

## ECB: What just happened?

Today's policy meeting and press conference was astonishing for a number of distinct reasons. Amid the noise, there are three crucial take-aways.

First, TLTRO3 has been unleashed from money market rates. Second, the deposit rate is no longer the fulcrum of policy—but for good reasons. And, third, we might have seen the end of the Draghi put—the end of “whatever it takes.”

### 1. TLTRO3 has now broken the deposit rate lower bound

It was widely expected that “targeted” LTROs could be tweaked to provide liquidity to banks to encourage the provision of credit to SMEs to help navigate any COVID-19 shutdowns. And for the first time, the ECB announced a series of weekly LTROs with a “starting” rate of interest of -50bps—that is, at the deposit rate, not MRO. All these are maturing end-June, at which point the pre-planned TLTRO3 allocation will be provided on modified terms. For 12 months, any take-up in June will be provided at least -25bps but potentially, if lending targets are met, as low as -75bps. After that, the lending terms on these return to “normal”—between 0bps and -50bps. Meanwhile, the size of TLTRO3 has been increased from 30% to 50% of each banks' non-housing, non-financial sector loans.

In other words, TLTRO rate has been linked to, but decoupled from, the two key policy rates. Most importantly, the TLTRO rate is no longer bookended by the two. Rather, the ECB has demonstrated that TLTRO rate can be taken *below* the deposit rate.

This is huge.

For the first time, ECB funding of the banking system has been decoupled from money market rates, and national central banks can now potentially subsidize bank lending at lower than policy rates. Why not -100bps? Or -200bps? The possibilities for future policy are enormous.

As to the calibration of rates, consider the following. At the moment there are about EUR615 billion in outstanding TLTROs, of which about EUR400 billion mature end-June—available to be rolled into TLTRO3. Until today, at the existing stock of purchases for monetary policy purposes, the Eurosystem as a whole is making monetary income, shared across the system, of about EUR1.9 billion per year if TLTRO lending targets are met. Suppose the EUR400 billion is rolled into the new program in June, but not more—leaving the total TLTRO unchanged—while the lending targets are met, making the average rate -75bps for one year. Then total system monetary income falls to EUR0.9 billion. In other words, for a year there is a subsidy to the banking system of EUR1 billion.

Suppose instead the EUR400 billion maturing is replaced by EUR785 billion in new TLTRO3 take-up, taking the total outstanding TLTRO to about EUR1 trillion. Then if lending targets are met, the Eurosystem makes *zero* monetary income over the next 12 months. That is, there will be roughly EUR1 billion in transfers to the remaining TLTROs (at -50bps) and EUR5.9 billion in transfers to banks taking the June TLTRO (at -75bps), while monetary income on EUR1.4 trillion of non-tiered reserves (at -50bps) reaches EUR6.9 billion.

The distribution here is unspoken, but this calculation puts today's policy innovation in perspective. It's not really about the Eurosystem providing transfers to banks to support bank lending into the Coronavirus Crisis, it's about a series of transfers *within* the banking system whereby stronger or perceived safer banking

systems with excess liquidity, like Germany and others, are taxed on non-tiered reserves to provide support to peripheral banks in lending to domestic corporates.

Eurosystem “capital” or profit and loss only comes into play once total TLTRO take-up in June exceeds EURO.785 trillion. Let’s take an extreme case. Suppose TLTRO3 June take-up reaches EUR1.785 trillion, with total outstanding TLTRO thus EUR2 trillion. Then for one year the Eurosystem will make losses on monetary income of EUR2.6 billion. However, this is a net figure. The implied transfers within the system are larger still, with EUR13.4 billion paid in interest for one year on the June TLTRO3 take-up, and EUR11.9 billion in interest paid by those whose balance sheets are harbouring the excess liquidity involved. So, there is an extra EUR7.5 billion transfers to banks, paid for by an increase in “tax” on non-tiered reserves of about EUR5 billion with the rest eating into National Central Bank (NCB) capital and reserves. In short, the TLTRO is not really about subsidizing bank lending to corporates by the system, but rather about transferring income within the system—with some small amount skimmed off NCB capital.

## **2. The demise of the deposit rate**

Today’s decision also revealed that lowering the deposit rate from here is challenging. The reasons were not made clear in the press conference, which served to create greater uncertainty. But they are quite understandable, in context. The following remarks might provide some perspective.

First, in a system with implicit net transfers, described above, a reduction in the deposit rate would further impair “stronger” banks over those accessing TLTRO funds. Imagine, for example, a 10bps reduction in the deposit rate. Then in the first case noted above the interest paid (“taxed”) on non-tiered excess reserves across the system would increase about EUR1.4 billion, from EUR6.9 billion to EUR8.3 billion. This becomes monetary income, meaning the Core banks would be paying higher interest to distribute across the system—to add to capital or transfer to the local sovereign. This hardly improves the profitability of Core banks in pursuit of greater support for non-financial corporates. Indeed, while taking considerably greater credit risk during TLTRO, these banks would in the aggregate be taxed a larger amount by the Eurosystem—making risk-taking even less worthwhile. So, in fact, by not lowering the deposit rate the Eurosystem was providing greater quasi-fiscal support to the Eurosystem as a whole in support of the Core.

Second, couldn’t tiering have been used to offset these negative effects on Core banks? In principle, if the tiering ratio had been increased from 6 to 7, then in the above calculation the total income on non-tiered reserves would be reduced from EUR8.3 billion to EUR7.5 billion, a saving of EURO.8 billion. A further increase of the tiering ratio from 7 to 8 would almost entirely eliminate the losses to the system from this thought experiment. But there are a number of problems with this.

For example, increasing the tiering ratio “blind”—that is, before the TLTRO take-up is known—creates the risk of squeezing the overall excess liquidity within the Eurosystem. Suppose the TLTRO rollover in June is only the EUR400 billion—so total liquidity is unchanged. Today, excess liquidity in excess of required and tiered reserves is about EUR1 trillion. Increasing the tiering ratio to 7 would reduce this to about EURO.9 trillion, and tiering ratio of 8 would bring this down to EURO.8 trillion. So, each integer increase in the tiering ratio squeezes excess reserves by about EUR100 billion. But the ECB’s existing framework relies on excess liquidity keeping EONIA floored at the deposit rate, and avoiding the non-linear relation with excess liquidity (See [slide 17 of Lane’s speech](#) in October.) So, to pre-announce an

increase in the tiering ratio without knowing how much liquidity is in the system creates the risk that an overall squeeze in the excess undoes the impact of the lower interest rate.

Moreover, there is a distributional problem. Total “excess” liquidity in Germany has decreased sharply in recent months, as tiering shifted bank reserves across the system towards the periphery—witness how Germany’s TARGET2 credit had fallen to recent lows. So, recent policy actions have forced excess liquidity in Germany from about EURO.6 trillion at the beginning of 2019 to about EURO.3 trillion—allowing for the tiering impact in Germany and redistribution of reserves. A further reshuffling of reserves and larger tiering would lower this surplus even further, making the front end of the bund curve more sensitive to sentiment—and with it rates and thus the euro.

This combination of political and technical factors made it extremely tricky to lower the deposit rate. This is why, working with Jens Nordvig and his Exante Data team in New York, on Tuesday this week we summarized our views on today’s meeting thus:

*The severity of the emerging Coronavirus crisis is likely to provoke a strong reaction by the ECB on Thursday. While markets are pricing in 11bps in cuts, we think there is a high bar to take rates even lower at this stage—further impairing bank profitability is inconsistent with asking them to intermediate emergency funds to corporates. Instead, a generous emergency TLTRO (ETLTRO) for 6-12 months, guaranteed at the deposit rate—or possibly lower—coupled with an increase in asset purchases from EUR20 billion to EUR40-50 billion per month over the same horizon, with additional emphasis on corporate bonds, will target support to SMEs and non-financial corporates while providing balance of payments support to the euroarea peripherals.*

In other words, while further rate cuts are possible, the circumstances have to be right. Additional liquidity is needed within the system before tiering can be further exploited with lower deposit rates—and today wasn’t the right time.

That said, an opportunity was still lost today, it seems. The tiering formula could have been tweaked to link tiering not simply to 6 times required reserves of each financial intermediary, but 6 times required reserves *plus* the amount accessed in the June TLTRO. That way, banks in the Core would have been provided relief on the claims they automatically create in the aggregate in accessing Eurosystem liquidity. It’s not clear who might have objected to such a policy innovation, and would have additionally supported Core banks at this difficult time.

All of this is a side-show, however.

### **3. The end of the Draghi put**

The key moment today was not the policy announcement, but the press conference.

Before we get there, let’s briefly recall the final policy announcement. An additional EUR120bn in net asset purchases were promised through December—on average EUR13 billion per month (EUR33bn per month on average, including the EUR20 billion monthly flow). These asset purchases would apparently include “a strong contribution from the private sector purchase programmes.” In other words, there would be a larger weight on supporting private sector assets. Meanwhile, in the press conference it was confirmed that this while purchases could deviate from the capital key for periods, by the end of the program the capital key would be met.

The problem with this announcement is that it fails to address emerging issuer limits which are considered close to binding for some countries—Germany in particular. While Lagarde correctly noted that these issuer limits will be less binding in the event of substantial net new issuances, setting a finite stock of purchases for the rest of the year feels like the Governing Council is acknowledging “this is all we can do within current constraints and we cannot do more until the monetary policy review concludes.” In other words, when it comes to asset purchases, we have shot our bolt.

Still, the package had potential. It might buy some time for some fiscal response in the weeks ahead while providing support to peripheral yields through discrete intervention. That is, it had sticking plaster potential—until the press conference when Lagarde managed to destroy the Draghi “put”—*the* pillar of the euroarea’s existence since 2012.

It could hardly have been better scripted. Halfway through the press conference, it was pointed out by the correspondent for MNI that the market reaction to the ECB’s package was negative; it compared unfavourably to the response to the Bank of England the previous day. After responding to the question, Lagarde quipped: “And by the way, comparisons are odious.”

Then, in her response to the very next question, Lagarde proceeded to explicitly contradict the implicit market “put” carefully sculpted by her predecessor—rendering comparisons not so much odious, as absolutely necessary.

It’s worth recalling the exchange in full. (You can watch for yourself from [32 minutes](#).) The question itself, courtesy of Jan Mallien at Handelsblatt, was in two parts.

The first part was about banks perhaps not being willing to extend credit because of the risks involved, suggesting a national or European guarantee scheme might better support emergency lending.

The second part referenced the possibility of rising bond issuance to manage the health crisis, especially in Italy, which might create pressure on government bond yields. Mallien wondered how the ECB might respond—by activating “the OMT program or could there be other possibilities to help certain countries?”

In response, Lagarde noted that indeed guarantee schemes would be appropriate—a guarantee by the “state, an agency of the state, or a European agency” in order to support banks in taking the credit risk at this time. This would improve the efficiency of the ECB’s TLTRO package. Very good.

Then, regarding the likely increased debt issuance and pressure on yields, Lagarde continued “we will be there... using full flexibility [of today’s announced package], but we are not here to close spreads; this is not the function or the mission of the ECB, there are other tools for that and there are other actors to actually deal with those issues.”

This answer, in the context of a question explicitly referencing OMT, strongly suggested that the correct response to any widening of peripheral spreads would be indeed to initiate this (so far unused) backstop associated with the “whatever it takes” promise surrounding redenomination risk. But the fact that since announced in 2012 OMT has been moulded to require an ESM program, including a sustainable debt trajectory, suggests that this is how Lagarde envisages resolving any peripheral yield blowout in the course of the Coronavirus Crisis.

To add icing to the cake—or pour fuel on the flames—within minutes the official ECB twitter account had tweeted this exact quote. If this was a slip of the tongue, apparently the ECB Press Office considered it a reasonable representation of the house view. Cue market panic.



Following the press conference, Lagarde was bundled into an interview with CNBC to try and row back on these comments. In this context, we were assured that Lagarde was “committed to avoid any fragmentation at a difficult moment for the euroarea. The high spreads we see due to coronavirus clearly impair monetary policy... we will use all the flexibility embedded in our asset purchase program.”

However, this statement does nothing to address the issue of how the ECB will respond to rising yields and redenomination risk—per Mallien’s original question. All this response tells us is that Lagarde is willing to use the additional EUR120 billion in the APP to support peripherals—which could mean some front loading, but the capital key remains sacrosanct.

To be sure, the existing EUR20 billion flow of APP through year end (say, EUR190 billion) plus the new EUR120 billion implies purchases of Italian assets of about EUR50 billion—of which about EUR30 billion will be spread evenly throughout the year, with about EUR20 billion available at discretion “up front.” But not all of this will accrue to BTPs.

It’s useful to compare this “finite” “buying power” with the selling potential of non-resident holders of BTPs. As of late-2019 non-residents held about EUR750 billion. And while some of these are *de facto* resident claims held at intermediaries abroad, there remains substantial scope for non-resident sales. Suppose, conservatively, non-resident claims are only EUR500 billion. Then the ECB has total firepower of only 10% of this total to support Italy in the event of non-resident capital flight, with perhaps only EUR30 billion available now. In addition, this ought to give residents pause for thought.

In other words, the ECB Governing Council today created a finite stock of reserves to defend Italy and others. And since markets know the amount, they can test the stock—creating a classic bank run, or first-generation currency crisis, scenario. The fact that the ECB is a central bank able to create liabilities at will makes the notion of a bank run somewhat farcical. But this is the consequence of the euroarea’s monetary circumstances. From being an elastic currency with infinite

firepower, the Governing Council has created a game of chicken with markets—a face off that markets will certainly win without a future change in policy.

One reasonable response to this is that the TLTRO at negative rates has created the ultimate carry trade for banks—get negative yielding liquidity from the ECB and rotate into govies, and you get a decent yield pickup in most places except Germany. This carry trade, just like the VLTRO in 2011 and 2012, will cap peripheral yields and provide support to the sovereign—though no one should mention this fact, as the liquidity is “really” being channelled to the real economy.

But there are two problems with this. First, at the moment banks are being asked to take on potentially large credit risk to extend credit to non-financial corporates and households. Perhaps the negative interest rate is not enough to compensate for this—in which case the take-up that might, in a roundabout fashion, support sovereign yields might ultimately disappoint.

Second, in any case, the sovereign carry trade only makes sense if the sovereign itself is unimpeachably solvent. Imagine an Italian bank contemplating borrowing at -25bps from the TLTRO in the hope of picking up a 200bps yield on the 10-year BTP for 12 months. This only works if BTP yields are capped. Otherwise the duration risk will massively outweigh the meagre negative rate.

And since Lagarde failed to dispel OMT concerns, despite her CNBC row back, it's not clear that repeating Draghi's VLTRO smoke-and-mirrors trick will work.

Hence, in short, Italy and the periphery are in trouble. At a moment of national health emergency, it certainly looks like the intention of the Core is to push Italy into a program to finally resolve her debt overhang—aided by Lagarde as wolf-in-sheep's-clothing. That President Macron complained today that the ECB's actions were too weak only serves to underline concerns that Lagarde is a German patsy.

## **What should happen next?**

At a moment of a truly unexpected crisis, today's press conference suggested the ECB is willing to choose Core over Periphery—Germany over Italy. That is, if Italy should be exposed to capital flight and rising yields—in the middle of an unprecedented health emergency—the ECB is willing to shoehorn Italy into an OMT/ESM program to resolve Italy's debt overhang and allow for greater euroarea integration thereafter. A clean slate.

To exploit the Coronavirus and the plight of Italy in this way is a disgrace.

Given that today's press conference has provided markets with a clear opportunity to run on peripheral assets, it seems likely peripheral spreads will widen further. The ECB's current package cannot, by design, provide the firepower to stabilize the euroarea.

In which case, there are three options from here.

First, euroarea fiscal authorities agree to share the fiscal-cum-credit risk from the emerging medical emergency across the currency area—obviating the need for a monetary backstop.

Second, Lagarde and the Governing Council reiterate Draghi's “whatever it takes” pledge—meaning ditching the OMT's “conditionality” clauses or APP capital key restrictions to unconditionality support the periphery during a medical emergency.

Or, third, the euroarea should prepare to disband—allowing the periphery to face this medical emergency with the tools to put the people over the misguided politics of the euroarea.

We have reached Lagarde's “whatever it takes” moment.