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ECB: AS LONG AS IT TAKES

Berenberg Macro Flash

Dovish for longer: The ECB is easing policy by slightly less than many observers had expected. However, the ECB stressed even more strongly than expected that it will maintain its aggressive stance for as long as it takes to move underlying inflation close to its de facto inflation target of 1.8-1.9%. Despite some surprises in the detail, today's package is thus in line with expectations. By exempting a significant chunk of bank deposits from the negative deposit rate and making its offer of long-term liquidity for banks even more generous, the ECB is mitigating the impact of a negative deposit rate on bank balance sheets and hence the ability of banks to transmit the ECB's monetary stimulus to the real economy.

In the press conference, ECB President Mario Draghi said that three major factors drove today's decisions: (1) A more-protracted-than-expected slowdown of the Eurozone economy; (2) a persistence of downside risks; and (3) a downward revision in projected inflation (see chart for ECB forecast changes). In addition, he pointed out that the baseline scenario underlying the ECB forecasts is somewhat favourable as it does not include the escalation of trade tensions since August and the recent increase in the risk of a hard Brexit. The ECB believes that the risks to the baseline scenario are tilted to the downside.

A "DIVERSITY" OF VIEWS

According to Draghi, a broad majority of Governing Council members was in favour of the package. The most controversial part of the package was the re-launch of asset purchases, where Draghi noted "more diversity" of views. This diversity reflected differences about the severity of the economic outlook, the need to act now rather than later and the general question whether it is appropriate for the ECB to re-launch net asset purchases. Draghi pointed out that a major reason for the re-launch of net asset purchases was that inflationary expectations had re-anchored to a range between 1 and 1.5% – a range which would not be the ECB's target.

In the introductory statement, the ECB ramped up its plea for governments to use their fiscal space or to structure their fiscal policies in a more growth-friendly way. According to Draghi, the mildly expansionary fiscal stance in place now would not be enough. Governing Council members unanimously agreed that fiscal policy rather than monetary policy should be the main tool to combat the economic downturn.

THE ECB DECISIONS IN DETAIL

- **Rates/forward guidance:** While the ECB cut the deposit rate by 10bp from -0.4% to 0.5% instead of the 20bp we had expected, it strengthened its guidance significantly: It dropped the previous notion that rates would remain at their present or lower levels "at least through the first half of 2020". Instead, the ECB stressed it would stay on hold "until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon and such convergence has been consistently reflected in un-

derlying inflation dynamics." In essence, the ECB replaced the time-contingency leg of the rate guidance with a beefed-up state-contingency part.

- **Tiering**: With the introduction of a two-tiered system for bank deposits, the ECB is softening the blow for banks from negative rates. Following the model of the Swiss National Bank, the ECB will exempt 6 times the amount of the minimum reserves. In our view, this could translate into a cost of €5.5-6bn for the Eurozone banking system relative to the current cost of €7bn. If so, this would be a net benefit of €1-1.5bn despite a lower deposit rate and higher excess reserves driven by renewed asset purchases (see table below for the numbers). The decision also opens up the option of further rate cuts. In that sense, it reinforces the forward guidance. With more bank reserves exempted from the penalty rate, the ECB gives itself some headroom to lower rates further and increase the amount of excess reserves via its asset purchases while limiting the costs for banks.
- **Asset purchases/issuer limit:** The ECB will re-launch net asset purchases worth €20bn a month from November. The open-ended programme will run until shortly before the first rate hike. The ECB will likely purchase a combination of government bonds, corporate bonds, ABS and covered bonds as previously. The ECB forecasts inflation at 1.5% in 2021 which is probably below what the ECB regards as "sufficiently close to, but below, 2%". Thus, the ECB seems highly unlikely to raise rates before 2022 – unless inflation were to surprise a lot on the upside. The asset purchase programme could therefore last for at least 24 months with a total volume of €480bn. More likely it will last longer. According to Mario Draghi there was "no appetite" on the ECB Council to discuss the self-imposed issuer limit for purchases of government bonds as the ECB would have headroom for quite a long time. To be able to purchase assets of €480bn, the ECB may still have to raise the limit from 33% to 40% at some point in the future, though – unless the ECB decides to tilt the asset purchases significantly away from government bonds or to expand the universe of eligible assets.
- **TLTRO**: The ECB also decided to make the terms of its new targeted long-term liquidity operations (TLTROs) – starting this month – more generous. The TLTROs will last for three years instead of two years planned originally. The ECB also abolished the 10bp mark-up on top of the deposit rate for these liquidity injections.

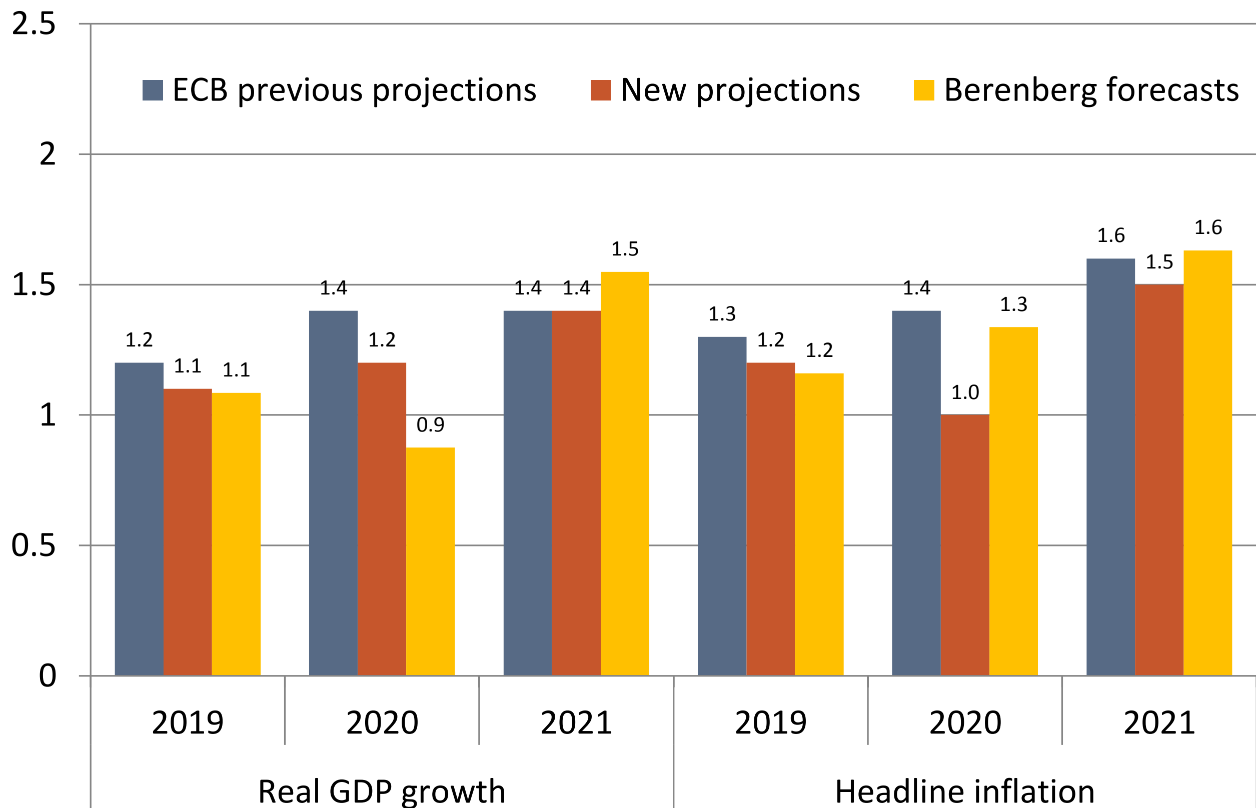
Will the ECB package make a major difference? Probably not. The impact of further easing on business and household spending is likely to be very small. In a situation that is almost akin to a liquidity trap, ever more negative rates comes close to pushing on a string. Nonetheless, further easing can still help to contain the downside risks. First, the ECB can prevent market turbulence which could potentially exacerbate the drag on the real economy from the challenging environment of trade wars, Brexit and the Chinese slowdown. Second, by lowering funding costs further, it can make it easier for governments to finance a modest fiscal expansion and nudge countries with some extra fiscal space to actually use it – think Germany.

Relative to previous net asset purchases of €60bn or even €80bn per month, the ECB's new open-ended purchase programme looks modest. On their own, purchases of €240bn in one year will raise the balance sheet of the Eurosystem by c2ppt of GDP in a year from its current level of close to 40%.

Although Draghi is not leaving before November, today's meeting will be remembered as his major final act. Given the bigger-than-usual divisions within the Governing Council, Draghi probably had to go all in to sway (most of) his colleagues to play largely the melody he had set out at the ECB's annual gathering in Sintra in early June.

Draghi made it clear that the ECB under his helm would do whatever it takes to firmly anchor inflation expectations and raise inflation back towards the ECB's target. While fiscal policy is more effective than monetary policy, waiting for a big fiscal boost would be like waiting for Godot. Further ECB easing could have notable side-effects. However, doing nothing in the face of a significant economic slowdown would have also entailed risks.

ECB previous projections vs. our estimates of new ECB projections (yoy, in %)



Sources: ECB, Berenberg.

Cost for banks of negative deposit rate by factor of minimum reserves not charged penalty rate

Tiering	Factor of minimum reserves not charged negative rate		Deposit rate (in %)			Net average reduction in cost from tiering in %
			-0.4	-0.5	-0.6	
No	1 (previous factor)	Cost in € bn (based on current excess reserves)	7.0	8.8	10.6	0
Yes	2		6.5	8.1	9.8	8
Yes	5		4.9	6.1	7.4	31
Yes	6 (new factor)		4.4	5.5	6.6	38
Yes	10		2.3	2.9	3.5	67

Costs are based on current excess reserves. Once the ECB relaunches net asset purchases, excess reserves and, therefore, costs would go up. In the case of the new deposit rate of -0.5% and 6 times the amount of minimum reserves exempted from the deposit rate, the cost could rise from €5.5bn to roughly €6bn. Source: ECB, Berenberg

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