

## 4. Policy challenges ahead

### Eurozone:

Following the latest meeting of the Governing Council of the ECB, the ECB announced on March 10th that it would reduce its deposit rate (on money deposited by Eurozone banks) by 10 bps to minus 0.4%. Its other key rates were cut by 5 bps, with one on the main refinancing operations (MRO) now at 0% and on marginal lending facility at 0.25%.

As many market participants had hoped, it also expanded QE, increasing the monthly purchases under the asset purchase program by €20bn to €80bn starting in April. More significantly, the scope of assets eligible to be included in the list of assets for regular purchases will include investment grade euro-denominated bonds issued by non-bank corporations from now on.

In our view, this will somewhat alleviate one of the issues the ECB has faced, namely the growing scarcity of government bonds of some countries, such as Germany. It comes at the risk, amongst other issues, of losses on these private sector bonds and will no doubt prove controversial. However, the alternatives would probably have been even less palatable.

In order to increase the QE program without including new sets of assets, the ECB could instead have changed its capital key, allowing it to purchase more bonds from more highly indebted countries such as Italy. Or it could have given up the deposit rate as a hurdle rate when it buys government bonds. However, this would have effectively resulted in an arbitrage opportunity for banks, with the ECB locking in losses with each purchase of bonds from the banking sector (which could then deposit the proceeds at a less negative rate with the ECB).

Finally, the ECB announced a new series of targeted longer-term refinancing operations (TLTRO). These are designed to stimulate lending to the real economy, by allowing banks to borrow on attractive terms from the ECB. These will now be very attractive indeed – from now on, borrowing conditions in these operations can be as low as the interest rate on the deposit facility, or minus 0.4%. This will depend, however, on the banks actually lending. The more banks lend, the closer the rate will fall to the deposit rate.

In our view, the package illustrates the growing ECB concerns about the potential impact on bank profitability from cuts in its deposit rate. This impact will be alleviated somewhat by the benefits bank will get from TLTRO II. Nevertheless, we would expect minus 0.5% to be the lower limit of how much further the ECB will cut the deposit rate, which will probably be reached at the next meeting.

All of which sounds quite impressive. However, stocks eroded their gains within hours, and the euro reversed its initial weakening, after Mario Draghi indicated during the press conference that he expected no further cuts. In the following trading days, equities strengthened again, as investors took a closer look at the package. The volatile market reaction showed three things. First, the ECB still has some options to move markets. Second, it now takes a very comprehensive set of

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