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Economic Research:

The ECB's New Normal And How We Might Get There

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Key Takeaways

- Exiting unconventional monetary policy is an uncertain process, and the ECB is therefore likely to continue using forward guidance to steer market expectations.
- Economic fundamentals do not currently seem to warrant another round of TLTROs. As these mature, the ECB is likely to keep the fixed-rate full allotment procedure to prevent liquidity bottlenecks.
- That said, if inflation expectations fall due to low energy prices, the ECB might consider delaying any tightening of liquidity by offering a new kind of long-term refinancing operation.
- Under full allotment, excess liquidity will stay high. Thus, the deposit rate will remain the ECB's key policy rate. However, the ECB is still likely to restore the symmetry of the corridor to keep its options open.
- We expect gradual rate hikes. The first in September 2019 to restore the corridor, a second in December to exit negative rates, and then twice per year from 2020. Then, after the repayment of TLTROs by 2021, a predictable, passive unwinding of quantitative easing, in a similar manner to the Fed.

The eurozone economy has shifted down a gear since the start of the year, but capacity pressures remain high, suggesting the economy is still running into supply-side constraints. Meanwhile, diminishing labor market slack has started to push up wage growth and is slowly translating into rising underlying inflation. Inflation expectations are also slowly edging up (see "Why Wages And Core Inflation Are Accelerating In The Eurozone And The U.K.," published Nov. 13, 2018, on RatingsDirect). In our updated forecast, we still see the eurozone growing above potential at 1.9% in 2018 and 1.6% in 2020, albeit slightly slower in 2019 than we forecast in September (1.6% compared with 1.7%). For our full forecast, see the table at the end of this article.

Against this backdrop, we expect the ECB to begin the normalization of its monetary policy. This undertaking will be multifaceted. The ECB hopes to unwind a large set of unconventional measures that will affect the size of the its balance sheet in different ways, exit negative interest rates, and raise its three key rates back to reset a corridor system. So, what will the ECB's "new normal" look like?

While Stepping Into The Dark, The ECB Is Likely To Keep Forward Guidance

Since the ECB ventured into unchartered territory, it has used forward guidance to reduce uncertainty around policymaking, reinforce the link between the use of unconventional and conventional monetary policy tools, and steer market expectations for the short-term rate. The ECB is now normalizing policy, but market participants and the ECB itself are still moving in the dark.

It remains unclear what the ECB's "new normal" will look like. Without guidance, expectations of the central bank's reaction to economic developments and the combination of its different tools could vary significantly across the market and thus be at odds with the ECB's aims. For example, at the end of 2017, a large section of market participants thought the ECB would raise rates from 2018, well before what the ECB had in mind. Meanwhile, unprecedented weakness in inflation has made it difficult to gauge how much the central bank can and will do to lift inflation to its target.

As ECB executive board member Benoît Cœuré has already hinted, the ECB is likely to keep some forward guidance on rates. We expect the ECB to do so with its other instruments until it has clarified the future shape of its monetary policy framework.

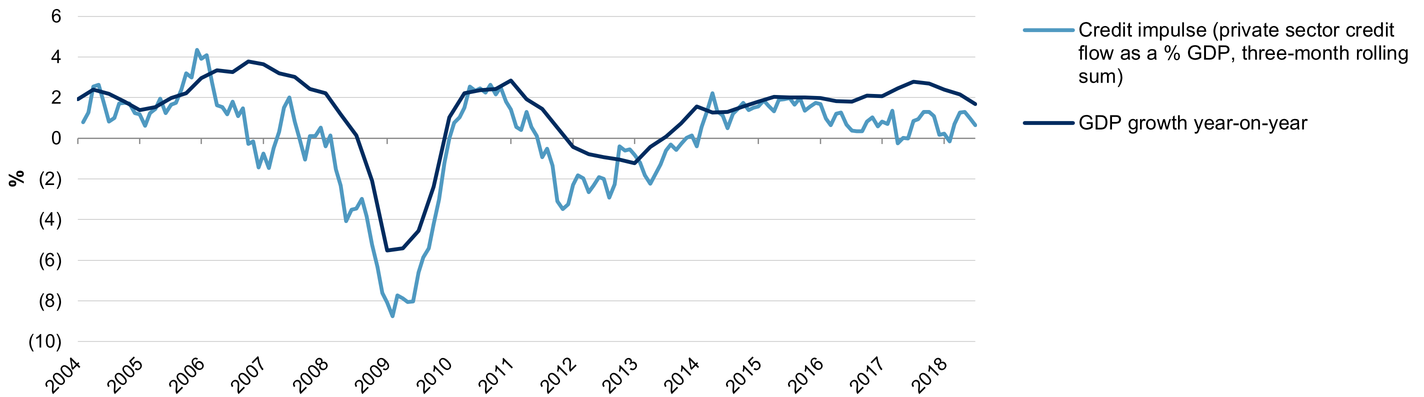
The ECB Is Unlikely To Restore The Role Of The Interbank Market In One Go

New instruments introduced since the crisis, such as targeted long-term refinancing operations (TLTROs), the fixed-rate full allotment procedure, and asset purchases, have provided banks in the eurozone with excess liquidity. This has eased banks' funding considerably and translated into easier financing conditions for eurozone corporates and households. As the ECB will likely want to avoid an unwarranted sudden tightening in liquidity conditions, it is unlikely to remove all instruments at once.

In the current macroeconomic environment, the ECB seems rather unlikely to do another round of TLTROs, which are set to mature in mid-2020 and March 2021. TLTROs have helped bolster credit growth and lower financing costs to historical lows in the eurozone (see chart 1). From a regulatory standpoint, they have given banks enough time to rebalance their funding. Only weaker banks in Italy are likely to struggle to meet their funding requirements, especially as financing conditions tighten on the back of recent tensions over fiscal policy. However, this is a country-specific problem, which has not spread to other countries. Besides, launching a third round of TLTROs in the current macroeconomic context could be interpreted as a collusion between the ECB's price stability mandate and the financial stability mandate with a strong bias toward the particular funding situation of some Italian banks (also the largest creditors of the Italian sovereign). From a monetary policy point of view, the full allotment procedure gives enough room to prevent liquidity bottlenecks.

Chart 1

The Eurozone Credit Impulse Is Still Positive And Doesn't Warrant Another Round Of TLTROs



Sources: Eurostat, ECB, S&P Global Ratings.

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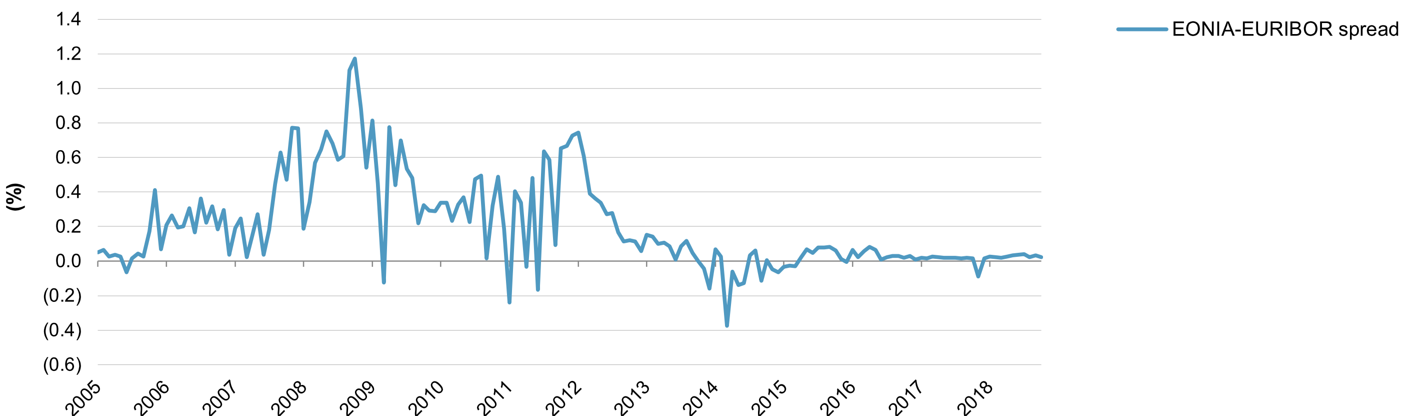
That said, the macroeconomic backdrop could change over the next six months, when the ECB will have to decide what to do about TLTROs. (Banks will have to start switching from TLTROs to alternative sources of funding to meet regulatory standards as soon as their maturity drops below one year, i.e. starting from June 2019.) There is a risk that weak inflation on the back of lower energy prices (see the table below for our forecast) could translate into weaker inflation expectations. This could be a reason for the ECB to delay the reduction of its balance sheet and excess liquidity that is set to start in 2020 with TLTRO repayments and launch a set of LTROs with maturity of longer than 12 months but shorter than three years, albeit at less attractive conditions than the current TLTROs.

Chart 2

The Interbank Market Shows Little Sign Of Fragmentation



Sources: ECB, Bloomberg, S&P Global Ratings.

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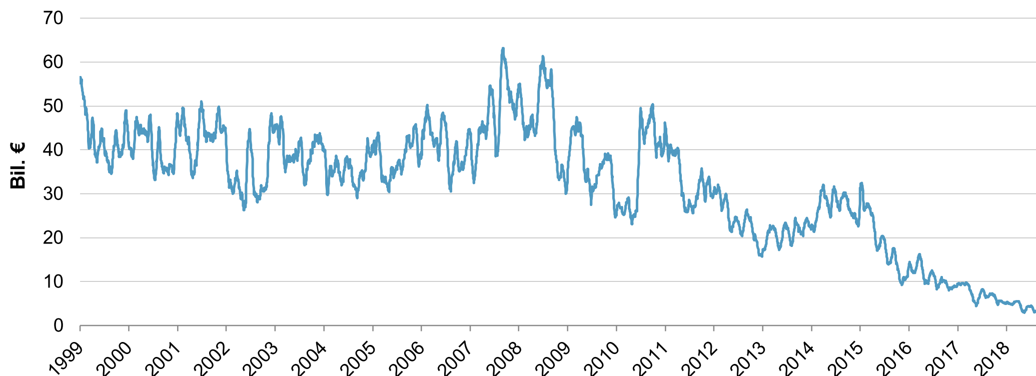
Chart 3

Volumes Exchanged In The Interbank Market Have Decreased As Excess Liquidity Has Risen

Volume of overnight interbank lending (one-month moving average)



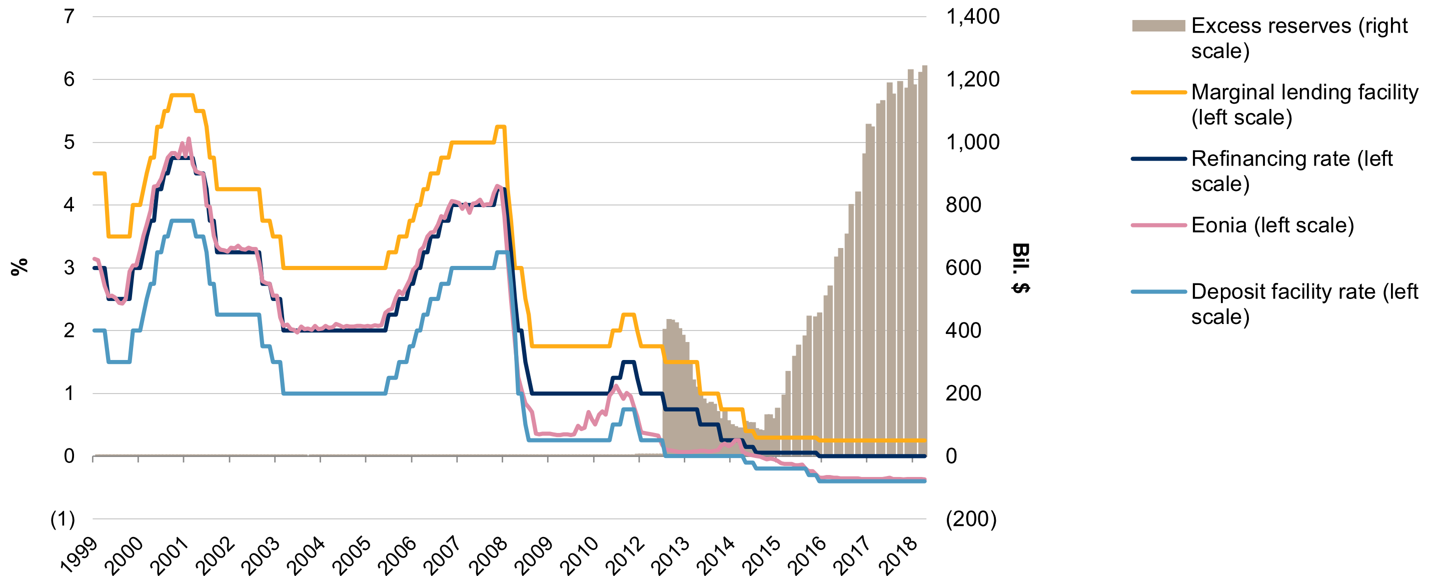
Sources: ECB, S&P Global Ratings.

In any case, the fixed-rate full allotment will likely stay in place beyond 2019, even if there are no clear signs of interbank market stress (see chart 2). With or without TLTROs, the ECB is unlikely to give the role of funding back to the interbank market at such an early stage of monetary policy normalization, especially if it is unclear whether it is functioning well. Volumes are now 92% lower than the pre-crisis average, suggesting the EURIBOR-EONIA spread might not be a good indicator of stress. Beyond this, the ECB will need to consider how it wants to accommodate rising liquidity needs that have emerged since the crisis, such as banks' demand for short-term safe instruments to meet regulatory standards or rising market-based finance.

Thus, the ECB will remain a provider of excess liquidity for now. With banks only marginally using the interbank market for additional funding (see chart 3), this will continue to push the short-term market rate to the deposit rate, meaning the ECB is set to continue operating a floor and not a corridor rate system (see chart 4). The ECB's key policy rate will therefore de facto remain the deposit rate and not the refinancing rate.

Chart 4

Excess Liquidity Has Pushed The EONIA Toward The Deposit Rate



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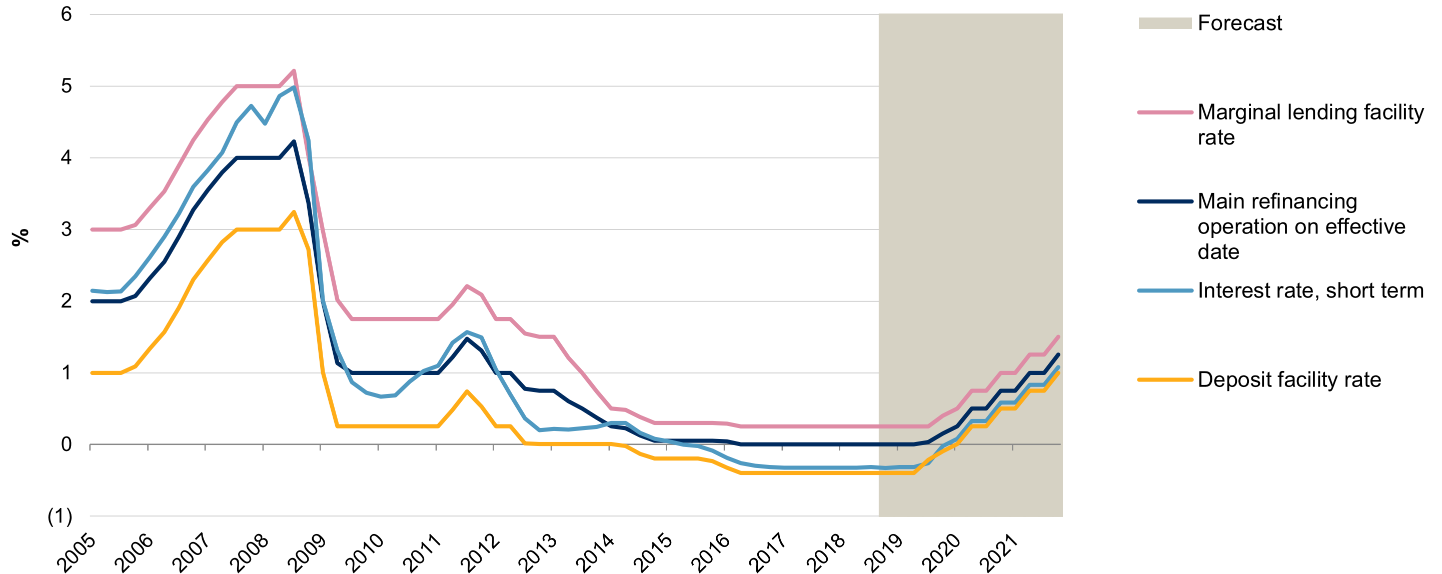
The ECB Is Set To Tighten Rates Gradually

Although in the current floor system the width of the corridor doesn't matter, we think the ECB may want to restore the symmetry of the corridor with its first rate hike as an attempt to normalize monetary policy, but also to keep the option to reinstitute the interbank market in the future. Thus, we expect the ECB to start by raising its deposit rate by 15 basis points (bps) in September 2019. With the symmetry of the corridor restored, it could then proceed with raising its three rates together in 25 bp steps--as in the past--as soon as December 2019, even if the deposit rate will effectively remain the main policy rate.

Consequently, we expect the ECB to exit negative rates in December 2019, bringing the deposit rate to 0%, the refinancing rate to 0.25%, and the main lending facility to 0.5%. From then on, we have pencilled in a gradual increase in rates with two rate hikes per year (see chart 5). This would bring the deposit rate to 1% at the end of 2021, which is still in negative real rate territory. Even so, we think the ECB could adopt an even more gradual exit scenario if capacity utilization falters or if inflation prints disappoint further.

Chart 5

The ECB Will Raise Rates Only Very Gradually



Sources: ECB, S&P Global Ratings.

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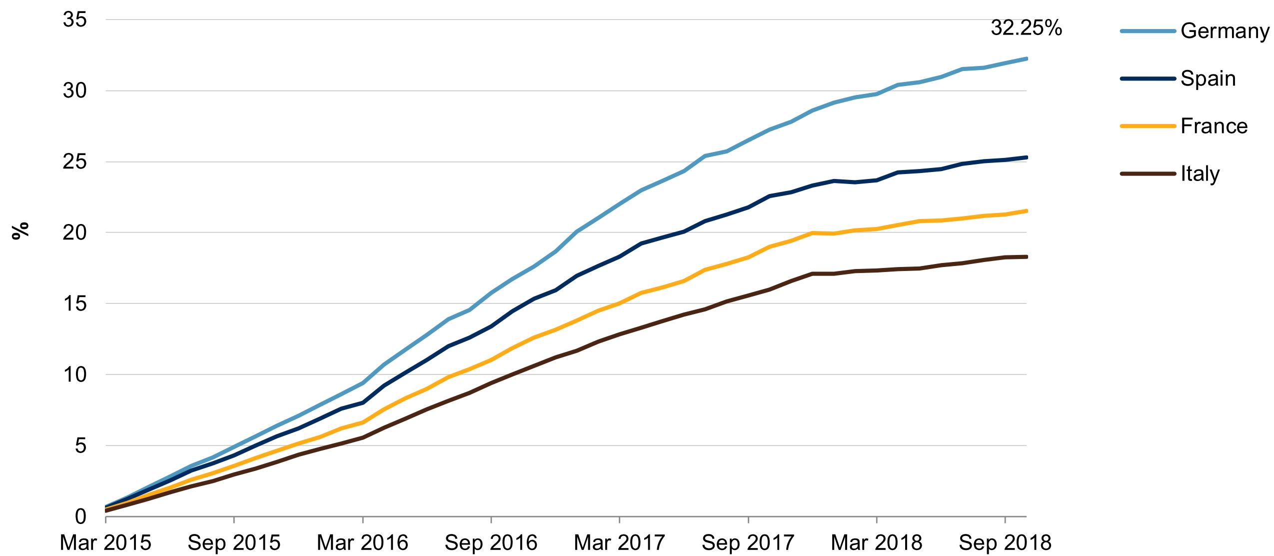
The First Reduction Of The ECB's Balance Sheet Might Come With TLTRO Repayments

As we argued in the past, we think the ECB is unlikely to engage in quantitative tightening until its policy rate has reached comfortable territory (see "What Can The ECB Take From The Fed's Policy Playbook?", published April 25, 2018). In the meantime, the ECB is set to reinvest maturing securities. The ECB has yet to clarify whether it will use the January 2019 capital keys update for its reinvestments. The new capital keys (based on national GDP and population size) will give more weight to countries like Germany and the Netherlands, which have been reducing their debt stock and for which the ECB has almost reached its issuer limit (see chart 6), suggesting the ECB might have to do some tweaks.

Chart 6



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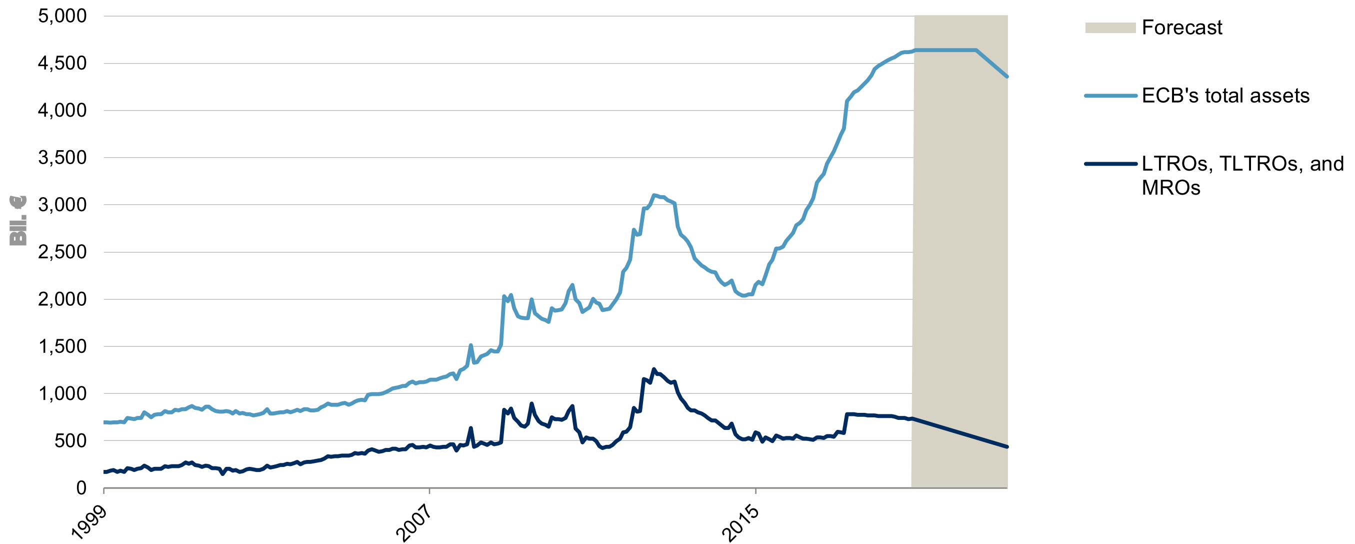
The first reduction of the ECB balance sheet is likely to come with the maturing of €725 billion of TLTROs between June 2020 and March 2021 (see chart 7), if the ECB does not do another round of TLTROs. That said, all this liquidity will not disappear from the system as some of the TLTROs are likely to be replaced by standard refinancing operations, which have been crowded out since then. In 2007, the sum of the ECB's main refinancing and long-term refinancing operations averaged around €443 billion. Under full allotment and given banks short-term liquidity needs for regulatory purposes, banks might even seek more liquidity than before the crisis, suggesting the reduction of the ECB's balance sheet might be less than €282 billion. Nonetheless, banks are unlikely to seek as much funding as under TLTROs from the ECB. Uncertainty about future funding is much lower than when the TLTROs were put in place and standard refinancing operations are much less attractive than TLTROs, for which most banks obtain a rate of 0.4%.

Chart 7



LTRO--Long-term refinancing operations. TLTRO--Targeted longer-term refinancing operations. MRO--Main refinancing operations. Sources: ECB, S&P Global Ratings.

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As the reduction of the ECB's balance sheet coming from TLTRO repayments is uncertain and outside the ECB's hands, the ECB will likely prefer to wait and see how the repayments affect financing conditions before it starts reducing its bond portfolio. Thus, we expect the ECB to stop reinvesting all of the maturing bonds from mid-2021. The ECB is likely to adopt a similar approach to the Federal Reserve: reducing the bond portfolio in a passive and predictable manner, avoiding asset sells. A question that will arise at this point is how big a balance sheet the ECB should keep. Currently it is about 40% of GDP, but it seems unrealistic to see the ECB shrink its balance sheet back to its 2007 level of 14% of GDP. As we argued above, the ECB might want to keep excess liquidity in the system, and thus operate with a larger balance sheet. What's more, a structurally low "neutral" rate suggests that the ECB will find it more and more difficult to achieve its inflation target with its policy rate alone, without hitting the zero lower bound.

Main European Economic Indicators November 2018

	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
Real GDP (% change)									
2017	2.5	2.3	1.6	3.0	3.0	1.7	2.5	1.7	1.6
2018(f)	1.6	1.6	1.0	2.6	2.6	1.5	1.9	1.3	2.9
2019(f)	1.6	1.6	0.7	2.3	1.9	1.5	1.6	1.3	1.6
2020(f)	1.4	1.6	0.9	2.1	1.9	1.5	1.6	1.5	1.5
2021(f)	1.3	1.5	0.8	1.8	1.6	1.4	1.5	1.3	1.4
CPI inflation (%)									
2017	1.7	1.2	1.3	2.0	1.3	2.2	1.5	2.7	0.5
2018(f)	1.8	2.0	1.3	1.9	1.6	2.3	1.7	2.5	1.0
2019(f)	1.8	1.5	1.2	1.9	1.9	2.1	1.5	1.9	0.8
2020(f)	1.8	1.5	1.4	1.7	1.8	1.8	1.5	1.7	1.0
2021(f)	1.9	1.7	1.6	1.8	1.7	1.9	1.7	2.6	1.2
Unemployment rate (%)									
2017	3.8	9.4	11.3	17.2	4.9	7.1	9.1	4.4	3.2
2018(f)	3.4	9.2	10.5	15.4	3.9	6.3	8.2	4.1	2.6
2019(f)	3.0	8.9	10.2	14.1	3.8	6.2	7.7	4.2	2.4
2020(f)	3.0	8.7	10.0	13.0	3.8	6.2	7.5	4.4	2.3
2021(f)	3.0	8.5	9.8	11.9	4.0	6.3	7.2	4.5	2.2
10-year bond yield (yearly average)									
2017	0.4	0.8	2.1	1.6	0.5	0.7	1.1	1.2	(0.1)
2018(f)	0.4	0.8	2.7	1.4	0.6	0.7	1.1	1.5	0.1
2019(f)	0.7	1.1	3.6	2.0	0.9	1.2	1.6	1.9	0.3
2020(f)	1.3	1.7	3.6	2.7	1.5	1.8	2.1	2.7	0.8
2021(f)	1.8	2.3	3.9	3.3	2.0	2.3	2.5	3.3	1.1
Central banks' policy rates (yearly average)									
	ECB	**BOE**	**SNB**						
2017	0.0	0.3	(0.8)						
2018(f)	0.0	0.6	(0.8)						
2019(f)	0.0	0.8	(0.7)						
2020(f)	0.5	1.3	(0.3)						
2021(f)	1.0	1.6	0.3						
Exchange rates	**USD/EUR**	**USD/GBP**	**EUR/GBP**	**CHF/USD**	**CHF/EUR**				
2017	1.1	1.3	1.1	1.0	1.1				
2018(f)	1.2	1.3	1.1	1.0	1.2				
2019(f)	1.2	1.3	1.1	1.0	1.2				
2020(f)	1.2	1.4	1.2	0.9	1.2				
2021(f)	1.3	1.5	1.2	0.9	1.2				

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