Viewpoint:
The European Central Bank's Latest Measures

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Key views

- On June 5 the European Central Bank ("ECB") introduced five measures that loosen monetary conditions.
- Two actions stand out. The deposit interest rate was cut ten basis points, to -0.1%; banks will now have to pay for holding reserves over the minimum threshold. A lending scheme was introduced to encourage commercial banks to borrow from the ECB at low rates and lend to businesses.
- The central bank's goal is twofold. First, to prevent deflation, at a time when consumer prices are rising just 0.5% a year. The ECB also wants to push more credit into the real economy, which might result in more investment, employment, and economic growth.
- I believe the ECB's measures are timid and indirect, and are unlikely to succeed, especially in the short term. The cut in the deposit rate might lower interest rates slightly, on the short end of the yield curve. The targeted long-term refinancing operations, however, won't deliver higher total credit, and will only locally ease supply constraints.

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When Mario Draghi was appointed president of the European Central Bank he was known as "Dov'è Mario" (Where's Mario), a reference to his habit of being somewhere else whenever he was needed. Fortunately for the eurozone, he didn't live up to his nickname. On July 2012, the euro's time of need, Mario stepped into the spotlight, promising to do "whatever it takes" to save the currency. Never had three words accomplished so much. That historical phrase was followed this month by another brilliant vocal performance, which should finally earn Draghi a better moniker: the Caruso of open mouth operations.

The package of measures announced in June 2014 is, I think, a breath of hot air to the eurozone, a lofty statement with no artillery support. Neither the new long-term refinancing operations, the negative deposit rate, nor the dangling carrot of outright asset purchases will raise inflation this month, or next month, or the month after. And, although a few banks may benefit from the "targeted lending" program, the new facility is a drop in the bucket, not the flood that would lift credit markets. The eurozone may end up dodging deflation, but if it does the ECB shouldn't take credit for it.

My sympathies are with Mario "Caruso" Draghi. It must be devilishly hard to design monetary policy for a motley bunch of national economies. It must make one mad having to listen to "suggestions" from two dozen national central bankers, prime ministers, and finance ministers. In addition, Draghi must get frustrated having to tip-toe around the issue of straight quantitative easing, lest he upset "the other" central banker in Frankfurt or a certain court in Karlsruhe. These institutional hurdles have given European monetary policy a unique brand: minimal substance, best delivery.

What they did

On June 5 the Governing Council of the European Central Bank announced five policy changes. First, the ECB cut the headline policy rate (the refinancing interest rate) from 0.25% to 0.15%.

Second, the central bank lowered the deposit rate from 0% to -0.1%. A negative deposit rate means banks will have to pay the ECB for holding reserves over the minimum requirement.

Draghi also shut the door to lower interest rates in the future. He said rates will remain for an extended period of time "at present levels"—rather than "present or lower levels" as he had stated in previous communications. Clearing up any ambiguity, Draghi said that "for all the practical purposes [sic], we have reached the lower bound."

Third, the Governing Council approved two "targeted long-term refinancing operations" (TLTRO) for a total amount of €400 billion. These animals are essentially loans to banks, which the central bank will extend on scheduled dates. The interest rate will be set at the "marginal refinancing operations rate" plus 0.1%—right now that would be 0.35%. The "targeted" bit comes from the fact that the TLTROs—or "teltros," as Draghi called them—are designed to increase net lending to the real sector.

How will "teltros" do that? The first two loan offerings will happen in September and December. Between March 2015 and June 2016 participants will be allowed to borrow more funds at quarterly offerings. For any bank, the additional loans will be limited to three times that bank's net lending between April 2014 and the time of the refinancing operation, and above a given benchmark. Loans to households for house purchases don't qualify. All TLTROs will mature in September 2018. And participating banks that don't meet their net lending benchmark will have to pay back borrowings in September 2016.

Fourth on the list of measures, Europe's central bank will stop sterilizing operations under the Securities Markets Program ("SMP"). The SMP was started in 2010 to buy securities, with the goal of lowering yields and improving liquidity in a sovereign debt market which was, at the time, under severe stress. The program is different from outright quantitative easing in that asset purchases are offset (i.e. "sterilized") through interest-bearing accounts, where banks deposit cash in an amount equal to the SMP's asset holdings. These deposits drain funds from the short-term money markets.

Removing the sterilization implies the central bank will in practice be delivering quantitative easing, but in a small dose. At the end of May assets under the Securities Markets Program amounted to just €160 billion. For comparison, the U.S. Federal Reserve has bought over a trillion dollars' worth of assets under QE3 alone.

Fifth, and finally, the Governing Council decided to "intensify preparatory work" on purchases of asset-backed securities. The central bank will consider buying "simple and transparent" ABS with underlying assets consisting of claims against the non-financial sector.

Why they did it

The ECB's aim is twofold. First, it wants to counter the risk of deflation. The headline inflation rate has been declining since November 2011. By May 2014 annual inflation was just 0.5%, and not rising. Some countries (Greece, Cyprus, Portugal, and Slovakia) have seen deflation for a few months in a row already, while others (Spain, Italy, Ireland)

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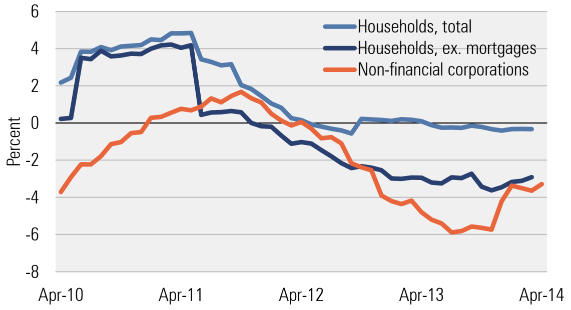
are on the knife's edge. Looser monetary policy may stoke inflation by weakening the euro. In the medium term prices might also be supported by more credit and faster growth of nominal spending.

The central bank's second goal is to support lending to the real economy. Credit balances have been contracting as the nonfinancial sector deleverages and banks shrink their balance sheets. Eurozone-wide, loans to households declined in 2013 and so far in 2014 keep on falling. Excluding mortgages, household loans are falling almost 3% a year (see **Figure 1**). Loan balances of non-financial corporations are contracting even faster, after falling in both 2012 and 2013.

Figure 1

Loans to non-financial sector

One-year percent change



Source(s): ECB, FactSet.

Impact of the measures

What will the new policies do? Take, first, the **targeted long-term refinancing operations**. The program will likely lower borrowing rates for some banks, especially those with weaker balance sheets in the periphery, but I believe the credit that this program can create in the short term is modest. First, because the allotted €400 billion isn't much, relative to the size of the eurozone economy. The net size of the program will be even smaller if the ECB allows the existing LTRO program to expire at the end of 2016, triggering repayments. Second, TLTROs are designed to be a long-term cure, not shock therapy. They will be introduced over two years, and the ECB loans will have a maturity between two and four years.

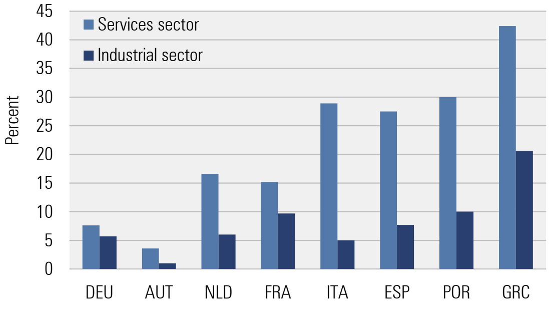
Another reason the "teltros" may not succeed is that banks are busy toning up their capital ratios. In the eyes of bank regulators, new loans bring additional risk to the banks' portfolios. To get in financial shape banks are trimming high-risk assets. Deleveraging has been intense in Spain and Italy, where some banks face pressure to pass the next round of stress tests. Businesses in those areas are thus least likely to find a bank willing to lend (see **Figure 2**). Cheap funding from the ECB does nothing to eliminate credit risk, and so I think TLTROs won't stimulate credit growth overall.

On the whole, supply isn't what limits fresh lending in Europe. Most banks can now access funding in the open market. Interbank lending spreads are within the normal range (see **Figure 3**). A few institutions with problems to issue debt, mostly in the periphery, will find the TLTRO terms attractive— assuming they can find borrowers to whom they're willing to lend. But supply-constrained markets are a minority. More likely is that, overall, the absence of credit growth is due to weak demand.

Figure 2

Factors limiting activity

% of businesses reporting that financial constraints limit activity

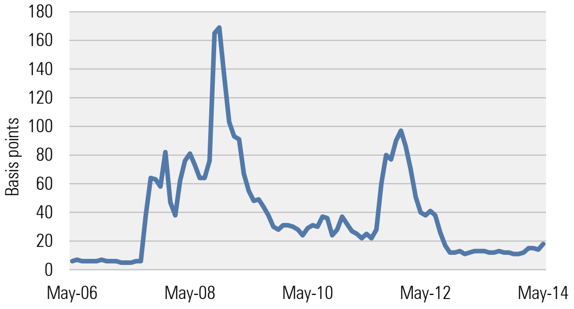


Source(s): Eurostat, FactSet.

Figure 3

Interbank market tension

Spread between 3-month EURIBOR and 3-month EONIA swap



Source(s): ECB, Bundesbank, FactSet.

The closest benchmark to the new lending program is the Bank of England's ("BoE's") Funding for Lending scheme ("FLS"). Launched in August 2012, the FLS allows commercial banks to borrow from the central bank at discounted rates, as low as 0.25%, against collateral. The borrowing limit is given by the amount of net lending banks do to nonfinancial businesses during a reference period. The interest rate on borrowings from the FLS increases if banks reduce their portfolio of loans.

The BoE's experience hasn't produced clean evidence of what "targeted funding" can do because we can't conduct a what-if experiment –i.e. what if the BoE had not started

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FLS? An evaluation of the program based on observed, raw outcomes may not be valid. That said, available analyses of the still-young Funding-for-Lending scheme suggest there's been a reduction in banks' funding costs, mortgage rates, and business loan rates.

The program so far has failed, however, to increase bank lending, especially to small and medium enterprises. The program was ineffective at increasing non-mortgage credit, and only somewhat successful at raising mortgage lending—which is the type of debt the TLTROs exclude.

The three largest banks in Britain (Royal Bank of Scotland, Lloyds, and Santander) have largely ignored the Funding for Lending Scheme and focused on shrinking their balance sheets and meeting higher capital requirements. For banks, like those three, that reduce loan portfolios the FLS charges a penalty that raises the interest rate up to 1.5%, much higher than market rates. Given the goal of sprucing up balance sheets, and that high interest rate, these institutions have little incentive to take up FLS funds.

Consider now the other splashy announcement by the ECB: a **negative deposit rate**. Charging for keeping deposits, instead of paying interest as is customary, should discourage banks from holding excess reserves. What the measure fails to do, however, is getting the banking system to "lend out" cash balances.

When, say, Bank One uses reserves to buy another asset or to make a loan, it directs the ECB to transfer balances to the counterparty's bank, Bank Two. Bank One's deposits at the ECB go down, and Bank Two's go up by the same amount. Open-market operations by the central bank, as well as currency withdrawals, do change total deposits. But lending and portfolio decisions by the commercial banks don't.

Lowering the deposit rate, however, does shift down the entire yield curve, through the familiar process. If three-month Treasury bills yield 0.25%, then Bank One would want to get rid of its ECB deposits, now costing ten basis points, and buy some bills. Say Bank One buys bills from Bank Two and transfers ECB deposits to them. But now the central bank charges for those deposits, pushing Bank Two to buy three-month bills too. Banks One and Two bid up the price of T-bills and the yield moves down to -0.1%—plus any liquidity, risk, or transaction premium there might be.

The trading chain doesn't stop there. Banks trade up the yield curve to take advantage of higher yields at longer maturities, pushing the entire curve down to -0.1%—again, plus the term premium. Arbitrage bids up non-Treasury assets as well, lowering the entire scaffold of interest rates and expected returns.

Throughout this process aggregate deposits don't change, because the central bank doesn't engage in asset purchases. The velocity of excess reserves might go up, as banks scramble to avoid the negative yield, but the level doesn't.

Banks can avoid the negative deposit rate by withdrawing physical currency from the ECB. That's a profitable strategy, however, only if transporting, storing, and safeguarding currency cost less than ten basis points. In fact you could make money by offering these services to banks at the cost, say, of nine basis points. (This case of arbitrage, though unlikely, illustrates a theoretical point: the lower bound on central bank deposit rates isn't zero, but some negative number.) Considering the costs involved, however, I don't think any bank will consider converting their ECB deposits into currency—even king-sized mattresses can't hide billions' worth of bank notes.

So far, then, we have determined two qualitative implications of a negative deposit rate. One, interest rates and expected asset returns will go down, possibly touching negative levels at the shortest end of the Treasury curve. And two, there won't be any change to aggregate reserves. Lower interest rates can, of course, result in an expansion of credit. But that's a move along the lending curve, thus proportional to the change in interest rates, not a shift of the supply curve of loans.

How big can the effects be? Not much. First, the deposit rate changed by just ten basis points. In addition, there's no reason why a cut from 0% to -0.1% should matter more than a reduction from 0.25% to 0%, which the ECB did in December 2011 to little effect. Second, total excess reserves are small, around €145 billion. Holding on to those reserves would cost less than €145 million, spread over hundreds of banks. Earnings and capital would scarcely be affected. That banks will raise interest rates on borrowers to make up for the ECB's "tax on banks" is, then, implausible.

Denmark's Nationalbank and Sweden's Riksbank are the only two other central banks that have adopted negative rates before, and neither provides clear evidence of what happens under the zero bound. The Swedish central bank set a rate for seven-day deposits at -0.25% between July 2009 and September 2010. It meant nothing, however, because banks had historically placed tiny amounts in term deposits. The three-month Treasury bill yield dropped to 0.1% during the period.

Denmark's case was just slightly more illuminating. The central bank there sets a limit on the current account deposits held by commercial banks. The excess balance must be invested in certificates of deposit at the central

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bank. In July 2012 the Danish central bank cut the rate it paid on those CDs from 0% to -0.2%, where it was held through April 2014.

As a policy experiment, the Danish episode faces the same drawback as the British FLS: we can't sieve the effects of the negative interest rate from everything else. That said, the apparent results of the negative-rate policy are underwhelming. The yield curve shifted and steepened a little, and the three-month Treasury rate got close to -0.2%, where it's been until recently.

Interest rates for bank loans didn't change noticeably, and there was no pass-through, in general, to retail deposit rates. Bank interest rate margins didn't react specifically to negative rates, but rather to low and declining interest rates.

Lending volume didn't pick up, and there was no rise in the demand for currency. The Danish currency did depreciate during the episode—a tiny 0.03 krones versus the euro, to 7.47. However, the Danish central bank's goal is to peg the krone to the euro, so the exchange rate move was within the bank's tolerated range, not a true market response.

What's next

Maybe the ECB's measures matter not because of the effect of lowering short-term yields by ten basis points, but because they signal the willingness to do more in the future. The problem is: what's in store is unimpressive too. Next (and last?) in Draghi's repertoire are asset purchases, probably coming this summer unless inflation rebounds. The ECB probably won't buy government debt outright, as the Federal Reserve and the BoE have done. Those purchases might go against the European Union Treaty, which forbids the central bank from financing national governments. Asset purchases will then be confined, as Draghi carefully said last week, to private asset-backed securities ("ABS").

The problem is that private ABS, which converts private sector loans into assets one can trade, are scarce in Europe. European regulations reduce the appeal of these instruments because issuers are forced to bear some of the credit risk. That's a far cry from, for instance, the United States mortgage-backed securities market until 2008, when lenders could turn their mortgage loans into sellable securities and forget about risk.

Today, the ECB would hoover up the entire supply of private ABS in the blink of an eye. For ABS quantitative easing to be significant, European regulators first need to change the rules. Then the market needs to deepen and spread across countries. Only then can the ECB start buying the stuff. That'll take years, if it ever happens. The upshot is that quantitative easing, à la ECB, won't shift inflation, interest rates, or the flow of credit this year or the next.

None of the new policies addresses the risk of deflation pronto. If the ECB wanted to boost inflation, it should have done so months ago, by targeting the exchange rate. The euro has appreciated 12% against the dollar since Draghi ended the eurozone crisis in July 2012. A dearer euro has lowered the cost of imports. Don't get me wrong: a commitment to devalue the euro wouldn't be the silver bullet for deflation. High unemployment and impaired balance sheets could still hold back nominal growth. But targeting the exchange rate may be faster and more effective than "teltros" and negative interest rates.

The new policies won't raise lending to businesses much, especially not where more credit is needed. If more credit is the goal, then Europe should poke elsewhere. It can pass policies that encourage banks in the "core" to direct lending towards the real economy in the "periphery." Or it can relax capital requirements for banks. It doesn't make sense to encourage lending with one hand, and force banks to raise capital ratios with the other.

Last week, when asked about QE, Draghi replied with an ominous "Are we finished? The answer is no, we aren't finished here." He sounded almost as dramatic as two years ago: "Whatever it takes. And believe me, it will be enough." If only they would let him walk the walk.

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