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To infinity and beyond

ECB post-meeting comment

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Summary

- The ECB announced a broad package of easing measures today, as expected. However, some of the details were still surprising.
- The deposit rate was cut to -50bp, with a two-tiered deposit rate system.
- Asset purchases will restart at a lower than expected monthly pace, but this was more than offset by the open-ended nature of the new purchases.
- The new forward guidance creates a stronger connection between asset purchases and a first rate hike.
- This makes it harder for the ECB to stop asset purchases in the future, as it now also signals a near-term rate hike. This extra hurdle adds to the dovish interpretation of today's announcements.
- Mr. Draghi stated that the Council sees this stimulus package is "adequate", and the market is reducing its expectations of further stimulus. However, we believe the economic developments will probably force the ECB to follow up with further easing.

Policy decisions

- The ECB cut the **deposit rate** to -0.50%, while leaving the refi rate at 0.00%.
- A **two-tiered system** was introduced for reserve remuneration.
- **Asset purchases** are restarted at EUR 20/month, with no specific end date. The ECB expects them *"to end shortly before [the Council] starts raising the key ECB interest rates"*
- **TLTRO-III** loans were made cheaper, by removing the 10bp spread over the average MRO or deposit rate. Additionally, the tenor of each TLTRO-III was extended to three years.

'Full action'

A majority in the Council believed that the ongoing weakness of incoming data and a worsening outlook warranted "full action" and Draghi specifically argued that the protracted shortfall in inflation was the main reason for today's decisions. As a result, **the ECB announced a comprehensive easing package including**:

- A 10bp deposit rate cut;
- Strengthened forward guidance;
- Asset purchases at 20bn/month (see page 3);
- Easing of the TLTRO-III conditions (page 4);
- And a tiered deposit rate to preserve the effectiveness of the bank lending channel (page 2).

The 10bp deposit rate cut was as expected, and the ECB's forward guidance still leaves the option of further rate cuts in the future. And, as we have argued in the past, the introduction of a tiered remuneration scheme for excess reserves now also makes this more feasible. Moreover, the ECB no longer states 'explicitly' how long the Council expect this period of low(er) rates to persist – i.e. they have removed their guidance on the timing of a first rate hike. Instead, the ECB has strengthened the data-dependency of its interest rate instrument, by stating that the Council expects rates *"to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon."*

The asset purchases brought a double surprise. On the one hand, the programme was restarted at a lower than expected monthly pace, but this was more than offset by the open-ended nature of the new purchases. Additionally, the ECB now gives the forward guidance that asset purchases are expected *"to end shortly before [the Council] starts raising the key ECB interest rates"*. In a way this has increased the hurdle for the ECB to stop their purchases in the future. After all, any hints of a halt to QE would also be pre-announcement of a rate hike in the not too distant future – making the decision to halt purchases a more hawkish one than previously. The flipside of this, is that it strengthens the open-ended nature of the asset purchases, since markets are not expecting any rate increases for the foreseeable future.

This is it? Well, probably not!

This is further amplified by the new ECB staff projections. **The growth and inflation outlook have both been revised down; inflation even across the entire forecast period**. And, with ECB staff now projecting 2021 inflation at just 1.5%, it is hard to imagine that the ECB will unwind any of this stimulus in the coming few years.

Table 1: Comparison of GDP projections

	2019	*2020*	*2021*
September 2019	**1.1**	**1.2**	**1.4**
June 2019	1.2	1.4	1.4

Source: ECB

Table 2: Comparison of inflation projections

	2019	*2020*	*2021*
September 2019	**1.2**	**1.0**	**1.5**
June 2019	1.3	1.4	1.6

Source: ECB

The latter conclusion is only further reinforced by Mr. Draghi's comments during the press conference. Whilst he argued that the Governing Council believes that this fresh easing package by the ECB is "adequate", this view does not rhyme with either the ECB's projections or the colour that Mr. Draghi added to those projections.

Draghi argued that the Council had made the interpretation of its medium-term goal more strict: over the projection horizon, inflation "need not only converge but would also have to stabilize at a level sufficiently close to but below 2%". In other words, 1.5% (as currently projected) does not even come close to that. Secondly, Mr. Draghi suggested that the ECB's baseline scenario perhaps purports a "relatively favourable view" of the economy as it does not contain a hard Brexit or a further acceleration of trade tensions. We recall that the ECB used to argue that its projections incorporate the expected impact of its policy measures. Well, clearly, then, the only conclusion must be that today's decision is not the end of the story!

We feel that, should there be little progress on the data front in the coming months (as per our view), another 10bp rate cut in December still is the most likely next step. And although the market has been quick to price out such a next move (with the December ECB Eonia forward jumping to -47bp today from -52bp yesterday), we doubt the market has made a permanent re-assessment of the ECB's intentions going forward.

The ECB's take on tiering

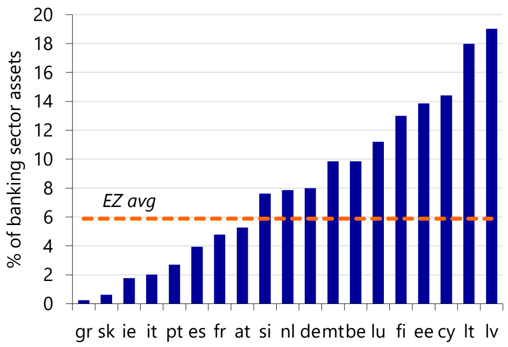
To preserve the bank lending channel as the ECB cuts rates further, the ECB announced a two-tiered remuneration system for excess liquidity**. This two tiered scheme will be effective as of the October reserve maintenance period and remunerates an exempted tier at 0.00%, while the remainder of banks' excess reserves will be remunerated at the deposit facility rate.**

The amount that is exempted will be determined as a multiple of the minimum reserve requirements of each institution. This multiplier is the same for each institution and the Governing Council can set the appropriate multiplier at each meeting, with changes effective at the next reserve maintenance period. In setting this multiplier, the ECB will consider a the level of excess liquidity in the Eurozone, as well as whether the exemption does not have unintended effects on the money market (i.e. reducing the effectiveness of the interest rate instrument).

Currently, the ECB has set this multiplier at 6 times the minimum reserves of each bank. At an aggregate minimum reserve requirement of around EUR 120bn, this means that up to EUR 720bn may be exempted from the negative rate. Interestingly, this amount is more than what we estimated as necessary to offset the impact of a 10bp rate cut on bank's (immediate) costs: on a total excess liquidity of roughly EUR 1800bn, we calculated that EUR 450bn would be necessary to compensate banks for the lower deposit rate.

This suggests that –in the aggregate– the ECB is now over-compensating the effects of the 10bp cut. One reason might be that the ECB is looking to cut the deposit rate again in the near term, but since the ECB can adjust the multiplier at each meeting, this is unlikely intended as a signal. Similarly, it doesn't seem to be a pre-emptive move ahead of the new liquidity inflow from net asset purchases: these will only start in November, and when the purchases start to increase excess liquidity, the ECB can raise the multiplier accordingly.

Figure 1: Excess liquidity as percentage of total bank assets



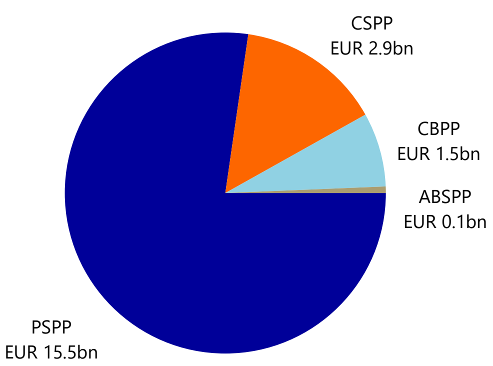
Note: These are rough estimates, using the ECB's basic rules on minimum reserves.
Source: Rabobank estimates

Rather, we believe that the decision to set the multiplier to a higher level than necessary in aggregate has been informed by the distribution of excess liquidity across the Eurozone. As we've noted in the past, a large share of excess liquidity is with core banks, while peripheral banks may only hold little excess over their required reserves. As such, **some banks will not be able to make full use of the multiple of 6 times their minimum required reserves, so the effective amount that is exempted is likely to be smaller. This also means that core banks with higher excess reserves should benefit more from the tiered system.**

Asset purchases: more of the same?

As expected, the asset purchase programme enjoyed the least consensus at today's meeting. **Reportedly, at least 7 members were against new purchases. Nonetheless, but there was enough support to restart bond buying.** Despite the reboot, the Council appears to have had little discussion on the actual parameters of the programme. The only thing that was explicitly changed is **the possibility for the ECB to buy negative yielding assets in all of its private sector purchase programmes**, extending a rule that was already in place for public sector purchases.

Figure 2: Expected breakdown of purchases



Source: ECB, Rabobank

Since there wasn't much of a discussion on the modalities, Mr. Draghi stated that the mix of asset purchases will be *"more or less similar"* to the previous round of purchases. **Going by the mix of purchases in 2018, and prior to 'tapering', we calculate this to amount to about EUR 5bn in the private sector programmes (CSPP, CBPP and ABSPP), and EUR 15bn in public sector purchases.** Figure 2 imposes the average distribution of purchases between January and September 2018 (when the ECB bought at a pace of 30bn/month) on the new monthly pace of EUR 20bn.

Although the programme is intended to be open ended, we expect that, if the ECB sticks to this monthly pace, it has –at most– a year before the constraints on the government bonds create a capacity issue. According to President Draghi, there was no appetite to discuss these constraints today, as the Council still saw sufficient headroom to continue net asset purchases under the current conditions. However, as we note above, we believe that it is unlikely that the economic outlook will have improved enough next year to allow the ECB to halt its purchases. **Therefore, we still see a discussion on the issuer limit and/or capital key as a matter of time.**

In other words, the programme appears to be somewhat of a compromise between the dovish and more hawkish members of the Council. The pace of EUR 20bn/month allows the Council to avoid making tough decisions right now, which may have reduced resistance from the more sceptical members. At the same time, the open-ended nature sets the Council up for such a discussion in the future, while the reiteration that the Council *"stands ready to adjust all of its instruments as necessary"* suggests that the APP can still be increased in scale if the outlook deteriorates further.

TLTRO-III? Just a reality check

The ECB's decision to change the modalities of the upcoming TLTRO-III loans was one of today's surprises. But Mr. Draghi largely presented this as a reality check, recalling that the key criteria for the design of these loans formulated in the past were: i) their impact on the transmission channel from market rates to households and businesses, and ii) their dependence on the macro economic outlook. With conditions for the latter having worsened and perhaps a desire among the Council to create the most bang for the buck (also in the context of delivering 'only' 20bn/mth of QE), it was decided to remove the 10bp premium on these loans and to extend their maturity with an additional year to 3 years. Should we read more into this? We doubt it. But, if anything, it would indeed strengthen banks' ability to pass lower funding costs onto their client base. And, against the backdrop of the tiering decision (which benefits core banks in particular), the relaxation of these modalities could be seen as a boon to peripheral banks.

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