IE Global Investment Event

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For Professional Clients and Institutional Investors

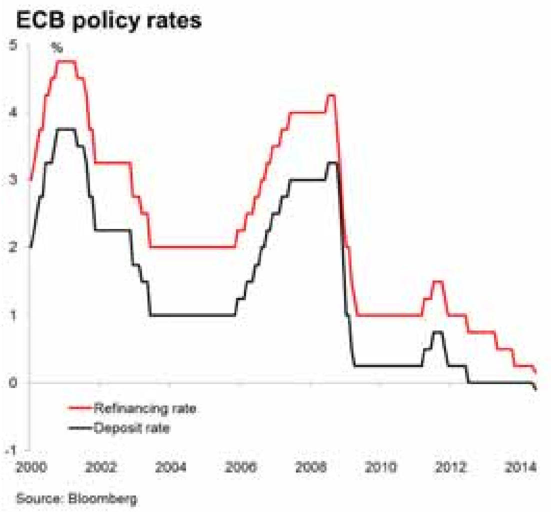
The ECB cuts deposit rate into negative territory and takes a step towards QE

The facts

- Yesterday, European Central Bank (ECB) president Mario Draghi announced a three pronged package of measures with the aim of stopping disinflation in the Eurozone becoming outright deflation.
- Firstly, the ECB cut both the refinancing rate and the deposit rate by 10 bp, to 0.15% and -0.1% respectively. The aim of these measures is to ease monetary conditions and weaken the euro, which has risen by 12% on a trade weighted basis over the last couple of years putting downward pressure on import prices. In addition, the ECB announced that it would stop "sterilising" the purchases it made under the Securities Markets Programme thus injecting €165bn of liquidity into the system further increasing monetary accommodation.
- Secondly, the ECB introduced new measures aimed at improving the functioning of the monetary transmission mechanism. It will offer around €400bn of "targeted" cheap four-year loans to banks provided that they can show that the money is being passed on to the real economy in the form of loans to companies and consumers. More significantly, the ECB said that it has accelerated plans to buy securities containing packages of loans to non-financial corporates in the secondary market. This could be seen as an initial step towards quantitative easing (QE).
- Indeed, thirdly Draghi reaffirmed that the ECB still has the option to use QE in the medium-term if inflation expectations decline significantly further.

The deposit rate goes negative for the first time

As expected, given recent comments from senior policy makers, the ECB cut its refinancing rate from 0.25% to a new record low of 0.15% and cut its deposit rate by 10 bp to -0.1%. The cut in the refinancing rate was a little smaller than the market had been expecting at 10 bp rather than the anticipated 15 bp. In addition, the ECB also put in place measures to "enhance" the functioning of the monetary transmission mechanism. In other words, to try and halt the slide in lending to companies and households, which is particularly rapid in the peripheral economies.



Source: Bloomberg

This is the first time in the ECB's history that it has had a negative deposit rate. In moving its deposit rate into negative territory it is following a trend started by its Scandinavian counterparts. When Denmark's Nationalbanken introduced negative official interest rates in July 2012 it was effectively the first central bank to do so given that the Swedish Riksbank has never really applied the negative rate it introduced in 2009.

Disappointing data forced the ECB to act

Both Eurozone activity and inflation data released since the start of the year have surprised to the downside, triggering the ECB to revise down its 2014 GDP forecast from 1.2% to 1.0% and its inflation forecast from 1.0% to 0.7%.

Source: Bloomberg

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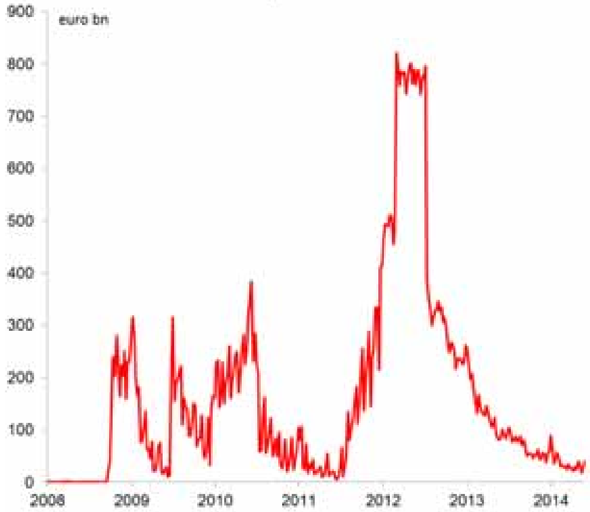
Eurozone activity data has consistently come out below market expectations since late March. Among the downside surprises was the Q1 GDP data which showed the pace of growth slipping from 0.3% qoq to just 0.2%. The inflation data has been surprising on the downside for longer, since February 2013. This trend continued on Tuesday when May's inflation rate came out at 0.5% yoy down from 0.7% in April and well below the ECB's target of close to but below 2%.

Negative deposit rates are unlikely to boost lending

The ECB's negative deposit rate means that it will be charging banks to place excess liquidity on deposit with it. In theory, this should make banks more likely to lend their funds to businesses and households instead of hoarding them. After all, doing so would earn the bank a positive expected return at the cost of taking the credit risk associated with this lending. In reality, a risk-adverse bank could also respond to a negative deposit rate by investing its excess liquidity in "low-risk" government bonds rather than increasing lending. Buying government bonds rather than lending the money has the added benefit of generating a lower regulatory capital charge.

Moreover, the lesson from the experience of Sweden and Denmark of operating negative deposit rates is that they only have an impact when there is excess liquidity in the system. As the chart below shows, this is not currently the case in the Eurozone. Reserves on deposit with the ECB have come down from an average of €689bn when the Eurozone crisis was at its height in the first half of 2012 to an average of just €36bn so far this year. A Danish central bank official recently said, when asked if Denmark's negative deposit rate led to higher lending, "the effect on the real economy has for all practical purposes been zero." It seems likely that the impact of the ECB's negative deposit rate will be similar.

Bank reserves on deposit with the ECB



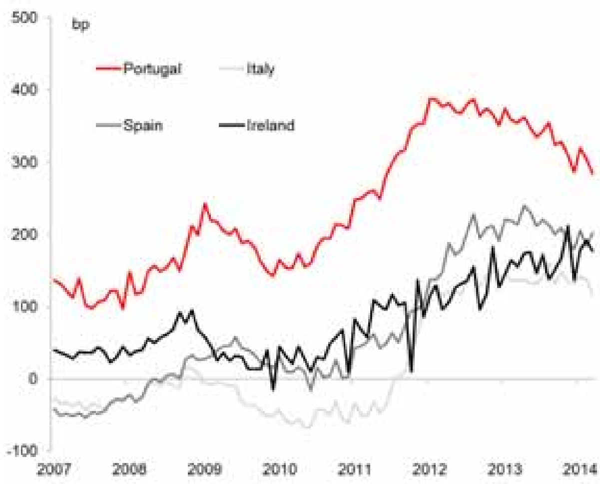
Source: Bloomberg

Why was it necessary to "enhance" the transmission mechanism?

The risk was that because the transmission mechanism for monetary policy was impaired the Eurozone could slide slowly from disinflation to outright deflation. Over the past year the stock of lending to Eurozone non-financial companies has fallen by 2.7%. Weakness in lending growth has been focused in the periphery countries (e.g. -4.8% yoy in Greece, -5.1% yoy in Portugal, -5.2% yoy in Ireland and -9.9% yoy in Spain).

In addition to lending volumes being poor in the periphery the cost of borrowing is higher in these countries, especially for small and medium sized enterprises. As the chart below shows, before the financial crisis the differentials were much narrower.

Small and medium size company borrowing spreads over Germany



Source: Bloomberg

Market reaction & investment implications

On the day, the market reaction to the ECB's new measures was mixed. The euro initially fell sharply versus the USD, but then recovered to end little changed. Similarly Eurozone equity markets initially rose, but then fell back a little. Overall, the Euro Stoxx 50 was up 0.9%, led by the peripheral markets with the Italian MIB rising 1.5% and the Spanish IBEX rising 1.1%. However, global equity markets were less moved by the ECB's actions with the S&P 500 up just 0.3% and the UK FTSE off 0.1% at the time of the European market close yesterday.

Markets would probably have responded more positively if the ECB had announced the immediate implementation of a programme to buy asset backed securities rather than merely accelerated its preparatory work. Mirroring the move in equity markets, peripheral bond spreads narrowed with the ten-year spread of Italy over Germany dropping by 6 bp to 153 bp and Spain's spread narrowing 3 bp to 142 bp.

Overall, the ECB action is probably a small positive for local risk assets, but more aggressive action at a later date may be needed in order to prevent deflation becoming entrenched in the Eurozone. Indeed, the actions taken today could be the first step towards an eventual asset purchase programme.

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