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Asset management

Hot potato

Economist Insights

The ECB managed to deliver a more comprehensive set of policy measures than expected. However, the market reaction was not very positive as the ECB shifted away from interest rate policies in favour of non-conventional measures. In particular, the ECB introduced a new targeted long-term refinancing operation (TLTRO) which, unlike the previous version, has a far greater potential size and more favourable conditions, including paying banks to borrow from it.

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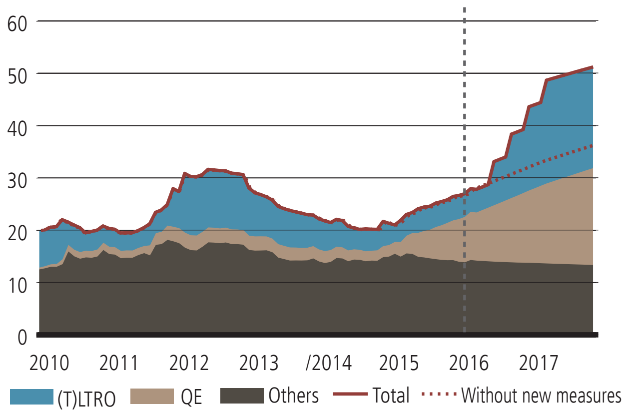
It is always a bit disheartening when you lay on a big surprise for somebody, and after the initial flush of joy they are clearly disappointed with it even though they had no idea it was coming. This is exactly how the President of the European Central Bank (ECB), Mario Draghi, probably felt on Thursday. Not only did the ECB deliver on market expectations of a further cut in deposit rates to -0.4%, but they surprised by increasing the pace of quantitative easing (QE) purchases, expanding QE to cover investment-grade credit, and introduced another round of targeted long-term refinancing operations (TLTROs) for banks. Yet after an initial risk-on rally the market quickly reversed to end the day worse than it started.

Perhaps Mr Draghi committed the sin of over-confidence. Everything looked happy in the markets until they heard him rule out further cuts to interest rates. The currency markets definitely didn't like it - the EURUSD appreciated about 2% against the pre-announcement level, reversing an initial 1% rally. Government bond yields also rallied and then sold off, with yields ending higher. Equity markets had much the same initial reaction, but after a good night's sleep decided that on balance the surprise was a welcome one.

Equity markets probably have the measure of it. The potential increase in the ECB balance sheet from these measures could be huge, much larger than that brought about by the QE that has been purchased so far. Before QE, the ECB increased its balance sheet through the first LTRO in 2012 (which was not explicitly targeted to increase lending at the time), but the balance sheet then shrank when the LTRO was paid back (chart 1). QE has increased the balance sheet, and the pace is increasing. But on top of that we now have another TLTRO programme, which, with full take-up, could help double the ECB balance sheet over the next two years.

Chart 1: QE is just part of it

ECB balance sheet as a share of Eurozone GDP by component, under current plans



Source: European Central Bank, European Commission, UBS Asset Management
Note: Assumes full take-up of new TLTRO, and rolling over of existing TLTRO debt into the new programme. GDP is European Commission forecasts.

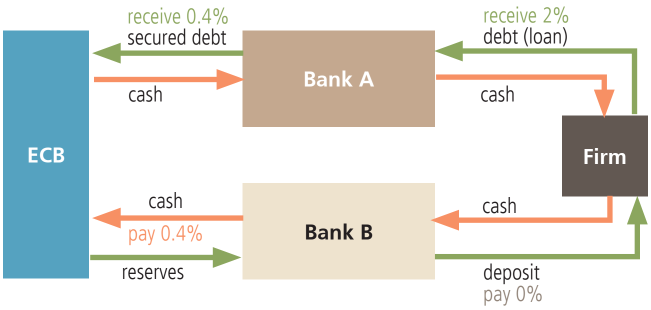
Even if the TLTRO is not a new idea, this version is far more favourable. Firstly, the size is potentially much larger. Secondly, banks will automatically be able to borrow at the current refinancing rate (which is zero) but under relatively mild requirements on their lending activity - they can even borrow at a negative rates. Yes, you read that correctly; negative interest rates. So banks will effectively be paid to borrow from the ECB.

If the ECB is paying banks to borrow money, does that not mean the ECB is making a loss? Actually, no. The money loaned through the TLTRO is created through an expansion of the monetary base. There are only two types of base money: physical notes and coins (which, when you read them, are a claim on the central bank), and electronic reserves at the central bank (another type of claim). Those reserves currently face a negative deposit rate.

Consider the case where Bank A takes out a TLTRO and is eligible for the negative interest rate (chart 2). Bank A offers secured debt in return for cash, and is effectively paid 0.4% for doing so. The cash is then loaned out to a firm, and the bank in return receives some interest (for example 2%). The firm deposits the money into Bank B (or buys things from other firms who then deposit the money in Bank B). So that is cash, and the firm is getting 0% on its deposit. Unless Bank B decides to keep this deposit in the form of physical cash, it will have to be placed as reserves at the central bank. Bank B then has to pay the ECB the negative deposit rate.

Chart 2: Handing over the hot potato

Illustrative example of flows and interest rate paid when the TLTRO is used by a bank to make a loan to a firm



Source: UBS Asset Management

Bank A earns interest from the ECB (plus interest on the loan), and Bank B pays interest to the ECB. So the TLTRO is like a hot potato. You want to be Bank A that takes out a loan but doesn't end up with the cash on its books. So Bank B now wants to get the cash off its books, and the best way to do that is to make a loan or buy some financial asset. This would leave another bank with the cash, and they would face the same incentive. Just like the proverbial hot potato, at the end of the day some bank will be left holding it so the ECB will be paid. The net financial impact on the ECB and the banking sector may be neutral, but the impact will vary between banks. The ECB hopes that this competition to avoid being the losers will encourage more lending.

However, this logic held true before simply because deposit rates were negative, and lending has not increased that much. But now there is a carrot as well as a stick, so the incentive should be larger. So the policies should provide some support, especially for banks that were planning to increase lending in any case.

More important for banks is that they will be able to refinance themselves at zero or even negative interest rates. Eurozone banks with bonds maturing (or callable) over the next twelve months may decide to refinance them using TLTRO funds rather than on the open market. This is likely to lead to savings of between 0.5 and 1.5% of interest for most banks. They may not replace all of their debt this way, not least for regulatory reasons, but this saving could offset some of the additional costs of the bigger negative deposit rate. The costs of that negative deposit rate are increasing as well, because the additional QE and TLTROs will increase the monetary base, and this money will end up in bank reserves at the ECB – all of which have to pay the negative deposit rate.

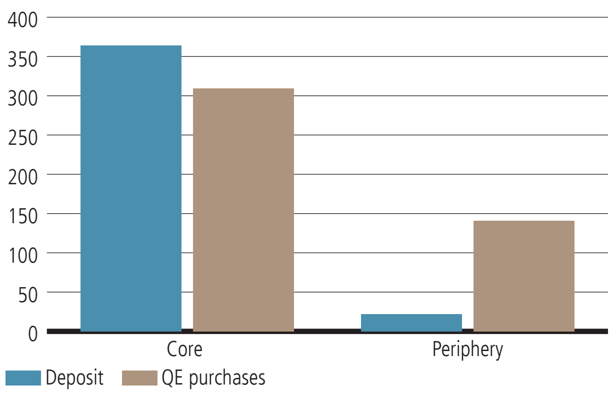
Quantitative divergence

The way that ECB measures hit banks differently is already evident when we look at the experience of QE in the Eurozone. As the ECB started buying government bonds through its QE programme it broadly followed the capital key of the ECB, linking purchase amounts to how much each country is responsible for the ECB's capital base. So in theory this should have spread out the liquidity around the Eurozone pretty fairly.

In practice, since the holders of bonds are not necessarily in the country, the resulting liquidity may not end up in the bank of that country. In fact, with home bias it is most often the domestic buyers who are least willing to sell the bonds. Virtually all of the extra liquidity generated in the Eurozone ended up in the core, even though about a third of the bonds purchased came from the periphery (chart 3). In short, the benefits have accrued to the core as almost all the liquidity injected by QE has ended up in core countries in the form of deposits, while very little has ended up where it is most needed, the periphery. On the other hand, those core banks will now have to pay more of the negative deposit rate to the ECB.

Chart 3: QEasy

Increase in bank reserves and quantitative easing by region, from end February 2015 to end November 2015, EUR bn



Source: European Central Bank, National central banks, UBS Asset Management Note: Core is Germany, France, Austria, Netherlands, Belgium, Luxembourg, Estonia, Lithuania, Latvia, Finland, Slovenia, Slovakia, Malta. All other Eurozone countries are periphery.

At a time when the markets are starting to doubt how much firepower the central banks have left, the ECB managed to make relatively minor changes to create a significant impact. Even when the aggregate impact can appear neutral it's still possible to make each individual change their behaviour, just to make sure they are not the ones with burnt fingers.