PICTET 1805

Flash Note

Euro area: monetary policy

ECB: escape the (NIRP) room

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The debate over the ECB's exit strategy has started in earnest. Recent comments point to a possible reversal in the exit sequencing, with a deposit rate hike preceding the end of net asset purchases.

A one-off adjustment in negative rates would have some merits, including for banks' interest margins, but also if it is part of a trade-off for a prolonged QE programme.

However, any ECB tightening would pose communication challenges. For the first exit steps to be manageable, several conditions need to be met, including a very cautious approach to QE tapering amid idiosyncratic risks in Italy. We think the ECB will insist on the difference between a "one-off adjustment" in its deposit rate and a "proper normalisation cycle".

We expect a change in the ECB's forward guidance at the 8 June meeting, a first deposit rate hike in Q2 2018 and the rates normalisation cycle to start very slowly in late 2019. Risks are skewed towards an earlier rate hike but a longer QE, in our view.

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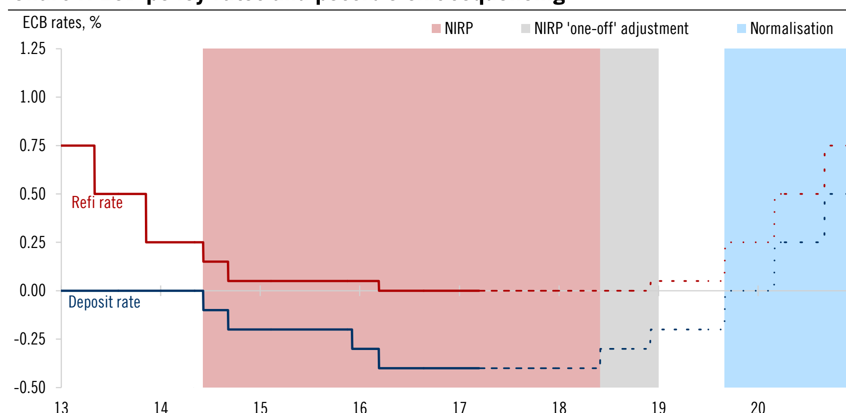
The ECB's press conference on 9 March, followed by comments from Governing Council members Ewald Nowotny and Ignazio Visco, have fuelled expectations that the ECB could hike its deposit rate, currently at -0.40%, before terminating its QE programme. Assuming that negative rates come with adverse side-effects and decreasing returns, then it would indeed make sense to start with a one-off adjustment in the deposit rate.

We see two specific motivations for a deposit rate hike to precede QE tapering: first, **less negative short-term rates should be positive for banks**, interest margins and credit supply; second, it could be part of **a trade-off with the hawks for a longer QE programme**, well into 2018 if not beyond.

However, any such decision would amount to monetary tightening and pose immense communication challenges. The ECB's exit strategy is likely to resemble an escape game, in which participants are locked in a room and have to solve a series of puzzles in order to escape within a set time limit. Not only is the ECB's exit from unconventional measures likely to be a delicate exercise in itself, but its sequencing will matter. Like in an escape room, if one step is missed, the whole mission comes under threat.

For the ECB's first exit steps to be manageable, several conditions need to be met, including a very cautious approach to QE tapering, in our view, amid idiosyncratic risks in Italy. Meanwhile a stronger US economy and a more hawkish Fed would provide a window of opportunity. **We expect a change in the ECB's forward guidance in June, a first deposit rate hike in Q2 2018 and a proper normalisation cycle to start very slowly in late 2019.**

Chart 1: ECB policy rates and possible exit sequencing



Source: Pictet WM – AA&MR, Bloomberg, ECB

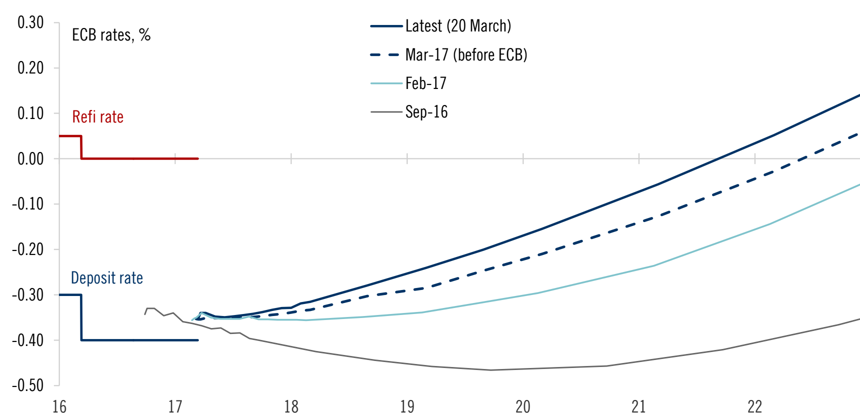
Shifting guidance

At this point one year ago, the dominant perceived risk was deflation and the ECB had just surprised markets with a larger-than-expected expansion in its QE programme. Today the focus is on ECB's exit strategy, amid growing expectations of an early rate hike. In less than nine months, the market has moved from pricing in a first ECB rate hike in 2021 to a situation where a small (10bp) hike is fully priced in by early 2018.

As we highlighted in recent months, the relentless improvement in economic conditions has been consistent with a tightening in the monetary stance (at least based on the ECB's past reaction function). Yet the ECB still has good reasons to be cautious, if anything because the lessons from premature tightening in 2008 and 2011 have been learnt. As regards QE, the four inflation criteria laid out by Mario Draghi are not consistent with a rush to the exit. In short, the ECB may turn more neutral, but **it will likely remain behind the curve until it sees 'the whites of the eyes' of core inflation**. We still expect the ECB to announce in September that it will extend QE into 2018 at a slower pace, tapering asset purchases with the objective of terminating the programme in a very gradual fashion.

The debate about a potential reversal of the ECB's exit strategy has heated up despite no formal change in the ECB's communication. The ECB implemented a Negative Interest Rate Policy (NIRP) in June 2014 when it first lowered its Deposit Facility Rate (DFR) to -0.10%. The DFR was then cut further, in small 10bp steps, to -0.40% in March 2016. **Since January 2016, the ECB's forward guidance states that the Governing Council wants to keep policy rates "at present or lower levels for an extended period of time, and well past the horizon of asset purchases".**

Chart 2: Eonia yield curve before and after the March ECB meeting



Source: Pictet WM – AA&MR, Bloomberg

But the ground seems to be shifting. The reference to the ECB's willingness to use "all available instruments within its mandate" was removed from the introductory statement in March, a change that was said to signal that emergency measures were no longer necessary as deflation risks had all but disappeared. Furthermore, during the press conference, ECB President Mario Draghi refused to rule out possible changes in the future, including the option to increase (some) policy rates before asset purchases are terminated (see "Fine-tuning ECB communication as the recovery broadens", 9 March).

Last week, Austrian Governor Nowotny said in an interview that the ECB would not necessarily follow the Fed's exit path (ending QE before hiking rates) adding that it could increase the DFR before the main refinancing rate (Refi, currently at 0%). Finally, this week Italian Governor Visco said that the ECB "could shorten the break" between the end of QE and rate hikes, although he insisted on the consistency of the package of measures.

Reassessing the exit sequencing

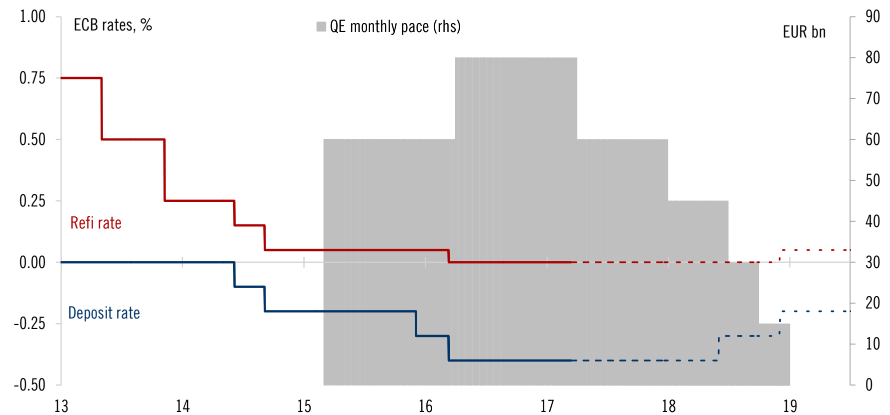
We have long been expecting the ECB to adjust its forward guidance this year, and **we still think that the reference to "lower rates" will be dropped in June**. In fairness, it could be argued that the ECB effectively dropped its bias for rate cuts long time ago. Indeed in March 2016, Draghi noted that the Governing Council "doesn't anticipate that it will be necessary to reduce rates further", a message he repeated two weeks ago.

More interesting and more uncertain, however, is the decision to allow for a reversal in the sequencing between net asset purchases and rate hikes. If and when the forward guidance is changed, we think **the ECB will insist on the conceptual difference between a possible "one-off adjustment" in the DFR and the beginning of a "proper normalisation cycle".**

We envisage the following sequence for ECB's exit strategy:

- **June 2017**: a formal change to the ECB's forward guidance leaving the possibility of a one-off adjustment in the DFR before net asset purchases are terminated in order to "remove part of the excess accommodation that is no longer seen as necessary"; a proper normalisation in policy rates would only start "well past the horizon of ECB's net asset purchases", i.e. in 2019 at the earliest.
- **September 2017**: a tapering announcement, with monthly asset purchases reduced to about EUR45bn in H1 2018, along with a commitment to reassess the pace of QE on a regular basis; the ECB's commitment to reinvest the principal payments on its QE portfolio should remain unchanged;
- **June 2018**: a one-off 10bp hike in the DFR, to -0.30% (no change to the main Refi rate); a commitment to reduce the pace of QE further in H2 with the objective to terminate the programme by year-end;
- **H2 2018**: asset purchases reduced to around EUR30bn per month on average in Q3, and EUR15bn on average in Q4;
- **December 2018**: a second 10bp hike in the DFR, to -0.20%, along with a one-off 5bp hike in the Refi rate, bringing those two policy rates (and the corridor) where they were at the beginning of 2015, when QE was implemented.
- **September 2019:** the beginning of a "proper", albeit gradual normalisation cycle in ECB's policy rates, starting with a 20bp hike in both the DFR and the Refi, to 0% and 0.25%, respectively. Our medium-term projections include 25bp rate hikes every six to nine months, up to a terminal rate of about 1.75%.

Chart 3: ECB's policy rates, QE, and a possible exit sequence



Source: Pictet WM – AA&MR, ECB, Bloomberg

Needless to say, a lot can happen in the meantime and the modalities of the adjustment in policy rates look highly uncertain. **A credible alternative would be for the ECB to move faster, removing all or part of negative rates in just one step**, although this may imply a Refi rate hike which would be more difficult to justify initially. Other technical complications will surely emerge, including as regards the width of the rates corridor or the liquidity procedures[1], but the ECB has all the tools at its disposal to deal with them, in our view, while communicating its strategy to the market. The biggest challenge facing the ECB is indeed communication, with the objective to keep broad monetary conditions loose enough as long as a "self-sustained adjustment" in inflation is not secured.

On the merits of hiking the deposit rate before ending QE

We see two main motivations for the ECB to reverse the exit sequencing and start with an increase in the DFR before the QE programme is terminated.

- **A boost to the banking sector, interest margins and the credit cycle**

The experience of negative rates has been somewhat mixed, in our view, amid side-effects, decreasing marginal returns (especially as regards the FX channel) and uneven effects across countries. Even a small adjustment to the DFR could have a significantly positive effect on the banking sector since sticky deposit rates have weighed on interest margins.

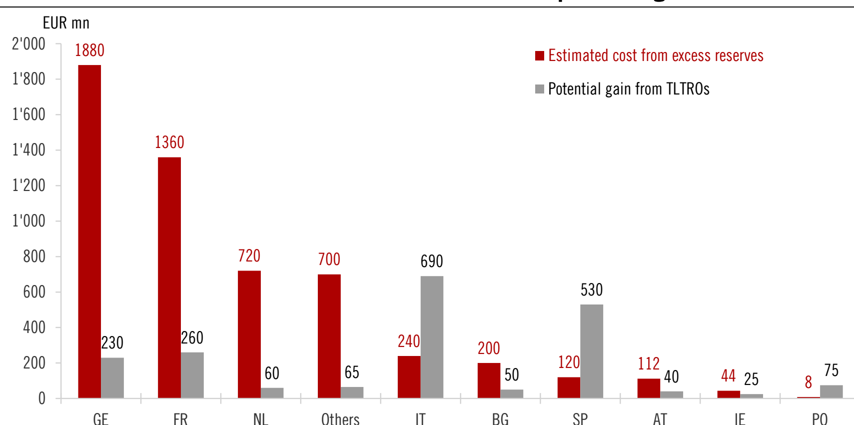
The counter-argument is provided by **Targeted Longer-Term Refinancing Operations (TLTRO-II), which have helped mitigate the cost of negative rates** for banks with large excess reserves[2]. Ahead of the final TLTRO operation this week, the maximum subsidy that banks can benefit from those long-term loans at a negative rate is about EUR2bn on an annual basis,

[1] Theoretically, the ECB could eventually switch back to variable rate refinancing procedures with fixed quantity (as opposed to fixed rate, full allotment procedures prevailing since 2008) in order to take back control of short-term market rates (Eonia) and to bring them back closer to the Refi rate as was the case before the financial crisis. Given the huge amounts of excess liquidity in the system (close to EUR1500bn), driven exogenously by QE, and no realistic prospects of the ECB selling its portfolio, this would only be possible if the ECB decided to drain liquidity from the system, e.g. by issuing debt certificates.
[2] TLTROs have a 4-year maturity and a fixed interest rate which can be as low as the ECB's deposit rate depending on banks' lending patterns relative to a pre-calculated benchmark. See all details here: https://www.ecb.europa.eu/mopo/implement/omo/tltro/html/index.en.html. The results from the last operation will be published on 23 March; we expect strong demand, above EUR100bn.

compared with a total cost of the ECB's negative DFR of around EUR5.5bn. Excess liquidity and TLTRO usage are unevenly distributed across countries, and so are the related costs and benefits. Our estimates suggest that **banks in core countries would benefit most from a DFR hike**, but indirect effects on peripheral banks' balance sheets could be positive, too.

In the end, the more the better for a bank-based economy, and the credit cycle could only benefit from a less negative DFR while TLTROs remain in place (the last operation will mature in March 2021).

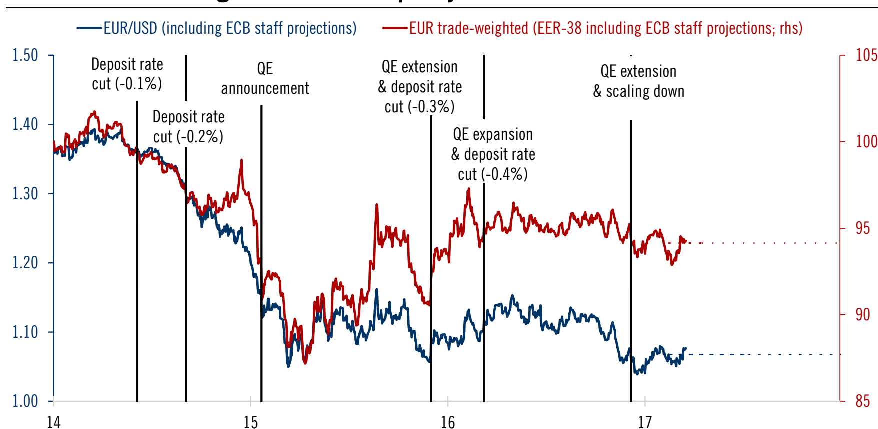
Chart 4: Estimated breakdown of excess reserves and potential gains from TLTROs



Source: Pictet WM – AA&MR, ECB, National Central Banks

Meanwhile one of the reasons why the ECB brought the DFR into negative territory in the first place – a strong currency – looks much less compelling today. In trade-weighted terms, the EUR depreciated by close to 15% from peak to trough between March 2014 and April 2015. Although negative rates were not the only factor, the combination of NIRP and QE certainly did play a major role.

Chart 5: EUR exchange rates and ECB policy announcements



Source: Pictet WM – AA&MR, Bloomberg, ECB

Since then, the EUR has rebounded by about 8%, although the EUR/USD cross has remained in a range and **the sensitivity of the currency to ECB's decisions has decreased**. Our impression is that the ECB could tolerate a modest appreciation in the currency as long as the euro area economy is doing well, core inflation is rising, and the Fed is normalising its monetary

stance at a slightly faster pace. Finally, we suspect that a small hike in the DFR would not materially change the ECB's assessment of the portfolio rebalancing channel and the interaction between QE and NIRP.

- **A trade-off for a longer QE programme**

In our view, the most appropriate way for the ECB to "sell" a one-off adjustment in the DFR would be to commit to a longer QE programme, or a more gradual tapering than is generally assumed. It is clear that the hawks are uncomfortable with an ultra-loose monetary stance when Germany, in particular, is approaching full employment and concerns over financial stability are mounting. On the other hand, we view the 'flow effects' of QE as crucial for countries like Italy where political risks remain high and economic/banking vulnerabilities could still threaten debt sustainability. The path of least resistance could be a trade-off between higher policy rates but a slower taper. Sovereign bond yields need to remain at levels consistent with debt sustainability and with such a trade-off could be a way to reach a politically-acceptable compromise. **The stronger the ECB's commitment to continue QE for as long as necessary, based on their assessment of the "self-sustained" nature of the rise in inflation, the easier it will be for the ECB to announce a first rate hike.**

One complication may come with more acute scarcity issues if the ECB extends QE for more than six months into 2018, according to our estimates. Our favourite policy option remains for the ECB to tolerate larger deviations in monthly asset purchases relative to capital keys in those countries where scarcity constraints become binding.

Conclusion

The ECB is likely to clarify its exit strategy in the coming months, starting with further changes to its forward guidance at the 8 June meeting. **We expect a first deposit rate hike in June 2018, but a proper rates normalisation cycle to start very slowly in late 2019.** Meanwhile we continue to forecast a very gradual reduction in the pace of ECB's asset purchases until the end of 2018. Under our baseline scenario where the euro area economy continues to do well and a political accident is avoided, **risks are skewed towards an earlier rate hike but a longer QE**, in our view.

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