Europe Watch

TIERS OF DISAPPOINTMENT

Europe Team

Economics & Markets: Strip away the excess

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- **But in practice, there's no obvious 'free lunch' in money markets**
- **First round of TLTRO-III sees no pick-up from banks: wait for December**
- **The SNB follows the ECB and makes the exempt tier multiplier variable**
- **Negative rates are here to stay. Savers remain under pressure**

Politics: No boost from Berlin this time

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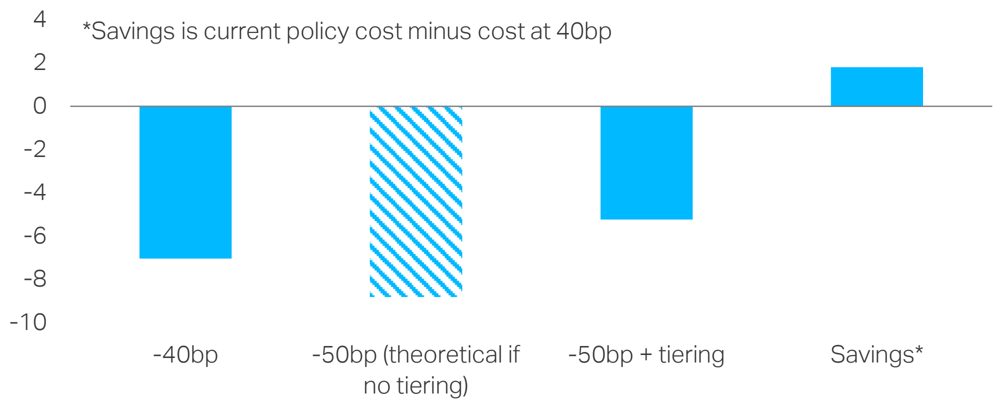
- **But this is a slow shift that will take time to play out**
- **With no substantive discretionary stimulus coming, automatic stabilizers will be the only cushion for the slowdown**

ECB tiering saves banks money

Annual cost to banking system of ECB rate policy, EURbn



Source: ECB, TS Lombard

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Has tiering created free money for banks? In theory, the third round of TLTROs – offering lending as low as -50bp – and tiering – offering 0% deposit interest – provide some arbitrage opportunities. And while euro area repo rates are at -50bp, banks could borrow at this rate and deposit at 0% to earn 50bp risk free. But there are at least two reasons why we think the extent of this risk-free arbitrage will be very limited.

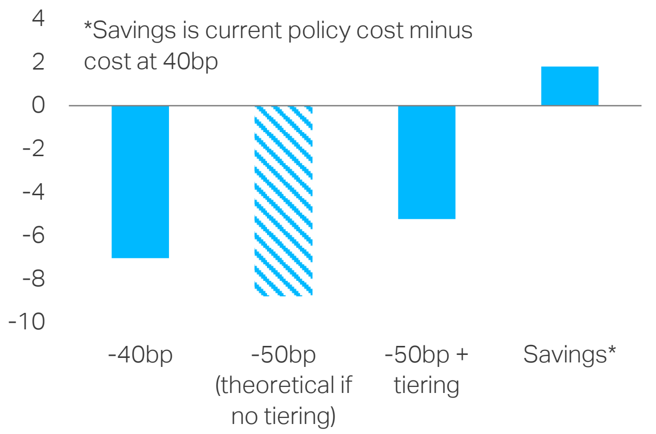
First, when banks face loan demand (a necessary precondition for accessing the lowest possible TLTRO rate), they should be able to make greater profits per unit of balance sheet by loaning the money out than by hoarding the reserves. But this mainly applies to northern Europe, where excess reserves are above the 0% tier so would not qualify for the more generous deposit rate anyway. In Italy, where excess reserves are low enough to create "free money" headroom, banks haven't had enough loan demand, so the probability of being granted a rate on TLTRO as low as -50bps is low.

As for the second route to accessing free money, it's equally only plausible for banks where excess reserves are below the 6x required reserves limit (public bank-level reserves data does not exist, but on a country level this means Italy, Portugal and Greece). We calculate that banks could earn at most €150m in this arbitrage, a mere 1.5% of Italian banks' total earnings last year.

The more powerful transmission of this round of policy is that, in aggregate, it saves banks money. Compared to the cost of depositing excess reserves at -40bp, moving to -50bp and some exempt excess reserves will save banks €1.8bn/yr.

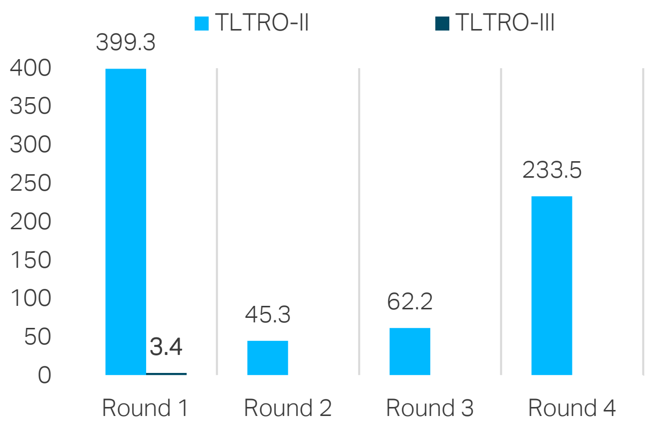
The response to the first round of the TLTRO-III programme has been surprisingly slow compared both to market expectations and previous vintages of the programme (Chart 2). EA

Chart 1: ECB tiering saves banks money
Annual cost to banking system of ECB rate policy, EURbn



Source: ECB, TS Lombard

Chart 2: Minuscule TLTRO pick-up, for now
TLTRO allotted amounts, EURbn



Source: ECB, TS Lombard

have banks requested only €3.4bn in total. In fact, only 28 banks took part in the auction, compared to the hundreds of previous TLTRO rounds. At the same time, by next Wednesday EA banks will repay about €32bn of TLTRO-II loans, resulting in a *net drain* of liquidity from the EA banking system.

Some commentators see this relative liquidity drain as an upside risk for money market rates, as banks might seek to replace that liquidity elsewhere, but it's unclear why. First, tiering hasn't started yet; it will come into force on 30 October. Second, as we explained in a Daily Note, there are other factors that contribute to keeping money market rates in check, including a new round of the asset purchase program. Finally, nothing forbids the ECB from intervening in the market with temporary operations, if needed.

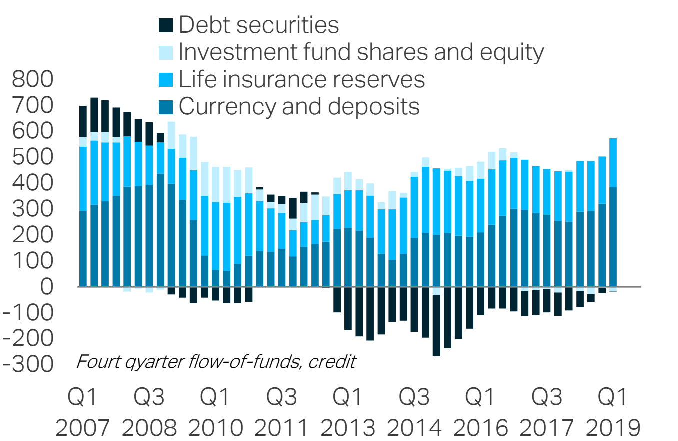
While the chronic lack of credit demand in large parts of the EA is certainly a factor behind a low TLTRO-III volume, we suggest not to read too much into this apparent anti-climax. The most likely explanation for the drop in demand is that in order to participate in the programme, banks had to submit a form with the details of their loan book ahead of the ECB policy decision last week. The more generous programme conditions – including the elimination of the 10bps mark-up over the applicable TLTRO rate and the deposit rate cut – might have caught most banks by surprise. We therefore expect many more banks to apply for TLTRO loans at the next auction in December, when bank treasurers will have figured out all the implications of the new easing package for their books.

The SNB wants the new policy instrument too. The SNB was the first central bank to introduce tiered deposit rates (in Dec-2014). Its implementation was designed to primarily exempt small depositors from the effect of the newly-introduced negative deposit rate. This was successful, and in fact all depositors were shielded from negative rates until very recently (bank margins took the hit instead). Over the summer, UBS announced that negative rates would begin to apply to clients with large deposits. But yesterday, the SNB raised its "exempt tier multiplier" from 20x to 25x and decided to change the calculation method to make it a function of excess liquidity, opening the door for it to rise further if conditions warrant. This move reduces pressure on banks at the margin (but it remains to be seen whether, now they have been implemented, negative deposit rates for bank *clients* are rolled back).

Negative policy rates are here to stay. In the press release, the SNB explains the decision as a response to *"the fact that the low interest rate environment around the world has recently*

Chart 3: Households build up cash balances

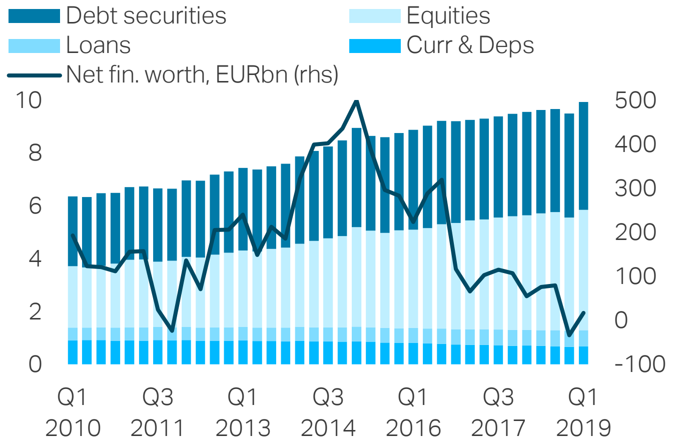
EA Households: acquisition of financial assets, EURbn



Source: ECB, Datastream, TS Lombard

Chart 4: Insurers and pension funds suffer

EA Insurers and Pension Funds: Financial Assets, EURtrn



Source: ECB, Datastream, TS Lombard

become more entrenched and could persist for some time yet". The SNB decision came shortly after Haruhiko Kuroda, the Governor of the BoJ, while commenting on the latest monetary policy decision to keep rates unchanged, commented that - compared to the ECB -50bps deposit rate - the BoJ still has considerable margins to cut its marginal deposit rate (-10bps) further. He also said that he is "more positive" now than after previous meetings about the idea of additional monetary easing. Global central bank easing is here to stay, and rates in Switzerland, the euro area and Japan (and Sweden too) seem poised to stay negative for much longer than it was possible to anticipate just months ago.

Before we come to implications for the real economy, this week's Macro Strategy analysed the impact of tiering on euro area banks. Although some banks may be able to achieve free profits (albeit very small, see above), the largest *nominal* impact is on German banks, as they have the highest level of required reserves (and therefore the largest total amount of excess reserves subject to tiering). And given the current weak profit outlook for German banks, the relief provided by tiering is a significant fraction of expected earnings: if "E" rises, then so should "P".

We bought euro area banks vs Euro Stoxx 50, and also bought AT1 CoCos in this week's Macro Strategy; the former to capture outperformance thanks to the ECB's focus on shielding banks from the negative effects of its policy, the latter to own a long-gamma position and for its diversification benefits.

There are also implications for savers. An environment of permanent low/negative rates and QE has severe implications for consumption/saving decisions by households and a potentially explosive impact on the balance sheet of pension funds and insurance companies. Households tend to be net savers in aggregate. The extent of this propensity to save varies from country to country and the difference is particularly visible in the EA when savings rates in countries such as Spain (6%) and Germany (11%) are compared.

At any rate, households tend to hold a portion of their wealth in real estate and relatively safe financial assets – mostly cash, deposits, insurance products, and government bonds. Some will benefit – in their Bank Underground blog, researchers at the Bank of England showed house prices were mainly a function of interest rates – and some will not. Households saving for retirement will need to save a higher proportion of their income for a given annuity. As a nation of savers, Germans in particular do not need a second invitation to save more. Meanwhile, the potentially positive wealth effect of higher asset prices is diminished in Germany as housing is a relatively small share of household wealth. ECB policy will lead to higher savings through the accumulation of currency and deposits (Chart 3); perhaps the reversal rate in the euro area's engine of growth has already been passed. .

No respite for insurance companies and pension funds. Similarly, insurance companies and pension funds are limited in the type and riskiness of assets they can invest in. Since the introduction of negative rates and the beginning of the APP, which compressed yields and flattened the sovereign curves everywhere in Europe, the net financial worth of EA insurers and pension funds has collapsed (see Chart 4 above).

Insurance companies in EA Core countries, where the sovereign yield curves lie now entirely below zero, are the most affected. Negative rates operate via two channels. First, the "income channel". Portfolios of fixed income securities – especially long-term ones – are rolled over at much lower rates, which makes it harder for insurers to guarantee the returns on their existing policies. Second, the "balance sheet channel" which reflects valuation effects on assets and liabilities. On one hand, falling interest rates means that the value of existing liabilities grows faster than that of assets – indeed, insurers invest only a portion of their assets in fixed-income.

On the other hand, the maturity of insurers' liabilities is than that of assets causing a mismatch that forces additional purchases of long-dated bonds, thus compressing term premia and profits further.

Mario Draghi acknowledged the severity of the side effects of a prolonged period of negative rates several times. However, unless a large fiscal stimulus from EA surplus countries comes to the rescue (which is unlikely – see the *Politics* section below) – or external demand surprisingly recovers permanently, rather than in another round of Chinese 2015-style stimulus, (also unlikely)– there seem to be no way out of the current, seemingly indefinite negative rate regime.

Politics: No boost from Berlin this time

- **German politics is becoming less austere – especially on investment**
- **But this is a slow shift that will take time to play out**
- **With no substantive discretionary stimulus coming, automatic stabilizers will be the only cushion for the slowdown**

Observers hopeful for a German stimulus will be disappointed… The ECB had a simple message for European governments last week: if you're sick of ever-looser monetary policy, you need to spend more. And through the summer, markets have been on tenterhooks for any sign that Germany in particular might be preparing to open its fiscal taps. We've been sceptical, however.

… despite early signs of a change in attitudes in Berlin. The debate on fiscal policy is certainly shifting, in Berlin and across northern Europe, and the medium-term consequences for public investment in particular could be significant. But as last Tuesday's Bundestag debate confirmed, for now any German stimulus (over and above the operation of automatic stabilizers) will be very limited.

The ground is slowly shifting

The frugal Dutch are already changing tack: the draft budget published by their government this week would see their headline budget surplus fall to 0.3% in 2020 (from 1.2% this year). In a longer-term perspective, the government intends next year to submit proposals for a public investment fund, which could require up to €50bn (around 6% of GDP) of new debt.

Germany is slowly dropping its commitment to a balanced federal budget. Germany's politics and its state machinery are more slow-moving, but there too change is in the air. For the last half-decade, the government has been politically committed to a balanced federal budget – known as the "black zero". Finance Minister Olaf Scholz promised last week to deliver another balanced budget.

But behind the scenes, the coalition government is quietly prepared to allow the budget to move into deficit as the downturn goes on (though the social security system has reserves equivalent to 2% of GDP, which should provide the bulk of ammunition for Germany's automatic stabilizers). Meanwhile, the centrist wing of Angela Merkel's own CDU is beginning to challenge the "black zero", and the conservative BDI employers' association has also been calling for more spending.

Consensus is also growing behind reform of the constitutional debt brake. More binding than the "black zero" is Germany's constitutional debt brake, which limits the federal structural deficit to 0.35% of GDP. However, the Finance Ministry's new SPD-appointed chief economist von Weiszäcker has been consulting with assorted policy wonks on reforms to the country's debt brake and on the need for greater public investment.

Meanwhile, the Greens (Germany's second party on current polls, who will likely play a major role in the next government) have proposed a debt-financed green investment programme, along with constitutional reform to make this possible. And this spring, a broad cross-party alliance voted through some minor constitutional tweaks to make it easier for the federal government to channel money to school IT and local housing infrastructure. Still, any more substantial constitutional change requires a wider consensus than currently exists, and it will probably be years before any such change sees the light of day.

But beware of false dawns

This is a slow process, however. So observers are right to suspect a change taking place in German attitudes. But none of this means that a major shift is just round the corner, and or that Berlin will suddenly announce a substantial package of fiscal stimulus in response to the current slowdown (or likely technical recession).

Barring a far more serious downturn or a trade war escalation, there is no major stimulus on its way. The fact is that barring the economy seriously taking the turn for the worse – or perhaps an exogenous shock like Trump suddenly turning his fire on the country – there is neither appetite nor capacity in Berlin for a discretionary stimulus.

This is a slowdown, not an emergency that would justify waiving the debt brake. The constitutional debt brake remains a serious constraint on the federal government's ability to spend. The Bundestag can choose to waive it in the event of an "emergency" – but that doesn't mean a run-of-the-mill slowdown. The orthodoxy in Berlin, and quite possibly the legal situation too (although there have been no test cases), is that demand management in normal times should be a job for automatic stabilizers.

Various clever schemes for circumventing the debt brake are now being floated… A recent article by two academics in *FAZ* speculated that the German government could use the theoretical €40bn surplus in its "control account" (a notional account recording non-cyclical ex post deviations from budget plans) as a pot of spending money. But this account records over-spending which must then be amortised, and doesn't work symmetrically in the case of under-shooting. Changing how it works would require legal or perhaps even constitutional changes.

… including proposals for a "shadow budget". The CDU-run economy ministry has also floated the possibility of setting up what has been referred to as a "shadow budget", in the form of legally independent public agencies to fund investment in climate-related projects, and borrowup to €50bn from investors at 2% (giving those poor German savers an opportunity to earn some decent returns). Agencies like this would not be bound by the debt brake (though their borrowing would be included in Germany's general government borrowing figures for the purposes of complying with the looser requirements of European law).

These are unlikely to come to anything. For the moment, they seem to be little more than trial balloons. And they have apparently been greeted with an appropriately raised eyebrow in Scholz's finance ministry, which seems more alive both to the discrediting effects of hare-brained schemes to circumvent one's own debt brake, and to the absurdity of choosing to borrow at significantly above-market rates.

Any extra spending for 2020 is likely to be in the region of €10bn. So what to expect? Well, we think Germany's federal budget is probably heading into 2020 in rough structural balance. A few weeks ago, we wrote that that might give it fiscal leeway in the region of €10-15bn for next year, if it decides over the coming months that a little extra spending would be helpful after all (the budget doesn't need to be passed until the end of the year). The finance ministry has since clarified that, after subtracting various government agency deficits, the figure is likely to be closer to €5bn – although we would never underestimate a government's ability to find some more cash down the back of the sofa.

Don't expect major policy change just yet. There are promising signs that German attitudes to government spending, and in particular to public investment, are beginning to change. But this change will take a long time to filter through into policy. And in the meantime, anyone counting on an unexpected boost from Berlin is bound to be disappointed

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