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For professional investors

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ECB stimulus is 'clever move' to boost bank lending

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Chief Economist

- **Deposit rate is cut to -0.4% as QE rises to EUR 80 bln/month**
- **TLTRO scheme would allow banks to borrow at negative rates**
- **Non-bank corporate bonds to be included in QE for the first time**

The European Central Bank's latest stimulus package is a clever move to boost bank lending that was welcomed by markets, says Chief Economist Léon Cornelissen.

The ECB on 10 March further cut interest rates and expanded its quantitative easing (QE) program to try to stimulate growth in the Eurozone. The already negative deposit rate was lowered by 10 basis points (bps) to minus 0.40%, while the main refinancing (repo) rate was reduced by 5 bps to zero, and the marginal lending facility rate was lowered by 5 bps to 0.25%.

Monthly purchases under QE rose by EUR 20 billion a month to EUR 80 billion, and the ECB said it would include euro-denominated, investment grade corporate bonds issued by non-banks for the first time. A new series of four Targeted Longer-Term Refinancing Operations (TLTROs) – a scheme under which hard-up banks can borrow funds from the ECB – will be launched from June.

European stocks jumped more than 2% on the news, while the euro initially fell by 1.3% against the US dollar due to the lower rates, and spreads on peripheral sovereign bonds tightened, indicating that investors think they are less risky thanks to the extra stimulus. The euro later rose on balance after ECB President Mario Draghi said he saw no need to reduce rates further.

Surprising on the upside

"It is clear that the ECB wanted to surprise on the upside," says Cornelissen. "The old TLTRO lending rate was 0%, but the new one will be as low as the deposit rate of minus 0.4%, which is an interesting move because one criticism of negative rates is that it undermines the business models of banks."

'It is clear that the ECB wanted to surprise on the upside'

"But with a negative TLTRO you compensate for this: you get money if you lend money. If banks borrow from the ECB in order to lend it out, they basically get paid. In this way you subsidize banks if they lend money, so it is a clever move."

Cornelissen said the rest of the package was a positive surprise following disappointment in December when the ECB largely underwhelmed investors. "The 10 bps cut to the deposit rate is basically in line with consensus, but the extra QE was above expectations. Interestingly enough the ECB will now buy non-bank bonds, so that's useful as they were running out of buyable bonds, and buying corporate bonds directly helps their owners."

"All in all it's not a game changer, but it is a positive surprise, and the markets like it. The ECB has again succeeded in surprising on the upside, in contrast to what happened in December, and you could say it's also a restoration of credibility for Draghi."

'You could say it's also a restoration of credibility for Draghi'

Deflation fears remain

The extra stimulus follows renewed fears that growth in the 19-nation Eurozone is stalling as inflation hovers around zero, threatening deflation. GDP growth in the fourth quarter of 2015 amounted to an unimpressive 0.3%, the same as in the third quarter, while headline inflation was minus 0.2% in February, a steep drop from the plus 0.3% in January and far below the ECB's 2% target. That target looks like being further away from ever being achieved, after Draghi forecast that Eurozone inflation would hit 0.1% in 2016, 1.3% in 2017 and 1.6% in 2018.

Following the March announcement, the already negative ECB deposit rate means banks must pay extra to leave surplus funds at the institution, rather than being paid interest for it, theoretically encouraging them to lend it instead. Draghi said he does not foresee rates falling any further on current economic projections. Japan has also introduced negative interest rates, surprising markets in January by setting a rate of -0.1% for deposits left by financial institutions.

Late to the QE party

The ECB's QE program began in March 2015, when it became the last major central bank to introduce it, more than six years after the US first used 'printed money' to buy bonds. The US Federal Reserve (Fed) has since ended its program, as its economy has been growing steadily, enabling the Fed to raise rates for the first time in almost a decade, from 0-0.25% to 0.25%-0.5%, in December 2015.

The ECB has not changed monetary policy since its meeting in December 2015, when a decision to cut deposit rates and extend the QE program by a year actually disappointed investors, who saw it as being too weak. The euro subsequently soared 2.6% against the US dollar in its biggest one-day gain in six years, and has since then on balance moved sideways although on a volatile path.

At the December meeting, Cornelissen said Draghi, who was known to want stronger stimulus measures as part of doing "whatever it takes" to save the Eurozone, was outvoted by less dovish members of the 25-person Governing Council.

However, many commentators believe that conventional monetary policy is running out of steam, and the time may eventually come to use 'helicopter money'. Under this kind of drastic action, money is metaphorically thrown out onto the streets from a helicopter, though in reality it would be paid into millions of private bank accounts. While directly stimulating public spending, it has the added bonus of creating much-needed inflation, or at least staving off deflation.

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