

ECB decision time: Everything you need to know about today's meeting

Today's European Central Bank meeting is crucial. The emergence of the Omicron variant is putting more downward pressure on European economies. With inflation on the rise, we look at Christine Lagarde's biggest challenges. Note, this is a resend of our coverage from last week

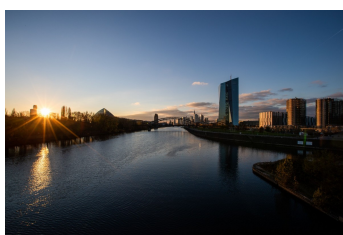
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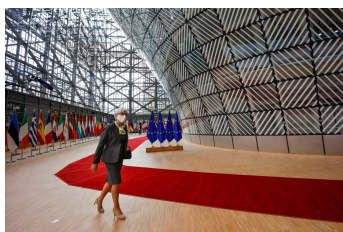
By Carsten Brzeski



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ECB President, Christine Lagarde, is facing many challenges

A lot has been said, analysed and speculated about the ECB's crucial meeting on 16 November. Most leading indicators are pointing to a loss of economic momentum in the fourth quarter, and the current fourth wave of the pandemic and the new Omicron variant will add further downward pressure to the eurozone economy, particularly to private consumption. At the same time, headline inflation has continued to accelerate and even "team transitory" has had to admit that inflationary pressure will last longer than previously anticipated. Against this backdrop, the ECB will have to decide on how to proceed with its emergency measures in particular and how much monetary stimulus the eurozone economy still needs in general.

Fresh round of staff projections

An important element for the discussions will be the next round of ECB staff macro projections. However, we don't expect any significant changes here. Back in September, the ECB had forecast GDP growth to come in at 5.0%, 4.6% and 2.1% in 2021, 2022 and 2023, respectively. Inflation was expected at 2.2%, 1.7% and 1.5%. Traditionally, the ECB's inflation forecasts have been highly

affected by the so-called technical assumptions on oil prices and the exchange rate, and these have hardly changed. Luckily for the ECB, the surge in oil prices after the September meeting recently came to an end, suggesting little additional pressure on the ECB's headline inflation projections.

The 2024 inflation forecast needs to be watched closely

The weakening of the exchange rate has been too insignificant to drastically change the inflation projections. As the ECB's inflation models seem to underestimate the current pass-through from higher producer prices to consumer prices and will also hardly capture any post-pandemic wage bargaining, we don't expect any significant change to the inflation projections. Instead, what needs to be watched closely is the inflation forecast for 2024.

Even if the inflation discussions between 'team transitory' and 'team permanent' become more heated, we don't see them being concluded any time soon. In fact, these talks could easily continue at least until the summer of next year. Consequently, with no fundamental changes to the inflation outlook, save for some stretching of the term 'transitory', the ECB's discussion will not focus on any tightening but simply on how to proceed with the Pandemic Emergency Purchase Programme (PEPP), the ongoing Asset Purchase Programme (APP) and Targeted Long-Term Refinancing Operations (TLTROs) for banks.

What's next for the Pandemic Emergency Purchase Programme?

Regarding the PEPP, President Christine Lagarde put the entire ECB in a corner when she – probably unintentionally – said at the last press conference that the programme would end as expected in March 2022. While the current fourth wave of the pandemic may be a good reason for the ECB to extend PEPP by one quarter, this option is unlikely given comments by Lagarde and others. The central bank could officially confirm the end next week but might want to play it safe and simply postpone a decision until the early February meeting.

The problem with ending the PEPP is the 'cliff edge' effect, as it currently runs at some €60b per month. An abrupt halt would bring total monthly net asset purchases by the ECB down from €80b to €20b (the size of the APP). Of course, the ECB could decide to simply stop PEPP and to just use reinvestments as a means to smooth the transition but we think that this would not be taken well by market participants. Instead, we think that the Bank will have to present a more powerful transition tool, which offers the same flexibility as the current emergency purchase programme.

Extending PEPP could be the easiest way out but could damage Lagarde's credibility

To maintain this flexibility, the ECB could simply extend PEPP, adjust the terms of the 'old' QE programme (APP) or introduce a new third programme. Extending PEPP could be the easiest way out but could damage Lagarde's credibility in communicating with financial markets. Adjusting the terms of the APP to give the same flexibility is possible but could lead to new lawsuits in Germany

as sticking to the capital key was one of the requirements for the German Constitutional Court to give the green light to it. This leaves the start of a new programme as an attractive option. In our view, the ECB could start a Post-Pandemic Transition Purchase Programme (PPTPP), with an envelope of €300b in order to provide a smooth transition after March 2022, while offering the same flexibility as the PEPP.

Words and action

ECB Executive Board member Isabel Schnabel was the first ECB official to say recently that “risks to inflation are skewed to the upside”, while also making the point that there could be “certain structural factors” pushing up energy price inflation in the coming years; the most notable being the green transition. If this wording is echoed in next week’s official ECB communication, it would mark a significant U-turn towards a much more hawkish ECB. However, we still think that the Bank might not yet be willing to fully go down this road.

Therefore, we expect the ECB to continue to sound cautious about the economic outlook, acknowledging the risk of higher inflation while sticking to the view that inflation is transitory and will eventually return to 2%. In order to gradually start the exit from ultra-loose monetary policy without giving up flexibility amid a fourth wave of the pandemic, we expect the ECB to confirm the end of PEPP in March 2022 and to introduce a third asset purchase programme to smooth the transition. TLTROs will not be extended at their current favourable conditions but instead, the tiering multiplier will be increased from 6 to 10.

Cautious recalibration

Given that the Fed has retired the word ‘transitory’, it would be wise for the ECB to prepare for outcomes other than inflation eventually falling back to below 2%. Therefore, a gradual recalibration of all emergency measures to prepare for the possibility of more permanent inflation is a very logical step and good risk management at the current juncture.

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ECB decision time: For banks, more deposit tiering as low TLTRO rate ends

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The ECB headquarters in Frankfurt

The end of TLTRO favourable rates is moving into view

What's to become of the TLTROs, the [Targeted Longer-term Refinancing Operations](#)? They're likely to be on the table at the 'big bang' meeting and the Eurosystem will particularly be looking at the expiry of the -100bp favourable rate on 23 June 2022. To mitigate the impact of this expiry on banks, we expect an increase to the deposit tiering multiplier (set at the initial value of 6 in September 2019, and not modified since), until the deposit facility rate returns to zero (which we expect to happen in late 2023), removing the need for such measures.

This is a rather complicated story, so bear with us. The rate on banks' TLTRO borrowing from the ECB has been made dependent on their lending to the real economy, in particular to businesses. If lending exceeds a benchmark, banks qualify for a borrowing rate as favourable as -100bp. The last favourable rate period runs from July 2021 to June 2022. Unless the ECB announces new modifications to TLTRO conditions (which we do not expect), the borrowing rate will increase to, at best, the deposit facility rate which is currently -50bp.

The end of the favourable TLTRO rate would lower Eurozone banks' negative rate revenues by about €950m per month

Banks have, especially over the past 1.5 years, borrowed significant amounts under the TLTRO. The ECB currently has €2287bn of TLTRO loans outstanding (note that the tenth and last tranche is concluded next week, with allotment announced on 16 December; [we expect this to be one of the smaller tranches](#)). The end of the favourable TLTRO rate would lower TLTRO negative rate revenues for eurozone banks by about €950m every month. That significant change in itself might already be a reason for the Eurosystem to take a look.

But there's more. Ending the TLTRO favourable rates brings back another issue: the considerable negative rate costs imposed on the banking system by the Eurosystem's asset purchases. This requires some explanation.

? How Eurosystem asset purchases cause reserves that banks cannot avoid

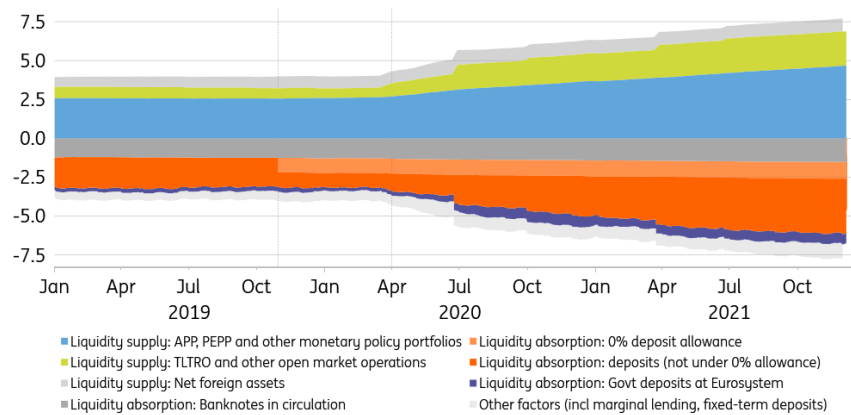
Both ECB TLTRO loans and ECB asset purchases necessarily lead to increased deposits (or "reserves") held by commercial banks at the ECB. This is a simple consequence of double-entry bookkeeping: both TLTRO loans and asset purchases increase the Eurosystem's assets, and increased deposits are the corresponding Eurosystem liability that increases in tandem. These Eurosystem deposit liabilities, or bank reserves, have carried a negative deposit facility rate charge of -50bp since September 2019.

Insofar as Eurosystem deposit liabilities are caused by asset purchases, the banking sector has no way to avoid them. An individual bank may try and reduce its reserves, for instance by substituting into bonds. But this will only offload reserves to another bank. Total reserves in the system are a given for banks. The collective banking sector cannot avoid or reduce these reserves, because the Eurosystem drives them with their asset purchases.

The unavoidable nature of reserves does not apply to those reserves that are created by TLTROs. In those cases, banks deliberately choose to take out a TLTRO loan. The associated reserves may and do however end up at other banks.

Back in 2019, the ECB acknowledged that imposing a negative rate on reserves that the banking sector cannot avoid may not be fair. Hence the ECB implemented a "deposit tiering multiplier". Initially set at 6, this means that since late 2019, an amount of 6 times required reserves, plus required reserves themselves, are exempt from negative deposit facility rate charges. When this tiering came into force, it reduced the negative rate cost of bank reserves by about €350m each month. See the light orange area in the chart below, and [this article](#) for more on involuntary reserves and deposit tiering.

Eurosystem liquidity supply and absorption (€ trillion)



Source: ECB, ING-calculations

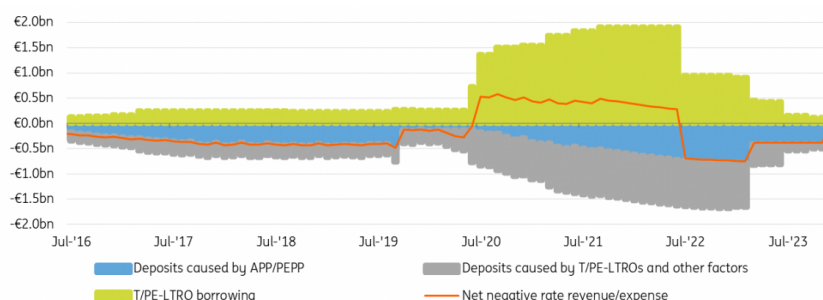
Since late 2019, both Eurosystem asset purchases and TLTRO lending have increased dramatically. Bank reserves have increased with them by an eye-watering 145%, from about €1850bn in October 2019 to over €4500bn today (see the orange area in chart). The increased reserves have driven up negative rate expenses for banks. Yet these are, in aggregate, more than compensated by the favourable ≈ 100 bp borrowing rate that most banks will qualify for. The ECB did not, therefore, think it necessary to revisit the deposit tiering calibration, even though the aggregate numbers hide substantial redistributive effects between eurozone banks, as both TLTRO borrowing and reserve holdings differ (we describe the redistributive effects [here](#)).

Moreover, this constellation of policies did muddy TLTRO goals: apart from their official goal to “[preserve favourable borrowing conditions for banks and stimulate bank lending to the real economy](#)”, TLTROs have simultaneously become an instrument to mitigate the negative rate costs imposed on banks as a result of asset purchases.

From a €300m monthly net gain to a €700m monthly net loss in July 2022

The mixing of TLTRO policy goals becomes a problem when, in July 2022, the favourable TLTRO borrowing rate ends. Extending the favourable rate may not be needed to stimulate bank lending, but what about the hugely increased asset purchases and the much higher negative rate cost the associated reserves impose on banks? These have gone from a monthly €120m after tiering was enacted in late 2019, to over €500m per month now, and may surpass €700m/month in July 2022. That's shown in the blue area in the chart below. The chart also shows the other negative rate revenues and expenses for the eurozone banking sector, under our base scenario of tapering after March 2022, and a first deposit facility rate increase in the first quarter of 2023, and furthermore assuming no net changes to TLTRO holdings compared to today (except for redemption at maturity).

Eurozone banks' monthly negative rate expenses and revenues on ECB reserves and TLTROs



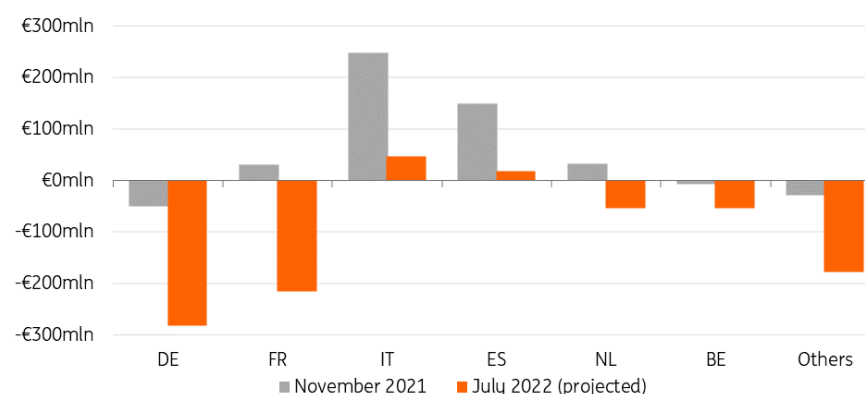
Source: ECB, ING-calculations

The monthly negative rate costs of reserves (the blue plus grey areas in our chart) are currently more than compensated by TLTRO borrowing rate revenues which are shown in the green area. This results in a projected monthly net negative rate revenue of €300m in June 2022 (the orange line). When the TLTRO favourable rate ends and no other measures are taken, the net monthly result abruptly turns negative to the tune of -€700m.

Some banks will be hit harder than others

Given the uneven distribution of TLTROs borrowing and reserve holdings over eurozone countries, some banks will be hit harder than others. The Italian and Spanish banking sectors manage to just keep net positive negative rate revenues, while banking sectors in Germany, France, Netherlands Belgium and elsewhere start to incur negative rate net costs again. Upon our assumed 25bp increase in the deposit facility rate in the first quarter of 2023, net negative rate costs halve.

Monthly net negative rate revenue/expense per country



Source: ECB, ING-calculations

What the ECB could do to dampen the impact in July 2022

We made some further calculations to see what changes to the deposit tiering framework would

be needed to mitigate the impact of the end of the -100bp favourable TLTRO rate on banks. The change in the multiplier needed to fully undo the aggregated impact would not qualify as just a tweak. Even doubling the multiplier, from the current 6 to 12 times required reserves being exempt from negative rates, would leave banks barely in a better position than where they were in September 2019. Note that the ECB should not be satisfied by just restoring the September 2019 situation in terms of costs imposed on the banking sector, because that is when the ECB decided to start deposit tiering in the first place.

Even under a multiplier of 15, some banks would continue to incur significant net negative rate costs

We can also calculate the multiplier that would reduce negative rate costs to what they were in the last quarter of 2019 under the assumption the ECB considered them satisfactory. These amounted to €125m/month. To get there, the tiering multiplier would need to be cranked up to 15. That sounds like a lot, and it is, but it would still exempt only half of ECB reserves of negative rates. It is also important to note that this tiering would reduce, but not eliminate the redistributive effects of the negative deposit rate. Even under a multiplier of 15, banks in e.g. Germany and France would continue to incur significant net negative rate costs, while those in Italy, Spain, Portugal and Greece would continue to make net negative rate revenues. This is due to the fact that banks in the latter group would continue to receive the full -50bp negative rate on their TLTRO borrowing, while some of the corresponding reserves have ended up with the former group, absorbing the -50bp deposit rate. There is little that generic deposit tiering can do about this.

A tweak to the deposit tiering multiplier as a temporary fix

As the favourable TLTRO rate expires in June 2022, eurozone banks face a strong hike in negative rate costs. This will last until the deposit facility rate is increased to zero, which we pencil in for the end of 2023. In the meantime, we don't expect a prolongation of the favourable TLTRO borrowing rate. The deposit tiering multiplier is the easiest tool for the ECB to turn to, but it has its shortcomings. For one, it would need to be increased very significantly to fully compensate banks. It would also leave the sizeable redistribution among eurozone banks unaddressed as some of the funds borrowed under TLTROs have been flowing from southern Europe towards the north. This will self-correct when TLTRO funds are repaid which will take time (the last TLTROs are scheduled to mature in 2024).

With deposit facility rate increases emerging on the horizon, the negative rate costs imposed on banks by the ECB's asset purchases will be of a temporary nature. We, therefore, expect the ECB to settle for a modest deposit tiering multiplier increase only, from 6 to 10. This will fall far short of compensating the increase in net negative rate costs many banks will experience, but will at least remove the sharpest edges. It would lower negative rate costs for northern eurozone banks by about 25%, compared to the no-multiplier-tweak scenario depicted in the chart above.

Article | 9 December 2021

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Christine Lagarde at the European Council building in Brussels earlier this year

Cold turkey or not, bond scarcity is here to stay

Among all the exceptional measures we've seen, the decision on the future of asset purchases isn't the most important thing, at least for EUR swap rates and core yields even though they're often most talked about. Bond scarcity, a key plank of current rate valuations will remain a fact of life. The stock of sovereign and supranational bonds available for private investors to buy is set to increase by only €160bn next year after ECB purchases are taken into account.

Inflation fear had the 2Y fall out of bed in October; this could happen again



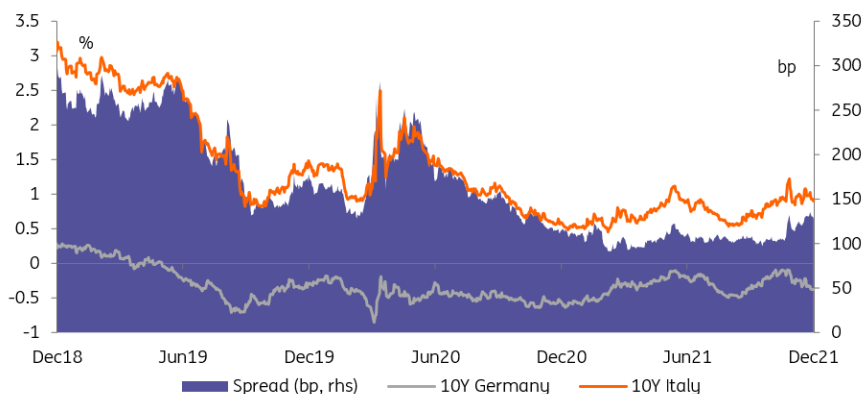
Source: Refinitiv, ING

This could change of course. Should the ECB decide to let markets go cold turkey at the end of PEPP in March, with only the €20bn/month APP net purchases for the rest of the year, that figure would grow to €330bn. Not a sea change, but a forewarning that private investors will need to step up in the future, provided they are compensated with higher rates.

Taper is really about hikes, in the market's mind

Instead, it is the signal about the timing and the extent, of the coming rate hikes that will matter the most. It has the potential to send 10Y core rates, for instance, Germany and swaps, higher by more than 50bp next year. The Covid-19 uncertainty, and an economic slowdown in late 2021/early 2022 means this is a debate for the latter half of next year. Here too, risks are skewed towards a more hawkish reaction, however. If Lagarde overemphasises inflation worries, rates will jump the gun and price-in imminent hikes again, as they did in late October.

Italian spreads are starting to price waning monetary support



Source: Refinitiv, ING

Our benign view for this meeting doesn't apply to higher beta fixed income, notably peripheral sovereign bonds. With valuations largely riding on ECB support, the degree of inflation worries will

have a direct impact on spreads. An improvement in fiscal fundamentals is a threat as much as an opportunity. They are a factor helping muffle bond volatility but we hope that this won't lull the ECB into a false sense of security. The bond market is on the mend, but it still requires crutches to walk.

Italian spreads, a spike to 150bp

With political background noise increasing next year, and in an environment characterised by less monetary support, our high confidence call is for sovereign spreads to widen at the start of 2022. In the case of the 10Y Italy-Germany spread, we think this will translate into a spike above 150bp in the first quarter. As with any attempt to forecast a spike in volatility, there isn't much certainty about its timing. Much will depend on how the ECB manages the policy change, starting at this meeting.

Article | 16 December 2021

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Christine Lagarde was shown where to sign the euro notes when she became ECB President

Taking only the negatives from Omicron

The Omicron impact on markets initially offered some support to the euro, as EUR-funded popular carry trades (short EUR/RUB is a notable example) were quickly unwound amid risk-off and falling oil prices. With markets quickly reverting their bearish bets and now looking less concerned about the new variant, EUR/USD is looking at fresh downside risks.

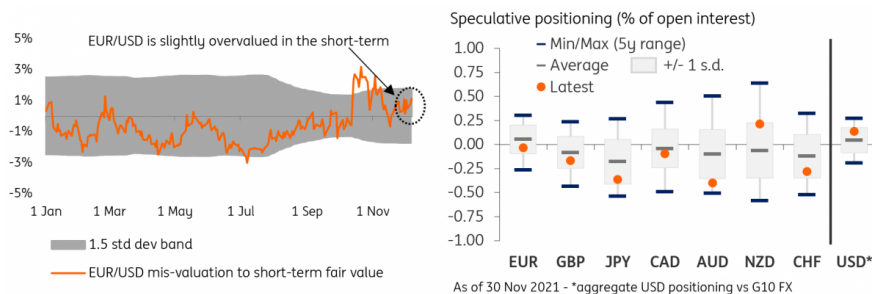
An additional factor weighing on the EUR recently is the re-rating of eurozone growth expectations due to restrictions in Germany and other EU countries. From a forward-looking perspective, markets seem to be pricing in a greater likelihood of tough containment measures in Europe than in the US and this keeps widening the US-EZ growth and monetary policy differential. The short-term rate differential has shown a high beta to EUR/USD in 2021 according to our short-term fair value model and has been a major contributor (along with relative equity performance) to the

recent EUR/USD weakness.

Hard to turn the tide

This should mean that EUR/USD may prove asymmetrically more sensitive to any hawkish surprise, whether that be on the timing of unwinding asset purchases or on staff projections), compared to signs of extra cautiousness. If, instead, we see no major surprises by the ECB, and given the Fed meeting risks prompting another spike in US short-term yields, we think EUR/USD may be set for another bad week. After all EUR/USD is slightly overvalued according to our short-term fair value model, suggesting there is still room for the pair to catch up with the unfavourable widening of USD-EUR short-term rates.

From a technical perspective, net speculative positioning on the EUR has declined of late, but, unlike some other G10 currencies, it is not in over-stretched net-short territory, as you can see in our chart below.



We think that only a hawkish turn can significantly turn the tide for the euro at the moment. Otherwise, many factors are pointing to EUR/USD weakness as we end the year. A move beneath even the 1.1200 lows is entirely possible. One potential counter-argument is the seasonal tendency of the dollar to underperform in December, although that may require much calmer markets to materialise.

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