECB extremely active plus the deployment of NGEU, I think an additional risk should be kept at bay. The key question is, what happens three years down the line? Did we take advantage of the time bought to deliver on implementation of NGEU, but more importantly on implementation of those much needed reforms.

And you were asking about countries, we're just learning the content of what countries want to do with the money they are going to receive, how they're going to deploy that money, and which kind of reforms they plan to do. There is certainly not enough information at this point, and whenever there is information there's too much of it.

Just to give you an idea, the German recovery plan that they submitted is 1,200 pages. The Italian one, if I recall correctly, is 400. So I'm still trying to digest all that information. But let me highlight something, which is that Italy is doing a very, very, very good job on paper. So Draghi seems to have a very clear plan.

All I said about insufficiencies of response, well Italy is clearly standing out form the pack on the fiscal response that they are trying to implement right now with Draghi. They are stepping up the national response, but they are also trying to use NGEU as much as they've been allocated.

Now NGEU has two components. Some of the money will get distributed as grants to countries. Some other will be distributed as loans. Italy is saying, I'm going to take all grants or loans. I'm even going to add money from my own. And we are going to deploy that very ambitiously, as quickly as possible. On top of that, I'm going to add some very ambitious reforms.

So what I would argue is that at least on paper the Italian recovery plan looks much better than what I've seen in other countries that either do not plan, for instance, to make use of the loans or are a bit weaker on the reform proposal. I said on paper, you need to deploy that and you need to deploy it efficiently. There's no warranty that we will have implementation rate, that we'll have implementation problems. There is no warranty that the government will stay for the full deployment of NGEU, which is six years, and in fact it's very likely these governments want to stay for the full deployment. But at least from the beginning, all the necessary ingredients for a successful plan are there, which cannot be told for other countries.

Rebecca

Great. Thank you, Ruben. There's clearly a lot more to come from the temporary boost implications that they take effect in the coming years. And that insight has been really, really useful.

Sadly, we're nearly out of time. But before we close, I'd like to say a very big thank you, Ruben, for joining us today, for taking the time to share your thoughts and insights. And hopefully Ruben's provided us all with some fascinating insights and I've no doubt that everyone will take some invaluable themes and concepts away from today's speaker series.

It only really remains for me to thank you all for dialing in, and I will now hand you back over to Matthew, our coordinator.

Coordinator

Thank you very much, everyone. That concludes your conference call for today. You may now disconnect. Thank you for joining and enjoy the rest of your day.

[END OF CALL]