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FOCUS NOTES

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ECB: A new LTRO is likely as forward guidance is unconvincing

- The ECB's reluctance to adopt a more binding form of forward guidance, the unwinding of the Fed unconventional stimulus, declining excess liquidity and recent encouraging economic data have led markets to discount higher euro area short-term rates.
- Next steps by the ECB are mainly dependent on market reactions to the Fed exit policy, given the expected slow pace of decline of excess liquidity and the subdued recovery of the economy.
- In our view, a new round of long maturity liquidity injection seems to be the most likely option the ECB may use to rein on persistently high short-term rates.

Last July, the ECB abandoned its long held stance of never pre-committing with respect to the future path of its intervention rates and introduced forward guidance by pledging to keep rates at a low level for an extended period of time. The new communication tool aimed at stemming the upward pressure exerted on euro area short-term rates due to the Fed exit discussions, which were heating up in the previous period. However, this time President Draghi's verbal intervention has had little effect. A decline in short-term rates proved short lived, as is evident by the upward drift of the overnight inter-bank lending rates. Before the recent FOMC decision, the long end of the EONIA curve stood higher even than in early July, before the announcement of the forward guidance by the ECB (Figure 1).

There are several reasons why markets are unconvinced that short-term rates will remain at the current record low levels for an extended period of time. These reasons include the type of forward guidance the ECB has chosen to implement, the expected tapering of asset purchases by the Fed, receding excess liquidity in the euro area banking system and emerging signs of stabilization and gradual recovery of the euro area economy.

While forward guidance is a major change in the ECB's communication strategy, it is considered rather vague, with limited clout to anchor investors' expectations of future short-term rates. Indeed, the ECB's form of forward guidance is much weaker than a state-contingent kind of forward guidance, such as the one the Fed has launched, tying its policy rate changes to the level of unemployment. It is also weaker than the forward guidance the Swedish and the Norwegian central banks have introduced, which both publish an expected future path of their policy rates with a horizon of two to three years. In contrast, the ECB has refrained from giving any clue as to how long the extended period of low rates it refers to might be. Moreover, ECB officials have repeatedly clarified that the forward guidance is merely a communication tool that conveys the ECB's expectations of low inflation prevailing in the period ahead and it should never be interpreted as a change of its reaction function. This implies that if headline inflation expectations ramp up, the ECB may hike rates sooner rather than later.

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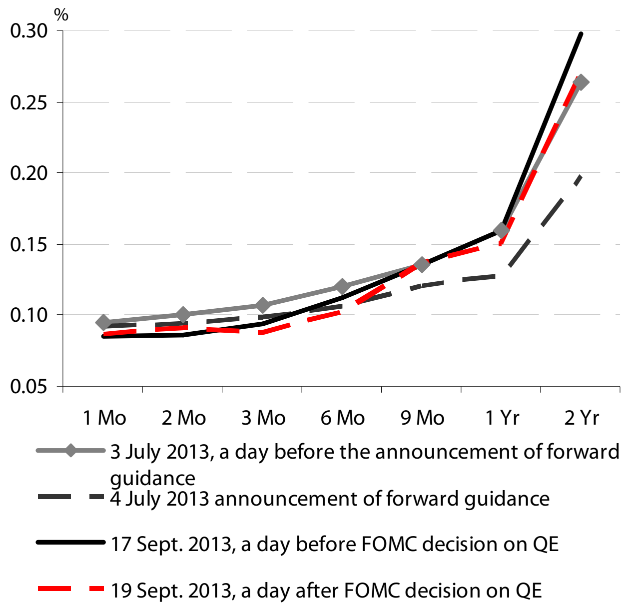
Expectations for Fed's decision to reduce the pace of assets purchases before year end signals the unwinding of unconventional monetary policy measures, affecting euro area interest rates. Higher US rates are expected to attract money market funds leading to higher rates across the curve in the euro area. Yesterday FOMC's decision to refrain from a widely anticipated QE tapering has removed some pressure from the long end of the EONIA curve (Figure 1). However, faster future exit steps and possible communication mistakes resulting in misalignment of Fed's intentions and investors' expectations constitute a risk of increased volatility on euro area rates. The recent FOMC decision to maintain the pace of QE stimulus unchanged while several Fed officials' comments had previously led markets to price in some tapering is an example of poor communication policy.

Figure 1

EONIA curves



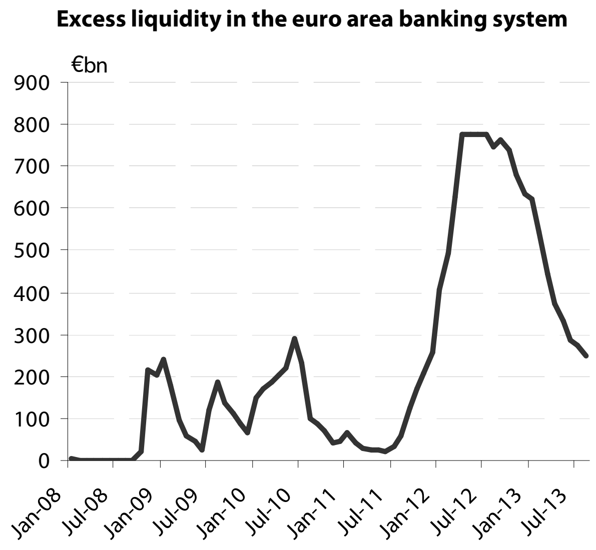
Source: Bloomberg

Passive monetary tightening due to diminishing excess liquidity (Figure 2) is another factor explaining why markets have proven unresponsive to Mr. Draghi's remarks that prevailing expectations of higher short-term rates are unwarranted. A liquidity gush caused mainly by the launch of two 3-yr LTROs resulted in a bit less than €800bn of excess liquidity, (i.e. the level of cash beyond what is needed for smooth every-day functioning of the banking sector), in the euro area banking system. As soon as banks were allowed to return liquidity back (12 months after the conduction of the operations), excess liquidity declined materially, standing at about €248bn as of end of August. This level is close to the threshold of €200bn, which historically has been associated with gradual normalization of the EONIA rate towards the Main Refinancing Operations rate, (currently at 0.50%). In the September meeting, Mr. Draghi tried to deemphasize the level of excess liquidity, arguing that in an environment of receding fragmentation in financial markets, less liquidity may still be compatible with very low EONIA rates.

Looking ahead, the outstanding amount of liquidity provided by the ECB will most likely decline from its current levels at a slow pace for a series of reasons. First, large repayments at the beginning of the "repayment period" followed by very subdued repayments subsequently (Figure 3) suggest that liquidity held for precautionary reasons has been repaid to a large extent. Second, banks in core countries hold very small amounts of ECB liquidity, suggesting that no large repayments are likely by them[1]. Third, most of the outstanding ECB liquidity is held by banks in periphery countries, which face the greatest challenges in raising funds from private markets to support their activities. Therefore, they are expected to disentangle from ECB liquidity provision only at a gradual pace. Since June, the average pace of weekly repayment of the two 3-yr LTROs is €2.54bn. Assuming that excess liquidity is affected only by LTRO repayments, such a pace implies that it will fall below €200bn in January 2014.

Figure 2

Excess liquidity in the euro area banking system



Source: ECB

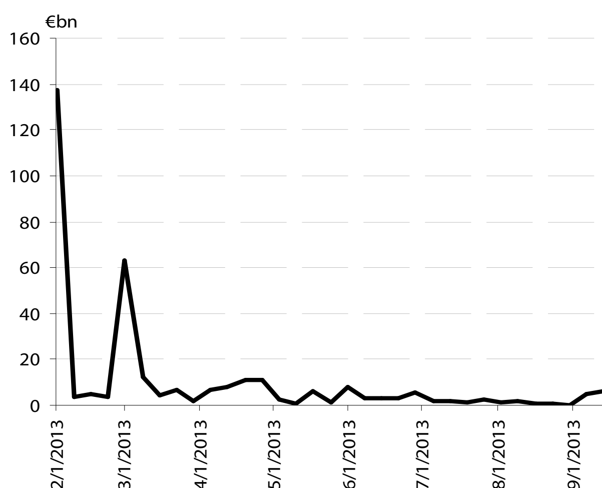
Finally, recent upbeat economic data marking a turnaround of the euro area economy may have added to markets expectations of higher short-term rates in the longer term. Q2 euro area GDP growth came in positive for the first time after six quarters and slightly stronger than anticipated, while signs of a broad based

[1] Banks in Germany, the Netherlands and Belgium combined hold less that €42bn of ECB liquidity. French banks remain heavily dependent on ECB, as their outstanding borrowing is about €93bn, of which about €25bn is idle liquidity sitting at the deposit facility. However, the reliance of French banks on ECB will likely not decline soon, given the challenges the economy is facing.

recovery have emerged, as besides exports, domestic demand has started contributing to economic recovery. Additionally, leading indicators keep improving in both core and periphery members, suggesting that a stabilization is materializing. Nevertheless, significant headwinds to the economy auger a very gradual recovery, while multiple sources of tension imply that the road ahead will remain bumpy. As a result, we do not expect much pressure from economic developments on short-term rates in the period ahead. In a similar tone, in the September meeting, Draghi sounded very dovish over the strength of the economic recovery, mentioning that the "shoots are very, very green", in an attempt to prevent markets from getting carried away by economic data.

Figure 3

Weekly repayment of 3-yr LTROs



Source: Bloomberg

A new LTRO, most favorable option to curb rates

Given that excess liquidity is likely to decline slowly from current levels and the subdued recovery of the economy, next steps by the ECB are mainly dependent on market reactions to the Fed exit strategy. A stronger state-contingent form of forward guidance would be more effective in averting increases in rates due to the impact of the Fed unwinding its monetary stimulus. However, such a scenario is highly unlikely, given the ECB's resistance to commit to maintaining rates lower than expectations on price developments may warrant.

Another option could be to cut the deposit facility rate below zero which would push down EONIA rates. We doubt that the ECB will embark on negative rates due to their uncertain impact on other lending rates. The Danish experience has shown that negative rates led to higher bank lending rates. The ECB will most likely refrain from taking any action that would affect adversely bank lending, one of the most problematic aspects of the euro area economy.

ECB officials have not excluded an MRO rate cut as an option to reign on short-term rates. In our view, there are good reasons for the ECB to favor the launch of another fixed rate/full allotment LTRO than a rate cut. First, an LTRO with maturity of at least two years would be more effective in bringing down the whole EONIA curve, as it would comply better with the ECB's declared intentions to keep rates low for an extended period of time. On the contrary, a rate cut that would easily be reversed later might prove less powerful in rendering the ECB's forward guidance more convincing. Second, liquidity injection would allow the ECB to target more efficiently those financial institutions that are in greater need of liquidity support. Third, we believe its easier to build consensus for a new round of liquidity provision than for a rate cut, given that some core countries, most notably Germany, have embarked on a solid economic growth path.

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