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Reality check

ECB post-meeting comment

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Summary

- Amidst increasing and more prolonged risks to the baseline outlook, the ECB extended its forward guidance to the middle of next year.
- Yet, TLTRO-III pricing was not as generous as markets had hoped. President Draghi explained it was mainly seen as a liquidity backstop.
- However, from President Draghi's press conference it became very clear that the ECB is actively preparing for the risks to the outlook. To our minds, the odds of a rate cut have increased, and new asset purchases cannot be ruled out either if risks materialise.

Policy decisions

- The ECB kept its key rates on hold, with the deposit rate at -0.40% and the refi rate at 0.00%.
- Forward guidance on rates was extended to *"at least through the first half of 2020"*.
- Forward guidance on reinvestments was reconfirmed as *"an extended period of time past the date when it starts raising the key ECB interest rates, and in any case for as long as necessary"*.
- TLTRO-III will be priced at MRO+10bp, with a potential discount to deposit rate+10bp.

Markets are disappointed

In addition to announcing the full details of TLTRO-III (see below), **the ECB extended its forward guidance to rates being kept on hold *"at least through the first half of 2020"*.** This adjustment came earlier than we (and probably most market participants) had expected. Nonetheless, it left markets –whose expectations for today's meeting had probably gotten ahead of themselves– slightly disappointed as no new measures, such as a tiered deposit rate were announced. In that sense, today's meeting was perhaps a bit of a reality check for the markets.

As Draghi explained, the decision to extend the forward guidance was based not on a deteriorating baseline outlook, but rather on the protracted and increasing downside risks to this baseline. Indeed, overall the **changes to the projections were relatively modest**, with this year's forecasts slightly higher and small cuts to the projections for the next two years. However, despite the ECB's baseline being relatively similar, Draghi stressed that risks have increased and are lasting longer now, given that we haven't seen a US-China trade deal, nor a Brexit deal being signed.

Although the inflation projection for 2021 was kept unchanged, Mr. Draghi underscored the importance of this 'miss' of its medium-term objective by noting that a granular discussion about the GC's policy options also included a discussion about the symmetry of the ECB's inflation target. The emphasis on symmetry only puts this 1.6% further away from their goal.

Table 1: Comparison of GDP projections

	2019	*2020*	*2021*
June 2019	**1.2**	**1.4**	**1.4**
March 2019	1.1	1.6	1.5

Source: ECB

Table 2: Comparison of inflation projections

	2019	*2020*	*2021*
June 2019	**1.3**	**1.4**	**1.6**
March 2019	1.2	1.5	1.6

Source: ECB

TLTRO-III: Only a backstop?

As anticipated, the ECB released the full details of its upcoming TLTRO-III. Base pricing, at MRO+10bp, was not received too well by the market. Consensus, including ourselves, had expected pricing to be MRO-flat at most. However, there was also a positive surprise: the rate that applies if a bank's lending targets are met would fall to 10bp over the deposit facility rate. At current levels, that is -0.30%. While this is higher than the -0.40% on TLTRO-II, it is cheaper funding than the expectations of MRO-20bp.

We believe that this design –a slightly worse base price, but still a decent incentive– gives two signals. First, TLTRO-III is intended as a backstop, as Draghi emphasised himself. The base rate is worse than the rate applied to the shorter 3-month LTRO operations, and this is clearly to discourage banks from using TLTRO-III for speculative reasons, such as carry trades. The fact that the loans cannot be repaid early also supports this notion. Second, the slightly better-than-expected rate for banks that meet their lending targets suggests that the ECB does want to ensure that lending remains on track. This is also apparent in the relatively lenient 'benchmark' that must be met in order to apply for the 'discounted' rate.

All-in-all, it seems that the ECB wants banks to start relying more on market-based funding again, which means that they shouldn't be too concerned with a modest decline in excess liquidity as a result of negative net use of the TLTROs. However, as Draghi added, the TLTRO-III is intended to avoid cliff-effects in this shift back to market-based instruments: it seeks to ensure that credit provision to the real economy remains healthy.

But plans are clearly being made

Yet reality is also sinking in with the Governing Council. And despite the market's disappointment with today's policy decision, we believe that Draghi signalled that the ECB is getting ready to deploy more easing if this is necessary.

The Eonia forward curve shifted up as Draghi didn't immediately see the need for deposit rate tiering, which saw the market price out some odds of a rate cut. **However, we would argue that the odds of another deposit rate cut have actually increased.** Although Draghi did note that *"at this point in time, the positive contribution of negative interest rates to the accommodative monetary policy stance and to the sustained convergence of inflation is not undermined by possible side effects"*, he later admitted that this situation could change if the ECB were to extend its guidance again or possibly even cuts rates. Whether it will require mitigation or not, the Council is clearly looking at the options to deploy its rates instrument again.

The same can be said for the Asset Purchase Program. President Draghi noted that they now "have the law on their side", after a favourable ruling in court about the ECB's purchases. And without giving specifics, Mr. Draghi signalled that the Council sees sufficient headroom to restart asset purchases if this is required. Especially, he argued, now that they haven't been buying additional bonds for some time. While the latter argument may not be very convincing amidst reinvestments and negative net bond issuance by countries like Germany, **it does signal that the ECB will find a way to restart the APP if this is required.**

That said, one interesting remark by Draghi was also that whilst it is having a more granular discussion about how it should respond, he also added that the ECB sees a certain role for fiscal policy should adverse scenarios materialize. This is also an acknowledgment that the effectiveness of its remaining instruments could prove insufficient in a worst case scenario.

Either way, the ECB's preparations for eventualities raises the question of what eventualities could spur the Governing Council into action. A sharp rise in the euro, caused by Fed cut(s) for example, might force the ECB to cut the depo rate. So if the Fed opts for an insurance cut in the second half of this year, the ECB may have to follow.

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