EURO AREA: MONETARY POLICY

ECB RATES AND TLTRO-III: DEVIL IN THE DETAILS

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SUMMARY

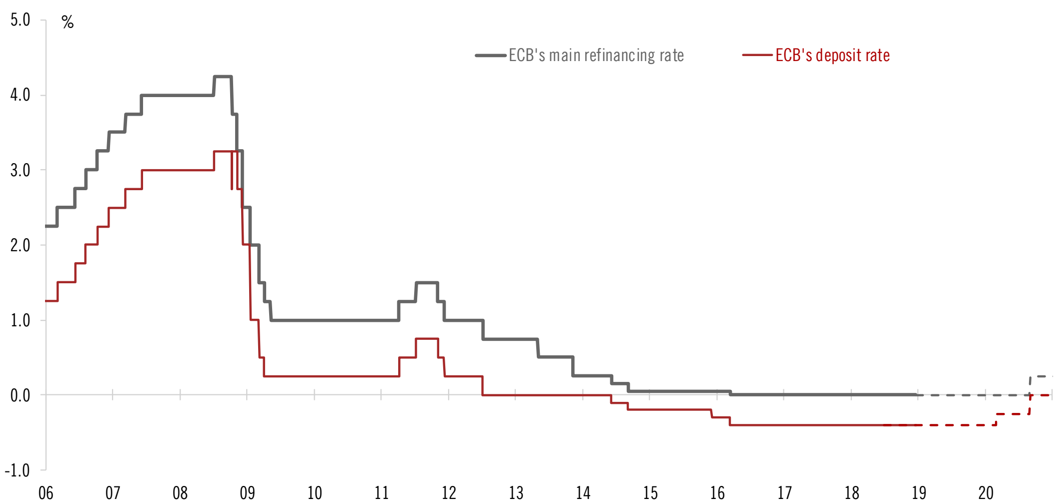
› We have revised our policy rates forecasts in the euro area based on the ECB's adjusted forward guidance. We expect a 15bp deposit rate hike in March 2020, followed by a 25bp hike in the deposit and refi rates in September 2020.
› The most important element of the ECB's package was the announcement of new targeted longer-term refinancing operations for banks (TLTRO-III), although their success will depend on their final modalities to be unveiled "in due course".

Never doubt Draghi

The package announced at the European Central Bank (ECB) meeting last week (TLTROs and forward guidance extension) was expected at some stage in the coming months, but what surprised us was the timing, the extent of the downside revisions to inflation and growth projections and ECB President Draghi's overall dovishness. Interestingly, despite the downward revisions of the growth forecasts, the ECB still considers risks surrounding the growth outlook to be tilted to the downside "due to the persistence of uncertainties related to geopolitical factors, the threat of protectionism and vulnerabilities in emerging markets". The ECB changed its forward guidance on rates to "interest rates to remain at their present levels at least through the end of 2019" from "through the summer of 2019", which is still significantly earlier than market pricing for the first-rate hike. During the press conference, Draghi mentioned that some ECB members even wanted to extend forward guidance to March 2020.

We have revisited our scenario accordingly and now expect **a 15bp deposit rate hike in March 2020**, **followed by a 25bp hike in the deposit and refi rates in September 2020**. The former would be a technical rate hike rather than the start of a normalisation cycle.

CHART 1: ECB POLICY RATES INCLUDING OUR PROJECTIONS



Source: PWM - AA&MR, ECB

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Meanwhile, the ECB announced a new series of seven quarterly targeted longer-term refinancing operations (TLTRO-III) with a two-year maturity, from September 2019 to March 2021, at a variable interest rate indexed to the main refi rate (currently at 0%) as opposed to a fixed rate as low as the deposit rate (-0.40%) in TLTRO-II. We note that indexation on the refi rate does not prevent the ECB from hiking rates next year.

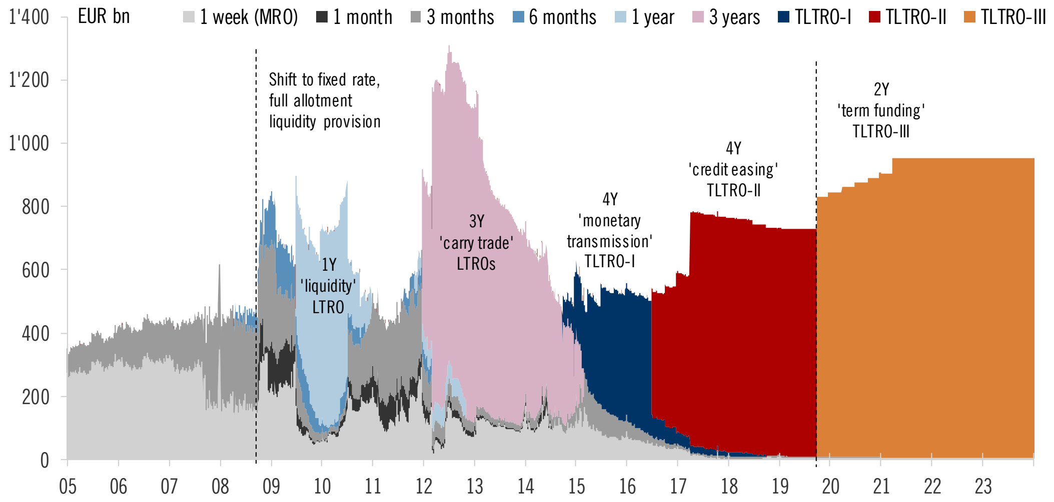
TLTRO-III: what matters and what doesn't

The latest comments from ECB officials have been consistent with **the Governing Council retaining some degree of flexibility** in terms of the most important TLTRO-III modalities, to be clarified "in due course", possibly only after the summer, depending on macroeconomic and financial conditions.

To be sure, it does not matter that market participants were disappointed, if not worried, by some aspects of the ECB's announcements. What matters is that the ECB's policy tools are carefully calibrated in order to serve the right purpose. Ultimately, if the ECB succeeds in reflating the economy, then the yield curve should steepen, supporting the banking sector, and the EUR should appreciate, among other things.

It also does not matter that TLTRO-III are unlikely to trigger a large increase in the ECB's balance sheet or excess liquidity due to limitations in borrowing capacity, less favourable conditions than TLTRO-II and uncertainty about the "built-in incentives" for credit conditions. Chart 2 shows liquidity projections under what we view as optimistic assumptions, including close to maximum TLTRO-III net take-up from peripheral banks (EUR 100bn) and modest demand from core banks, leading to an increase in total outstanding refinancing operations by about EUR 200bn by the end of 2021.

CHART 2: ECB: OPEN-MARKET REFINANCING OPERATIONS, INCLUDING OPTIMISTIC PROJECTIONS (*)



Source: PWM - AA&MR, ECB (assuming TLTRO-II rollover and extra demand of €100bn from peripheral banks and €125bn from core banks)*

What does matter is that TLTRO-III provide banks with a rolling facility for term funding rather than proper credit easing. That said, the ECB could always loosen the rules, by excluding TLTRO-II amounts to be rolled into TLTRO-III (unlikely), by adding mortgage loans to the pool of eligible loans (although Lithuanian GC member Vitas Vasiliauskas ruled it out) or by adding a more generous subsidy in the form of a 20bp to

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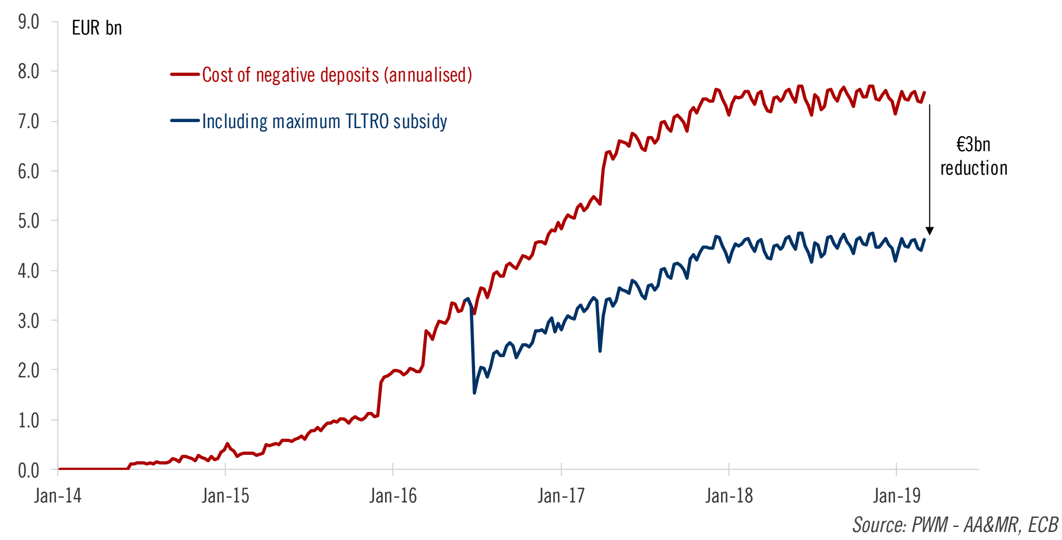
40bp premium below the refi rate for those banks exceeding a net lending benchmark. This last option has our preference notwithstanding some contradicting press reports in recent days.

If we are wrong and TLTRO-III are conducted at the refi rate or higher, we doubt that banks' demand will be much higher than what is needed to roll previous operations (around EUR 720bn), with the two-year Eonia currently trading at around -0.3% and March 2021 Euribor at -0.1%.

As for banks specifically, **it does not matter that the ECB did not discuss mitigation measures for negative rates** during the March meeting as long as they don't introduce a tiering system for excess reserves that would risk signalling even lower policy rates, in our view, although we reckon that exemptions could still be contemplated as one option to compensate for the side-effects of negative rates at a later stage. Meanwhile, TLTRO-II helped reduce the aggregate cost of negative deposit rates for the banking sector by up to EUR 3bn on an annual basis, with an outsized effect for peripheral banks that met the lending criteria and had much lower excess reserves than banks in core countries. This could still be a feature of TLTRO-III if the ECB opts for a premium below the refi rate.

In the end, we still believe that the ECB will choose the simplest option, hence our forecast of a 15bp deposit rate hike in March 2020 as a first normalisation step.

CHART 3: COST OF NEGATIVE DEPOSIT RATE AND TLTRO-II 'SUBSIDY'



Source: PWM - AA&MR, ECB

From a broader macro perspective, **what matters is what the banks will do with the ECB's long-term funding**, having reduced their aggregate holdings of government debt securities by over 20% since the beginning of ECB QE in Q1 2015, while expanding their stock of loans to the non-financial private sector by about 9%. Things are more complicated in practice than this simple trade-off would suggest, but for TLTRO-III to be a success, they still need to create the right incentives for banks to keep expanding their balance sheet in a productive way notwithstanding regulation headwinds.

What matters, above all, is what governments and other European institutions make of this opportunity to lock in cheap funding for longer. While the OECD's call for a

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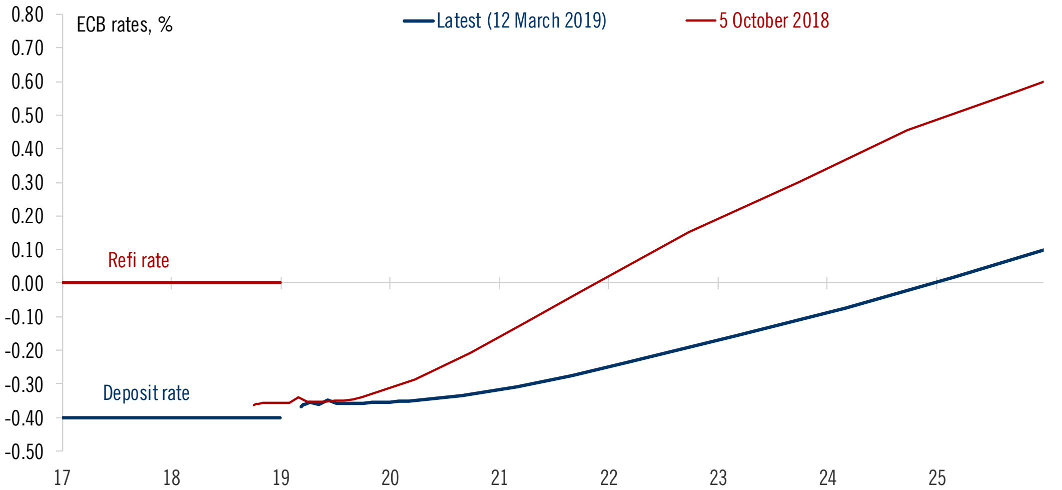
coordinated programme of fiscal stimulus and structural reforms looks too ambitious and politically difficult to realise, the ECB's response appears as if the euro area might be facing a 'Japanization' in its own, for better or worse.

CHART 4: ECB POLICY RATES AND MARKET EXPECTATIONS (EONIA SWAPS)



Source: PWM - AA&MR, Bloomberg

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