

Cheap funding in focus for the ECB's December meeting

We're expecting the European Central Bank's TLTRO, the Targeted Longer-Term Refinancing Operations, to be at the heart of its stimulus package that we're expecting in December



Christine Lagarde

All options are on the table

It's been a very active week for ECB officials with comments by, amongst others, Christine Lagarde, Klaas Knot and Madis Muller, all suggesting the Bank is still keeping all options on the table going into its December meeting. While Klaas Knot didn't want to exclude a rate cut, stressing that no single option should be ruled out in the decision-making process, ECB president Lagarde put the most focus on the PEPP, its Pandemic Emergency Purchase Programme and TLTROs as being highly effective and flexible instruments during the crisis.

ECB Governing Council member Madis Muller indicated that the central bank's stimulus package aimed for December should have the TLTRO operation at its core. According to Muller the PEPP by itself may not be the best tool. Instead, measures which particularly address financing conditions for the private sector, notably the TLTRO, would be a possible tool that should be on the table.

Extending the special interest rate period

The TLTRO-III operation lasts for three years and currently has €1,699bn funds allotted to the banking sector. The operation has seven tranches altogether, with two more to go. The 6th tranche is allocated in December 2020 and the last one in March next year. To ease the TLTRO-III conditions the ECB has put in place a special interest rate period, during which banks can get the funds for a one year time period at -1% subject to meeting certain lending conditions. Currently, it runs from June 2020 for twelve months.

Extending the special interest rate period would directly provide more support to banks

Among the options the central bank could do in terms of the TLTRO-III programme could be to extend this special interest rate period to make it even more attractive to banks. This would also make the risk of substantial early repayments from tranches one to five in September 2021 less likely. Extending the special interest rate period would directly provide more support to banks and thus their possibility to lend to the real economy. This could well prove to be the easiest solution to keep the operation attractive and to lessen the pressure from early repayments going into 2021.

Changing the benchmarks

Another option would be related to the lending benchmarks. Most participating banks are likely to be well-positioned to meet the two different lending thresholds. But for those which experience difficulties in meeting these conditions due to the sheer lack of lending demand, the ECB could take another look at how the lending benchmark calculation is set. It could even come up with another set of lending requirements.

Several banks have indicated that they have drawn all the funds from the TLTRO-III that they could. So, if the ECB just wants to increase the size of the operation, it would need to increase the maximum borrowing allowance per issuer to get any meaningful effect. Any changes in the December meeting to the TLTRO conditions would come too late for that month's tranche. The deadline for submitting bids for tranche six is 9 December, that's just one day before the ECB meeting.

The ECB can only provide cheap liquidity to support the real economy

Should the ECB not provide new tranches to the TLTRO-III programme, easing some of its conditions would give even more importance to the last tranche due to be allotted next March. The ECB's monetary policy had already been stretched when the eurozone entered the crisis. Besides stabilising financial markets and ensuring that the eurozone is not hit by another existential euro crisis on top of the current one (aka restoring transmission mechanisms), the ECB can only provide cheap liquidity to support the real economy.

Most action still has to come from fiscal policy. The second lockdown wave will force the ECB to substantially lower its growth forecasts in December. As the inflation goal will also still be out of reach, the ECB will once again step up monetary stimulus. Going into the December meeting, it is clear that views on what to do still differ. We continue expecting the ECB to increase QE, spread across both the PEPP and APP, and to alter both the conditions and duration of the TLTROs.

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