27 October 2022

Flash: ECB review

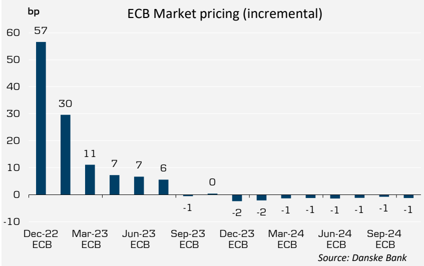
75bp and tightening liquidity conditions

- At today's meeting, the ECB decided to hike all policy rates by 75bp and gave signals that it is slowing the hiking pace. Lagarde emphasised the data dependency, and the meeting-by-meeting approach to calibrate policy rates. This was in line with expectations and we do not alter our view of a rate hike expectation of 50bp in December.
- There were a number of technical details. These included a small change to the rate by which the minimum reserves are remunerated (now the depo rate and not the MRO rate) and a large overhaul of the TLTRO terms. The latter is set to cause a significant drop in excess liquidity already from 23 November.
- Inflation risks are to the upside, while growth risks are on the downside.

Key takeaways

- 75bp rate hike, but less going forward.
- Weakening growth outlook featured more prominently.
- Markets pricing ECB to end its hiking cycle early.
- Technical changes to TLTROs and minimum reserve remuneration.

Inflation still above target in 2024



Source: ECB, Eurostat, Macrobond Financial, Danske Bank

Increasing prominence of slowing growth, but too high inflation leaves ECB narrative broadly unchanged

With the ECB still firmly in tightening mode, the recession risks for the euro area economy are increasing. Inflation remains too high for comfort and the ECB expects it to stay above target for an extended period, as price pressures continue to broaden. Hence, further monetary tightening is needed to guard against the risk of a persistent upward shift in inflation expectations. Lagarde acknowledged that growth in wages may be picking up amid a historically tight labour market, and together with the effect from the depreciating euro this means inflation risk remains firmly on the upside. The ECB's rapid interest rate increases should further sharpen the downside risks for the economy in 2023, adding to the hit to real disposable income from soaring energy prices. The latest bank lending survey already pointed to deteriorating credit conditions amid waning loan demand, especially for fixed investments (see *here*). Lagarde also reiterated her call for fiscal policies to be temporary, targeted and tailored to avoid conflicting with the ECB's inflation tightening mandate.

Reinvestment discussion to take place in December

ECB markets and in particular the periphery were supported by the reinvestment discussion being postponed until the December meeting, where a road map for how to end the full reinvestments is due to be discussed. Whether they come to a formal decision remains to be seen and sources are reported to have suggested that only key principles would be discussed. Markets had implicitly priced in a risk of this road map being presented today, but were relieved by the postponement of the discussion. ECB data show that under the PSPP programme, on which where the discussions will focus, is around EUR20bn/month. Italy outperformed Bunds by 15bp, despite Bund yields declining 15bp on the day.

Changing reserve remuneration

The ECB also announced a change to the reserve remuneration system so banks are no longer remunerated at the MRO rate (2% effective from 2 Nov) but at the deposit rate (1.5% effective from 2 Nov) of their minimum reserve requirement, which is about EUR164bn in total.

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Big change to TLTRO remuneration

There had already been a significant discussion about how the ECB would address the ‘flaw’ in the TLTRO remuneration rate. Lagarde said that the decision was taken for monetary policy purposes in light of high inflation, tightening liquidity and supporting the repo markets.

The TLTRO is a complicated measure and in our view the most complicated measure the ECB has ever introduced. TLTROs were ‘super charged’ at the start of the pandemic, which have led to an outstanding amount currently of EUR2.1trn. The rate of the operations is complicated to calculate. First of all it depends on the banks’ loan book development, with loans to households (excluding house purchases) and loans to non-financial corporations. Most banks are likely to receive the best possible rate according to our calculation. The best possible rate under the old system was set as the average deposit rate from the start of the individual operation until Jun22, while the rate on the remaining period until maturity would be the average deposit rate from the start of the operation to the maturity of the operation. With the rising inflation and thereby higher policy rates, this has so far been a very favourable funding tool for banks.

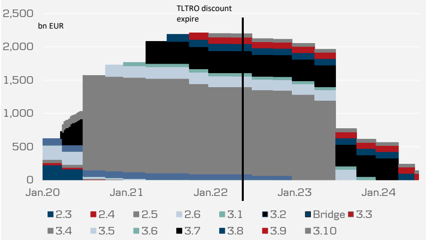
Starting on 23 November, the rate will now be the average deposit rate from 23 November until maturity of the operation or potential early repayment. According to our calculations this means that banks will see their funding rate on these operations increase by around 2.5% compared to the old system, assuming market pricing materialises.

Indicative TLTRO rate assuming market pricing materialises

	TLTRO3.1	TLTRO3.2	TLTRO3.3	TLTRO3.4	TLTRO3.5	TLTRO3.6	TLTRO3.7	TLTRO3.8	TLTRO3.9	TLTRO3.10
TLTRO start	Sep.19	Dec.19	Mar.20	Jun.20	Sep.20	Dec.20	Mar.21	Jun.21	Sep.21	Dec.21
TLTRO maturity	Sep.22	Dec.22	Mar.23	Jun.23	Sep.23	Dec.23	Mar.24	Jun.24	Sep.24	Dec.24
Old TLTRO system'	-0.46	-0.33	-0.10	0.14	0.40	0.62	0.89	1.14	1.40	1.63
Old' terms to 22Nov22	-0.46	-0.38	-0.37	-0.36	-0.34	-0.32	-0.29	-0.26	-0.20	-0.13
23-11-22-> Maturity		1.52	1.99	2.16	2.26	2.31	2.35	2.37	2.39	2.40

Source: Danske Bank

TLTRO maturity profile



Source: ECB, Danske Bank

Peak cycle rate and drop in excess liquidity

Today, markets repriced the ECB’s expectations for further rate hikes by around 25bp to the cycle peak, which we define as the highest point in the policy rate in the coming 5y. Markets are pricing 57bp for the December meeting and we expect 50bp at that meeting. Markets are pricing the ECB deposit rate to peak at 2.58%, slightly above our 2.5% call.

In response to the changed TLTRO terms, we expect a significant drop in excess liquidity from 23 November. However, the magnitude of this drop is difficult to ascertain; an early indication could be around EUR500-1,000bn, but there is a lot of uncertainty about this. Historic collateral suggest 2-5bp upside risk to €STR on the back of lower excess liquidity.

Cycle high ECB policy rate

Source: Macrobond Financial, Danske Bank

EUR/USD still heading lower

With the ECB meeting over, policy rates are higher and EUR/USD lower. Indeed, the ECB’s hike of 75bp and its public acknowledgment of the stagflationary risks (risks to the downside for growth and to the upside for CPI), the market is likely to maintain a negative view about EUR/USD spot. This stagflation theme and that higher European interest rates remain negative for the currency are well in line with our long-held USD-positive view and we have repeatedly seen such market reaction. Thus, we continue to forecast EUR/USD spot in the low 0.90’s and view today as confirming and likely supporting that view.

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None

Date of first publication

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