The Handover of Power

The message behind Mario Draghi's parting package will be as important going forward as the measures themselves, argues Crédit Agricole CIB Eurozone economist *Louis Harreau*. Here, he analyses their impact on bond markets, banks and the wider economy, and anticipates that incoming ECB president Christine Lagarde will now be free to apply her political skills to the service of the central bank, with fiscal policy and political risk in focus.

Was the package of measures announced by the ECB in September in line with your expectations? What do you think was most interesting about it?

The most interesting part of the September package is the horizon of the ECB's monetary policy tools: the reinforcement of the forward guidance on rates, the open-ended duration of QE2 and the extension of TLTRO III's maturity show that the ECB intends to remain very accommodative for a very prolonged period of time. This is a significant change versus the ECB's communication in the past, including when it started implementing the forward guidance or when it announced QE1. At that point, the ECB was communicating on the fact that its tools were temporary and that they should help increase inflation in the near term, allowing the ECB to exit its accommodative monetary policy. As stated by former ECB president Mario Draghi in 2016: "Interest rates have to be low today to be high tomorrow".

In September, however, the ECB did not even pretend that it intends to normalise its monetary policy in the foreseeable future — the message was, "rates are low today and they will remain low tomorrow".

The second element of this package is that, in line with what was suggested in Sintra, the ECB tried to show that its monetary policy has no limits: the implementation of the tiering system is not only a way to support banks' profitability, but also, and more importantly, it is a way to show markets that the ECB can cut its rate further; the open-ended duration of QE is not just a long term commitment to buy bonds, but more importantly symbolic evidence that the ECB can buy whatever it wants.

Regarding our expectations, we have to admit that the ECB had prepared markets — and economists — for the package: in Draghi's speech in Sintra, most elements of this package were explicit, starting with QE2 and the rate cut. The tiering had been discussed at the ECB since March this year, so its implementation was also expected. As for the change in the modalities of TLTRO III, it was not necessarily publicly discussed, but the disappointing aspects of those operations (short maturity, high cost) naturally led us to expect a change if the ECB embarked on more easing. So overall, the announcements were broadly in line with our expectations, even if we were surprised by the fact that the ECB extended its timeline for the intervention.

Has the market's reaction to the September measures been reasonable?

The market's initial reaction was choppy — partly because, one, there was a misunderstanding of the possible impact of the tiering and, two, the announcement on QE was mixed. Several market participants expected the tiering to increase interbank rates (Eonia, €STR, repo rates) and consequently trigger an increase in the short end of the curves — which has been proven wrong since then. Regarding QE, the worries are more legitimate in my view — the fact that the ECB did not discuss limits creates uncertainties about the length of QE2.

This second issue, the fact that markets remain uncertain about the ECB's ability to implement a long and ambitious QE2, partly explains the repricing that has happened since September: 10 year Bund yields have increased by almost

Farewell event for Mario Draghi; *Photo: ECB/Flickr*

30bp, while 10 year swaps have remained above 0% since mid-October.

Other elements have to be taken into account: lower risk aversion due to better developments regarding the trade war, as well as lower Italian political risk and the feeling that recession risks have faded.

My feeling, however, is that markets continue to underprice the ECB's willingness and ability to support the Eurozone: the technical question of QE's limits is minor regarding the ECB's commitment to its mandate and to its inflation target. Consequently, we expect the ECB to issue stronger communication on accommodative monetary policy, and we expect markets to gradually re-integrate this renewed pressure on yields.

To what extent does the tiering (in conjunction with the whole package of measures) help banks? To what extent is it a reaction to criticism of ECB policies?

Tiering has an immediate effect for banks: the total cost of excess liquidity put at the deposit facility (at €10bn before the implementation of tiering) was reduced by €4bn. So this should support banks' profitability. In the September package, the ECB announced another significant measure to help banks: the easing of TLTRO III modalities, specifically that TLTRO III will have a maturity of three years (instead of the two years previously announced) and a rate equal to the deposit rate (instead of deposit rate plus 10bp).

TLTROs' support for banks is often undervalued: they provide liquidity (more than €600bn today), at a very low cost (banks are paid to take liquidity from the ECB), and more importantly, TLTROs provide term funding for banks: four years in the TLTRO II series and three years in the TLTRO III series.

What is interesting with the September package is that the ECB is trying to use every lever it can to improve credit conditions for the private sector: lower market rates with the QE and so lower market-funding cost for banks, improved ability to take risk for banks due to the better profitability thanks to the tiering and term funding via TLTROs.

Most criticism of the ECB's policies is unfounded. However, what is true is that with those measures, the ECB tried to address the only legitimate point of criticism: unconventional monetary policy hurts banks. This criticism is not legitimate because banks' profitability is an important topic (it is not), but rather because if banks' profitability is too low and if banks are too weak to take risk, they cannot grant loans to risky actors (households and SMEs), which means that the ECB's very accommodative monetary stance does not benefit the private sector.

Unfortunately, tiering and TLTROs are not enough to overcome the negative impact of low rates on banks; this is why the banking sector will probably have to continue its efforts to regain profitability. The good news, however, is that the ECB is aware of this concern and it is likely to pursue its supports for banks as much as possible.

Some market participants seem to disagree with the ECB about the likelihood of it hitting APP limits. How do you explain this and what are your expectations?

When talking about the APP limits, what we actually mean is the purchasable universe of German public bonds below the

33% issue and issuer limit: when the ECB runs out of German bonds to buy, the PSPP — and so the APP — will have to end. This is why the question of the APP limits is so important.

Estimating the purchasable universe in the APP is an extremely complex task: you have to list all purchasable assets (more than 2,000 bonds for the PSPP alone), you have to know the outstanding amount for each of them, and — this is the most complex part — you have to estimate the market price of all bonds at the time the ECB bought them. This is why nobody has a perfect estimate of what is still purchasable — apart from the ECB.


Louis Harreau, CACIB

More importantly, the ECB could be flexible in the implementation of the APP. First, in the breakdown of programmes: it could weigh more on the private purchase programme (CSPP and CBPP3), and therefore keep some space for a longer PSPP.

The second option is deviation from the capital key: theoretically, German bonds should represent 24% of the PSPP purchases. However, since the beginning of the PSPP, the ECB allowed itself some flexibility in this allocation: Estonia, Cyprus, Latvia, Lithuania have been "underpurchased" by more than 60%. The ECB has only purchased 40% of what it is supposed to according to the capital keys, because the public debt was too small (as for Estonia, the ECB simply has not purchased a single public bond since May 2016). The ECB could apply the same for Germany: not enough public debt implies no purchase, and QE continues without Germany. However, for obvious political reasons (and for monetary policy reasons), it is hard to justify QE that excludes a quarter of the Eurozone economy. This is why the ECB could be flexible on this front, but only to a certain extent: limited deviation from the capital keys.

'The only powerful-enough answer is a fiscal capacity at the Eurozone level'

From those caveats, we estimate that the ECB can continue its QE for 12 to 18 months, possibly 24 months depending on how flexible it is. However, the communication around QE is far more important than the basic implementation: the fact that the ECB states that QE may continue is more important than whether or not it actually continues QE.

If the ECB does not address the limits issue, it will struggle to convince markets that it can continue QE over an extended duration. Even worse, if markets believe that the limits are unmovable, the ECB risks being perceived as powerless. This means that, no matter how likely it is that the ECB will hit the PSPP limits, the ECB will have to change those limits. Not necessarily so it can continue QE, but so it can *communicate* on the fact that it can continue the QE if it wants to.

Do you expect governments — notably Germany — to rise to Draghi's challenge, i.e. make fiscal policy do more of the work?

In my view, the biggest challenge Draghi addressed before leaving the ECB is not about national fiscal policy. His biggest challenge was this one: "There is one thing that all the successful monetary unions have, and that's a central fiscal capacity."

Indeed, a more balanced fiscal policy in Germany and in other northern countries would support the economy there and therefore slightly ease the ECB's task. However, I do not think that a fiscal package in Germany or in other countries is likely to dramatically change the Eurozone outlook. Even if they change their minds about fiscal consolidation — which is what seems to be gradually happening — they are unlikely to adopt a very aggressive fiscal policy and, more importantly, if they increase their fiscal support they are likely to calibrate this fiscal support for their national needs, not for the Eurozone's.

Governments are pragmatic: if the outlook deteriorates further, then they are likely to react appropriately, not to ease the ECB's burden, but rather for their own goals. These reactions will make the ECB's job slightly less complicated, but are unlikely to remove all pressure on the ECB. So yes, I assume that Germany and other governments will use more fiscal policy if needed, but I do not think that it will change the ECB's situation.

On the other hand, the best — if not only — solution to ease the ECB's task and so favour a quicker exit from non-conventional monetary policy is the implementation of a common fiscal capacity for the Eurozone. National governments can — and have to — act, but in my view, the only answer that is commensurable with the current situation, the only powerful-enough answer is a fiscal capacity at the Eurozone level — a fiscal capacity that would be implicitly backed by the ECB. This is Draghi's challenge that the Eurozone will have to rise to, or it will face negative rates for an extremely prolonged period of time.

On the probability of such an implementation in the short

term, I would be pessimistic — there is political work to be done. However, the technical work is ready, European citizens are increasingly convinced of the benefits of the euro as a currency, and the political will is present in several countries, so I'm rather optimistic on the medium term — also because it is the best, if not the only, solution for the Eurozone.

Does the restart of APP on 1 November and prior announcement of the September package mean that Lagarde's influence will not be felt for some time, with the direction of ECB policy now set for a prolonged period?

On the contrary, the September announcement should help Lagarde make her mark as the head of the ECB. The monetary policy tools that have been announced are not supposed to be changed in the coming months, if not years. This means that the new president will be free to focus on the structural issue regarding the ECB's monetary policy: the broader scheme of monetary policy implementation, redefinition of the target, discussions on "greening" monetary policy or taking into account inequalities. Being released from the monetary policy tools, Lagarde will be able to exert a stronger influence on the monetary policy system.

It is true that Lagarde will have limited influence on the ECB's monetary policy stance over the next few months: rates will not be hiked, QE will not be stopped, the TLTRO III will not be changed regardless of what she thinks about them. However, I would say that this is always the case: all ECB presidents have their hands tied by their predecessors' decisions: past monetary policy impacts economic outlook, and economic outlook is the basis on which future monetary policy will be decided. Finally, it is worth reiterating that all decisions are taken by the governing council, not by the president — even if the president has significant influence — consequently, Lagarde will be dependent not only on what was decided in September, but also on what other members of the governing council think.

'The September announcement should help Lagarde make her mark'

What changes in style and substance do you anticipate under Lagarde, if any?

Lagarde has a very different background from Draghi: he was an incredible technician who gradually morphed into a politician. When appointed president, he was already known to be a very good central banker, who had to add more leadership and communications skills to his arsenal. Lagarde, by contrast, is famous for being an exceptional leader and a very good speaker; she will have to put those skills to the service of the ECB's monetary policy.

More structurally, Lagarde is a consensus builder — this is pretty clear when looking back at her work at the Eurogroup when she was minister of finance or at the European Council during the 2015 Greek crisis when she was at the head of the IMF. Draghi was more inclined to make decisions by himself or with a limited group of people and then to force the governing council to consent to his decision. This strategy was extremely powerful during the crisis: the ECB was proactive, because its president was proactive. However, it may have reached its limits at last September's meeting: the dissensions were too big, which muddled the ECB's communication.

The consequence of having a consensus-builder as president could encourage a more united governing council and hence clearer communication. On the other hand, since consensus-building takes time and, to reach a consensus, you need to make concessions, this could mean that the ECB will be less proactive and slightly more hawkish under Lagarde's presidency.

What are the key risk factors for the macroeconomic outlook? What are your expectations for the Eurozone economy?

The Eurozone will probably face a long slowdown: GDP growth should be around 1% in 2020 and 2021 — the global slowdown and trade tensions are likely to continue next year and could fade gradually in 2021. The ECB's accommodative monetary policy should help the Eurozone, but to a limited extent beyond what it has already done.

Regarding the main risks, Brexit seems to be the most limited: a no-deal Brexit would have a negative impact on the Eurozone, but this impact should be limited, and not significantly different than what is already expected in the event of a Brexit deal.

The trade war is (and is likely to remain) the main theme of the coming years. If it intensifies, it would harm the global economic outlook for all countries around the world, so it would have an indirect but significant impact on the Eurozone. But the main risk is an escalation of tensions between the US and the EU: a full trade war between the two economic areas is unlikely given their interconnection, but, given the magnitude of the consequences, we cannot ignore the possibility of it.

Finally, the political situation in the Eurozone remains a source of uncertainty. Markets have totally de-priced this risk since the change in government in Italy this summer; however, the Italian story is not over: the current coalition seems to be holding on, but we do not know for how long — the polls show that political risk is still there. Other countries may face political uncertainties: in Spain and Belgium, there is still not a stable coalition, whereas in Germany the political landscape is fragmented, making future coalitions more complicated.

For most of the past 10 years, political risk has been the biggest threat for the Eurozone. Today, this risk is lower, but it has not disappeared. ●