Flash

Monday, 30 November 2015

# Can the ECB deliver without disappointing?

ECB will likely cut the deposit rate further below zero…

..and maybe install a two tiered system…..

The QE programma will be changed in various ways:

- Monthly amount bought will be raised by maybe €20B
- Programme to be extended beyond 2016, maybe even made open-ended
- Assets purchased will be enlarged to local & regional government debt, maybe also to corporate debt or bundled loans…

TLTRO programme may be extended too

**ECB president Mario Draghi** was widely expected to strike again a dovish tone in the press conference following the October ECB meeting. He did so, but went even further than at the September meeting to the point he de facto pre-announced a further easing of policy. "*In other words,* Draghi said, *if one had to summarize what was the attitude or the stance of the Governing Council discussion today (October meeting), **one would say it was not "wait and see", but it was "work and assess".***

During the whole month of November, various key members of the ECB executive board including chairman Draghi massaged markets further in the direction of a substantial further easing of policy. The markets clearly signaled they received and fully understood these signals from the ECB tower in Frankfurt. Forward eonia rates dropped easily below the negative ECB deposit rate of -0.20% and the current eonia rate of -0.14% to about -0.30%. Longer dated yields fell too (5-year swap trades at about 0.17% and so did the euro. Peripheral spreads narrowed. **In other words financial conditions eased significantly on expectations of bold ECB action**.

Importantly, markets took their cue from ECB comments rather than the evidence of the latest batch of economic data. Since the late October ECB meeting, euro area activity indicators strengthened and both headline inflation and underlying inflation, rose slightly. Market inflation expectations were also slightly higher, even as the oil price dropped again.

**In normal times, the latest information on the Eurozone economy might have been enough for the ECB to stay sidelined and continue a "wait and see" stance**. Now, however, there is almost universal agreement that the ECB will take further drastic unconventional, measures aiming at strengthening growth and bringing inflation faster back to its objective of close to, but below 2%. **Why is the market so sure about this?** Effectively, this is down to the credibility of Mr Draghi. He and the other ECB governors cannot first steer markets in their desired direction by words and when it succeeds, refrain from doing what has moved the markets in the first place. **Mr. Draghi is regarded as a master in massaging financial markets ahead of decisions and traders are very aware that he often alters policy more boldly than markets anticipate.**

Mr Draghi's track record means market participants surely know that betting against him can be costly. Within the first few months of his tenure (end of 2011) He reversed the rate hikes implemented only months before by his predecessor and brought the repo de facto to zero. He effectively ended the euro crisis with his "whatever it takes" statement. He lowered the deposit rate below zero and started the massive programme of sovereign debt purchases. Most of these measures were taken in the face of opposition from the once so mighty Bundesbank representatives in the ECB council. Once again, these officials have openly spoken out against more measures, but doubtless Mario Draghi will prevail again. **So, we do expect Mario Draghi to take far-reaching extra measures.** However, can he again surprise markets with even bolder actions, as markets have already discounted a lot in market prices?

Before we speculate on the various measures that may be taken, we quote in length Peter Praet, the ECB chief economist and together with Mario Draghi one of the architects of the current unconventional policy, who explained why the ECB cannot be satisfied by the current (improved) environment.

*"On the face of it, the incoming data points to an overall picture of normalisation in the euro area economy."*...... "**Yet policymakers have to set this positive snapshot of the economy against a wider backdrop that is less compelling**. *The risks around the evolution of the global economy have shifted downward, making the contribution of external demand to the recovery less assured. Domestic demand, though rising, also appears relatively weak if one considers that we are still in an early phase of the recovery and that there are important tailwinds supporting the economy – namely our monetary stimulus and lower oil prices. Investment has so far failed to perform its "accelerator" role for the recovery."*

**"So how should the central bank react in this environment?"** *"Any potential action needs to be viewed in a context where the balance of risks to fulfilling our objective is on the downside." ..." a central bank cannot allow itself too much discretion over the time horizon when inflation should return to its target. A numerical objective which is rarely realised – looking forward and in retrospect – is no hard objective. Our independence rests on the fact that we are accountable, and that means delivering price stability over a horizon that is verifiable by the public." "Moreover, central banks know that if they lack a verifiable commitment to control inflation symmetrically over a horizon for which the public retains some visibility, this can result in inflation expectations becoming "unanchored". **It is in this spirit that a central bank may choose to proactively counter downside risks and thereby underpin the public's faith in the effectiveness of monetary policy."***

## QE buying: More and longer

At the October meeting, Draghi suggested that the QE programme should be reviewed if conditions had changed for the worse since it was put together in early 2015. ***"And to the extent that these conditions change and possibly worsen, we will have to adjust our QE programme or in general our monetary policy stance. That's the sense of our discussion about downside risks."***

**We expect relatively minor changes to the 2016 and 2017 growth and inflation expectations,** given also the technical assumptions like the weaker euro, the lower yields at tenors to and the stable oil prices when compared to the September ECB staff forecasts. *Dramatic changes are* **not needed to adapt and re-inforce the QE programme though, as one more year has expired since its start and inflation is still seen well below the objective in the medium term**. Indeed it is the absence of marked *upward* revisions to inflation that is the main argument being advanced for further policy action. Praet clearly said that the longer one stays away from the inflation objective, the bigger the chances that inflation expectations become de-anchored.

## One year extension or open-ended?

**So even possibly unchanged inflation projections may be used to justify an extension of the duration of the QE programme. We expect it to be prolonged for one year or to be made open-ended**. Draghi is heavily influenced by the past Fed policy. The Fed's third QE programme was open-ended. Instead of time dependent, QE became data-dependent ("until the outlook for the labour market has improved substantially in a context of price stability"). The ECB might commit to buy assets as long as one or another inflation goalpost has not been reached. However, extending the programme would do little to speed up the return of inflation to levels closer to the ECB's target through the next year or so. As a result, the ECB will most likely also **raise the amount of monthly purchases signalling the intention to reach its target faster**. We think they may raise the monthly amount by €20B to €80B.

## Regional & Local debt, maybe also corporate debt or bundles of loans

**The ECB will probably expand the scope of its buying programme to regional and local debt.** The EU gave (start 1 Jan. 2016) recently regional and local debt a similar favourable regulatory treatment then central government debt under Solvency 2 (applicable on insurers and pension funds, not banks). It makes investing in this kind of debt more favourable. The EU decision has no obvious immediate link with the QE programme, but as the ECB will have to buy more debt, they will need to expand the scope of the assets that qualify for buying. It is well documented that the ECB will have difficulties to buy enough German (and some other countries) sovereign debt under the existing quota system to reach its QE target of about €1.1 Trn (based on the size of the country, the 2-to-30-year maturity boundaries, the inability to buy debt yielding less than the deposit rate and finally the 25/33% issue limits in case of debt with or without CAC clauses). **German Länder have however substantial debt outstanding**. Allowing to buy this debt would help the ECB reach its purchase targets. It was also one of the modifications under discussion at the ECB according to the famous Reuters article based on ECB "sources". **Regarding corporate debt**, it would be more symbolic than substantial, as we think that there is not that much corporate debt to buy that fulfils reasonable criteria about size, credit quality and equal treatment. Finally, the **Reuters article mentioned (based on ECB sources) the possibility the ECB would start buying rebundled loans at risk of non-payment**. We suspect it would be a kind of securitization in which the ECB buys the higher rated tranches. This measure might be intrinsically positive for banking systems like the Italian one that have lots of non-performing loans. However, we suspect that this kind of measures goes too far for too many governors to get accepted at this juncture.

## Lower deposit rate (-30 bps?)

Mario Draghi said at the October press conference that the option of lowering the depo-rate had been discussed. This was an important signal as previously the ECB seemed to suggest that this key policy rate had hit their lower bound. We think this major shift largely reflects the effect changes to the deposit rate are seen having on the exchange rate of the Euro. It is likely to be the most effective tool the ECB has to weaken the euro. Draghi said the following on the subject: "***one of the downside risks to our inflation projections comes from the exchange rate.*** *As I've said before, the nominal effective exchange rate* ***has been appreciating*** *over the last few months – four, five months – to a somewhat significant level. But let me restate****: the exchange rate is not a policy target for the ECB. It's never been; it's not now. However, it's significant, as I've just said, for price stability and for growth."*** The sharp weakening of the euro since the press conference proves the effectiveness of a lower deposit rate. Disappointing markets by not lowering it now might lead again to an appreciation of the euro. A lower deposit rate also helps the ECB bond buying, as the ECB doesn't buy bonds yielding less than the deposit rate and the measure enlarge the universe of eligible bonds.

**The market has now discounted about a 15 basis points cut in the deposit rate** (eonia forward trades currently near -0.30% and usually trades about 5 to 7 basis points above the deposit rate). We are conservative on our call for a 10 bps cut, which is also the consensus and are aware that the ECB might choose for a bigger cut. 12 of the 44 economists participating in the survey expect a cut to -0.40 basis points and one even
-0.45%. **There are four elements to our comparatively cautious call in this regard**. First, as indicated above, recent economic data don't point towards any need for dramatic action at this point. Second, that take the deposit rate into ever more negative territory represent something of a leap in the dark. While this is true of most unconventional measures, we think this argues for small steps rather than giant leaps. Third, to the extent that the exchange rate is a key consideration in this decision there may be a desire to have some leeway to act further in the (unexpected) event of Euro strengthening. We suspect that the ECB doesn't see infinite scope for deposit rate cuts. We wouldn't be surprised if they regarded cuts below -0.50% as likely to entail potential costs to the financial sector as significant as the benefits that might follow in terms of a weaker exchange rate. The final argument for a modest adjustment to the current deposit rate relates to rumours about the possible introduction of **a two tiered system** in which banks would pay a standard rate (e.g. -30%) for a limited amount of liquidity they park at the ECB and a still more negative rate (e.g. -0.50%) for amounts above that limit. Such an approach would lower the associated costs for the banking sector. It would also hit the German and French banks proportionally more than others as they park more money at the ECB, while banks of peripheral countries would largely escape the penalty. **A big deposit cut might spark accusations of a beggar-your neighbour policy action that may rekindle concerns about currency wars.**. A small 'headline' deposit rate cut together with the introduction of a second notably more penal deposit rate could be more readily justified on the basis that it is intended to avoid excess funds being parked with the ECB. It might also represent a compromise within the council to appease the hawks who don't feel further measures are appropriate now. Finally, this would signal to markets that more cuts are possible which is very important if the ECB wants to avoid a market correction based on a judgment that the ECB has now eased policy as far as is possible. Some subtle combination of this sort would also be consistent with the **idea that Draghi always does more than markets expect, even if we stick to our 10 basis points 'headline' rate cut expectation.**

## TLTRO programme extended?

The targeted longer-term refinancing operations, put into place in mid-2014, allow banks to fund themselves easier and thus help restore the functioning of the transmission mechanism. It was linked to the loans provided to the firms and households. After a relatively high take-up in the initial operations, banks lowered their demands quite sharply in the more recent ones. The reason is obvious. The cost (repo-rate) exceeds the investment opportunity in most cases with swap rates negative till the three year tenor, which is the duration of the TLTROs. The last TLTRO operation is scheduled in June 2016. Despite the low take-up, the ECB might extend the programme.

## Impact on other central banks

**ECB decisions have already affected other countries and the policy of their central banks, but in case of a deeper deposit rate cut and a bigger than expected QE programme, there** might be again pressure on the currencies like the Danish, Swedish & Norwegian crowns and the Swiss franc and thus eventual further easing by their central banks (eventually via FX interventions if rates are already deep below zero). We don't think it will influence the Fed's decision on a lift-off in two weeks' time, but the more the dollar strengthens, the softer the Fed guidance will be on the gradual nature of the tightening path.

**Piet Lammens, KBC Brussels**
**Austin Hughes, KBC Dublin**

# Contacts


| Brussels Research (KBC) | | Global Sales Force | |
|---|---|---|---|
| Piet Lammens | +32 2 417 59 41 | **Brussels** | |
| Peter Wuyts | +32 2 417 32 35 | Corporate Desk | +32 2 417 45 82 |
| Joke Mertens | +32 2 417 30 59 | Institutional Desk | +32 2 417 46 25 |
| Mathias van der Jeugt | +32 2 417 51 94 | France | +32 2 417 32 65 |
| **Dublin Research** | | London | +44 207 256 4848 |
| Austin Hughes | +353 1 664 6889 | Singapore | +65 533 34 10 |
| Shawn Britton | +353 1 664 6892 | | |
| **Prague Research (CSOB)** | | | |
| Jan Cermak | +420 2 6135 3578 | **Prague** | +420 2 6135 3535 |
| Jan Bures | +420 2 6135 3574 | | |
| Petr Baca | +420 2 6135 3570 | | |
| **Bratislava Research (CSOB)** | | | |
| Marek Gabris | +421 2 5966 8809 | **Bratislava** | +421 2 5966 8820 |
| **Budapest Research** | | | |
| David Nemeth | +36 1 328 9989 | **Budapest** | +36 1 328 99 85 |


**ALL OUR REPORTS ARE AVAILABLE ON WWW.KBCCORPORATES.COM/RESEARCH**