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ECB preview: higher rates, tighter liquidity

ECB to hike rates by 75bp and introduce TLTRO-based tiering

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FLASH NOTE

SUMMARY

- The ECB is widely expected to hike policy rates by 75bp at its 27 October meeting and to commit to additional tightening in the next few months. We don't expect much clarity on what it considers the 'neutral rate', but a growing consensus seems to be in favour of having the deposit rate at 2% by the end of the year (implying a 50bp hike in December), with a reassessment of the economic and inflation outlook in early 2023.
- A special focus of attention next week will turn to measures limiting the attractiveness of TLTROs. We expect the ECB to introduce a TLTRO-based tiering system to reduce the gains for banks benefitting from cheap TLTRO loans (the average rate on which is below the ECB's deposit rate) and redepositing excess reserves at the ECB (at the deposit rate). This system will incentivise banks to repay the share of TLTRO not used for regular funding before June 2023.
- A broad-based reverse tiering system based on all banks' excess reserves may create risks for the transmission of monetary policy to euro area money-market rates. Retroactive changes to TLTRO terms would raise legal risks and threaten the credibility of an instrument that could be needed again in the future.
- The ECB will likely confirm that Quantitative Tightening (QT) will start in 2023, once policy rates are normalised. Crucially, QT will be a passive, gradual process.

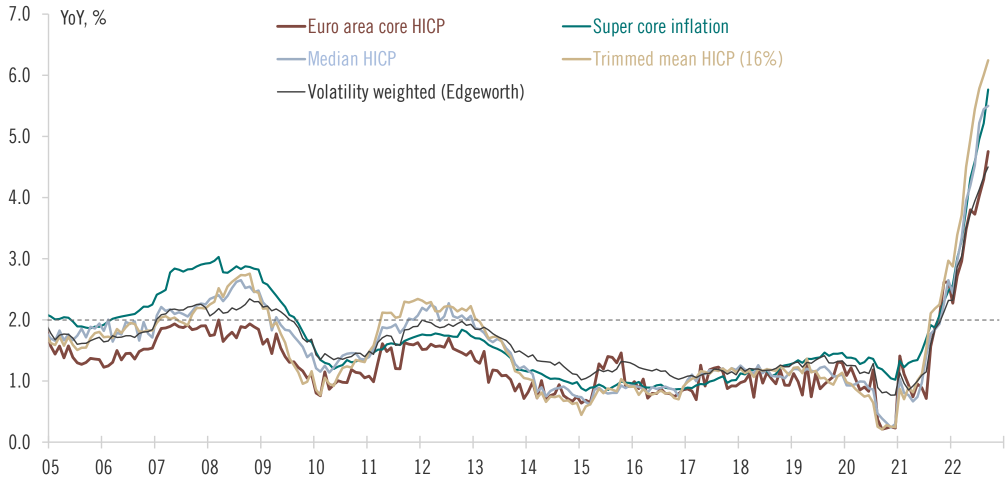
GETTING TO 2% BY DECEMBER, THEN WHAT?

A second consecutive 75bp rate hike from the European Central Bank (ECB) looks like a done deal at the 27 October meeting of the Governing Council. Contrary to previous meetings, no dissenting comments or controversy have appeared in media reports over the size of the upcoming rate hike. Even the most hawkish members of the Governing Council (GC) have argued that 100bp would be a step too far, while a smaller hike than 75 bps would destroy the ECB's credibility.

Moreover, a strong consensus seems to be emerging around the idea of bringing the ECB's deposit rate to 2% by the end of the year, which the ECB's chief economist Philip Lane described as the upper range of neutral rate estimates. This would imply a 50bp hike in the deposit facility rate at the December meeting.

The risk is that the ongoing broadening of inflationary pressures pushes the ECB to deliver a third 75bp hike in December. In that context, it will be interesting to see if ECB president Christine Lagarde repeats her comment from last month that **75bp rate hikes are "not the norm",** as well as her view that the ECB will stop hiking by March 2023 at the latest.

Chart 1: selected measures of underlying inflation in the euro area



Source: Pictet Wealth Management, Eurostat, ECB, as of 21 October 2022

The discussion around the terminal rate is more open, with some über-hawks endorsing the market pricing of a 3% terminal rate. Whether the ECB needs to raise rates above neutral will depend on the medium-term inflation outlook.

On the one hand, core inflation is likely to remain elevated going into next year—not because of strong economic fundamentals, but rather because of energy prices, first-round effects on energy-intensive goods and services, but also inertia in some HICP items after rapid post-pandemic price increases.

On the other hand, consumers' and firms' inflation expectations are no longer increasing, and there is still little sign of a wage-price spiral, including in Germany, where the latest wage settlement in the chemical industry was relatively modest. Looking at inflation expectations, the ECB's Survey of Professional Forecasters to be published on 28 October will provide the ECB with an important input.

Meanwhile, the risk of a deeper-than-expected recession in the EU is rising despite additional fiscal support and the prospect of EU-wide measures to mitigate the energy shock. **When the ECB staff updates its macroeconomic projections in December, we expect it to downgrade the growth outlook further and to show inflation returning to the ECB's 2% target by 2025.** This would be the decisive argument for the ECB to pause rate hikes in 2023.

TLTRO-BASED TIERING TO TRIGGER REPAYMENTS AND TIGHTEN LIQUIDITY CONDITIONS

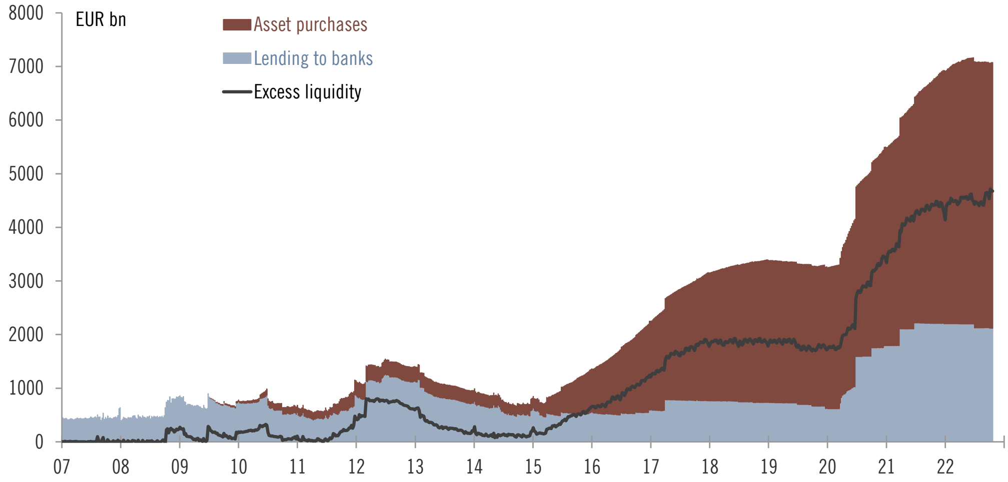
The bigger discussion next week will be on liquidity conditions, specifically on measures aimed at **reducing the attractiveness of Targeted Longer-Term Refinancing Operations** (TLTROs). As a reminder, under the very favourable TLTRO conditions, the interest rate paid by banks is set as the average ECB's deposit rate *over the life of each operation*, i.e. below the *current* deposit rate of 0.75%. This wedge emerged because the ECB is hiking rates faster than expected when the instrument was designed. The net profit recorded by banks, between the TLTRO rate they pay and the deposit rate they get, is amplified by the TLTRO special discount of 50bp that ran between June 2020 and June 2022. The ECB decided not to address the issue at its September policy meeting, but the debate continues to rage.

When policy rates rise, banks' excess reserves are remunerated at higher deposit rates. This is monetary policy 101, so where's the problem? **The problem comes from the huge amount of reserves created** by TLTROs (EUR2.1 trn) and QE (EUR4.9 trn), resulting in EUR4.7 trn of excess liquidity in the system. Assuming a deposit rate of 2% by year-end, commercial banks would benefit to the tune of EUR100 bn on an annual basis.

The optics are bad against the backdrop of a historical shock to households' income, and political pressure cannot be ignored. Note that some countries have implemented a windfall tax on bank profits for similar reasons.

In the end, the best argument for changing banks' liquidity conditions is that the ECB introduced dual-rate TLTROs and reserve tiering in order to mitigate the impact of negative policy rates on the banking system. The goal then was to soften the blow of negative rates on banks' profits and to ensure the proper transmission of monetary policy. **This precedent strengthens the case for doing something similar in reverse now that policy rates are raising rapidly**.

Chart 2: ECB's asset purchases, lending to banks (LTROs) and excess liquidity



Source: Pictet Wealth Management, ECB, Bloomberg, as of 21 October 2022

A recent article by Reuters points to three main options for the ECB:

- **An ex-post change to TLTRO terms and conditions.** This is the worst option in our view, exposing the ECB to legal complaints while threatening its

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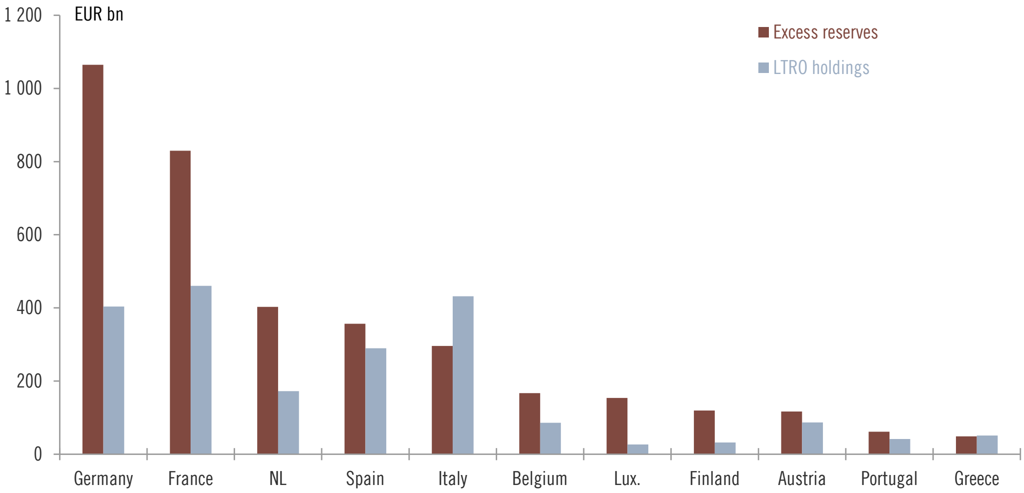
credibility. We think TLTROs are an important part of the ECB's toolkit and could prove useful again in the future, but banks will think twice before using them if the ECB can change their terms retroactively. TLTROs have played a decisive role in ensuring the transmission of monetary policy, but are also used by banks to meet their regulatory obligations, including liquidity ratios.

As a matter of fact, the ECB may well introduce new non-targeted LTROs in H1 2023, but at a less favourable interest rate (e.g., the main refinancing rate) to allow banks to roll over the share of TLTROs that they use for pure funding and liquidity ratios, hence reducing the risk of a liquidity cliff.

- **A new reverse tiering system that reduces the share of bank reserves remunerated at the deposit rate** (on the ECB's deposit facility) by increasing the share of reserves remunerated at 0% (on national central banks' current accounts). We think this is the least bad option, but design will be everything. Our preference goes to **a targeted tiering system** in which the amount of excess reserves remunerated at 0% is defined **as a share of TLTRO borrowings**, while reserves above this threshold are remunerated at the deposit rate. Alternatively, under a pure reverse tiering scheme, of the kind operated by the Swiss National Bank, excess reserves could be remunerated at the deposit rate only up to a multiple of the minimum required reserves, with the excess remunerated at 0%. In practice, the ECB could do this in reverse by forcing banks to park a multiple of minimum reserves at national central banks' current accounts, remunerated at 0%, with the excess going to the deposit facility, remunerated at the deposit rate.
- A final option would be to change the remuneration of minimum required reserves (MRR, currently remunerated at the ECB's main refinancing rate of 1.25%) while applying similar rules to excess reserves. This would be highly complicated and could impair the conduct and transmission of monetary policy in the future. Too much pain for uncertain gain.

Chart 3: euro area bank excess reserves and TLTRO holdings (September 2022)



Source: Pictet Wealth Management, ECB, as of September 2022

Money-market participants are concerned that reverse tiering may create market distortions by aggravating collateral scarcity issues and keeping a number of short-term market rates too low compared to the ECB's policy rates. The net effects will

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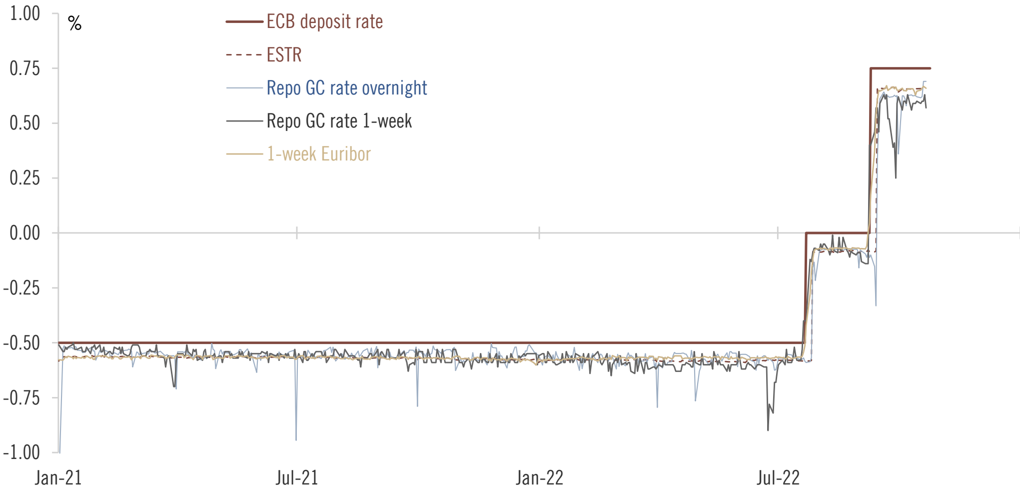
depend on the calibration of whatever tiering system is adopted, which we expect to be relatively "generous" for banks in order to limit market distortions.

Indeed, if the tiering exemptions are too high, the *average* reserve remuneration will decline and banks may be incentivised to seek higher yields in money markets, putting downward pressures on €STR and other short-term rates, hence **impairing the transmission of higher policy rates**.

Moreover, all the above options come with complications related to the heterogenous distribution of excess liquidity and TLTRO holdings across countries (*Chart 3*). In peripheral countries, especially in Italy where TLTRO holdings exceed excess reserves, it remains to be seen how much TLTROs will be repaid as **some banks might be forced to rely on more expensive funding** in money markets to maintain a certain amount of excess liquidity remunerated at the deposit rate. In short, **liquidity plumbing matters for the conduct of monetary policy**.

Chart 4: ECB and euro area money market rates



Source: Pictet Wealth Management, ECB, Bloomberg, as of 21 October 2022

On the positive side, this week's announcement by the German debt agency that it will significantly increase its holdings of government debt securities for repo-market trading suggests that debt management offices are taking the issue seriously. Moreover, even a partial repayment of TLTROs in H1 2023 will release a significant amount of collateral in the system which should support repo market activity.

PASSIVE QUANTITATIVE TIGHTENING IN 2023

Some hawks would like to start reducing the ECB's balance sheet proactively, but we see a large consensus in favour of a more pragmatic, cautious approach when it comes to Quantitative Tightening (QT), if only to ensure the smooth normalisation of policy rates first. Lagarde made clear that QT would only start once rates have reached a more neutral/normal level. The recent events in the UK, which forced the Bank of England into a major U-turn on bond purchases, could be viewed as a useful reminder that any aggressive withdrawal of liquidity risks being highly disruptive for the bond market and the transmission of monetary policy.

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When it comes to QT, boring is beautiful. We expect the ECB's QT process to start in Q2 2023, and to be predictable, gradual, and passive, starting with the end of reinvestments under the Asset Purchase Programme (APP) but not actively selling bonds any time soon. The latter will result in a balance sheet run-off of EUR25-30 bn per month on average, including EUR22 bn of government bonds.

Still, the combination of large TLTRO repayments of more than EUR1 trn by Q2 2023 and the end of APP reinvestments could lead to a relatively fast pace of balance sheet reduction in 2023, followed by a more gradual decline in the following years.

The risk is that large net issuance of government debt in coming years meets lower demand without the backstop of the ECB as a marginal buyer, putting more widening pressure on bond yields and spreads. This may in turn fuel speculation around the ECB's recently unveiled Transmission Protection Instrument (TPI), which could be activated in coming months even if it is not used in size.

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