Global Financial Trends

THE TLTRO BAZOOKA (IN CHARTS)

Shweta Singh/Davide Oneglia

- **Longer-term refinancing facilities have become a key policy tool for the ECB since the global financial crisis**
- **We expect a fresh round of TLTROs to be announced in March or at the latest by June**
- **In its absence, Italian and Spanish lenders could face a significant funding squeeze by mid-2019**
- **Some claim TLTROs is a more powerful tool than QE**
- **But the refinancing operations are not a magic wand**
- **The euro area needs a demand – not a supply – boost**
- **But a meaningful fiscal stimulus is missing**
- **Expect more backdoor fiscal transfers**

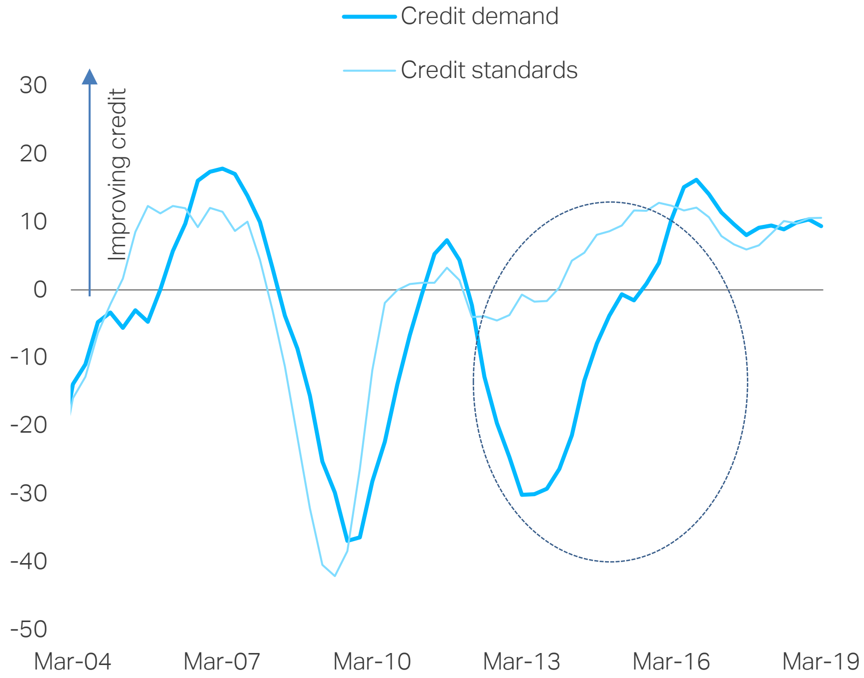
Summary key points

Not just about liquidity	• Longer-term refinancing facilities have become a key tool for the ECB since the global financial crisis • TLTRO-II – launched in June 2016 – was the ECB's most generous credit-easing scheme • The aim was to ease the blow to banks' profitability from negative rates and to reduce fragmentation within the euro area • Italian lenders alone took up just over a third of the €740bn TLTRO borrowings. Spanish banks were also large borrowers.
TLTRO-III	• We expect a fresh round of TLTROs to be announced in March or at the latest by June. • The first TLTRO-II repayments are due in June 2020, but lenders will come under pressure from mid-2019 • Italian and Spanish banks have been among the largest borrowers of TLTRO funds and may see a significant funding squeeze • EA growth has dimmed and the QE boost has ended, the ECB will be keen to avoid any tightening in financing conditions • A meaningful fiscal boost is lacking and the central bank is running out of monetary ammunition
TLTROs, QE, backdoor fiscal transfer	• Some argue that TLTROs could be more powerful than QE • Credit-easing policies work through the banking system, but QE works largely by side-stepping banks • QE has a more far-reaching impact through portfolio rebalancing and wealth and currency effects • But the impact of ECB QE has been limited because of self-imposed constraints on the bond-buying scheme • Instead. TLTROs combined with negative deposit rates constitute a form of backdoor fiscal transfer within the EA • If the ECB were to stick to its QE rules and if there continues to be no genuine fiscal easing, TLTROs – and negative rates – could be among the very few policy options left open to the ECB
No magic wand	• The impact of TLTROs on boosting credit growth and economic expansion has been muted at best • Credit in Italy and Spain – the largest TLTRO borrowers – continues to contract • Credit easing measures are helpful when banks are constrained in their capacity to meet demand for loans • But it is mainly weak demand that has held back lending in the EA in this cycle, hence the boost from TLTROs is limited • There are many ways to 'cheat' the TLTRO-II benchmarks to benefit from the ECB's subsidy while engaging in carry trades • The key risk here is that the doom loop between banks and sovereign balance sheets – especially in Italy – could strengthen

Key message

Paucity of demand is a bigger problem from eurozone credit

ECB Bank Lending Survey; net share of respondents reporting improving credit demand and supply for small firms; change from pre-crisis averages



Targeted long-term refinancing operations (TLTROs) are the new buzzword. Some analysts reckon TLTROs could be more potent than QE. We expect a fresh round of TLTROs to be announced in March or at the latest by June.

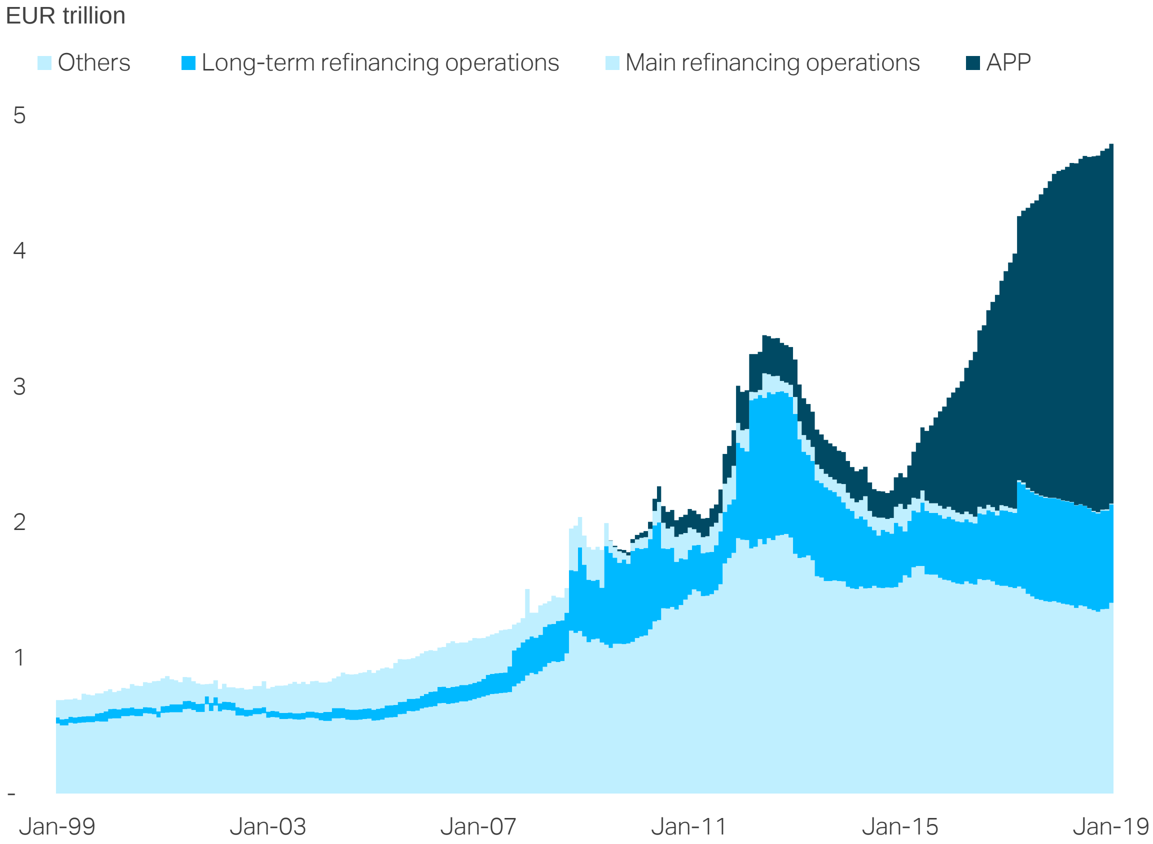
The ECB allotted its last round of TLTRO-II loans in March 2017 and the first repayments are due in June 2020. But under new Basel banking regulations, lenders will start to feel the pressure from mid-2019. Italian and Spanish banks have been among the largest borrowers of TLTRO funds. As a result, they could experience a significant funding squeeze as the repayment date approaches. Italian spreads in particular could widen rapidly, raising concerns about the transmission of ECB policy. The looming funding squeeze from TLTRO repayments comes against the backdrop of a much weaker EA growth outlook and the ECB's exit from QE.

The ECB's refinancing operations are no longer just about managing liquidity. LTROs have become a key monetary policy tool for the central bank since the global financial crisis. But the impact of TLTROs on boosting credit growth and economic expansion has been muted at best. For instance, credit in Italy and Spain – the largest TLTRO borrowers – continues to contract. Credit easing measures such as TLTROs are helpful when banks are constrained in their ability to meet demand for credit. But it is mainly weak demand that has held back bank lending in the EA in this cycle. Besides, there are many ways to 'cheat' the system to benefit from the ECB interest rate subsidy while engaging in carry trades. Take the case of Italian banks, which appear to have parked a decent share of their TLTRO borrowings in higher-yielding BTPs. More TLTROs could intensify the doom loop between sovereign and banks' balance sheets

In many ways, TLTROs combined with negative deposit interest rates constitute a form of backdoor fiscal transfer within the EA. The programme is designed in such a way that it helps economies with greater funding needs and higher borrowing costs (such as Italy) at the expense of those (such as Germany) with ample excess liquidity. If the ECB were to stick to its QE rules and if there continues to be no genuine fiscal easing, TLTROs – and negative rates – could be among the very few policy options left open to the ECB.

Refinancing operations not just about liquidity management

Surging excess liquidity



Until the Global Financial Crisis, refinancing operations were a tool to manage liquidity and did not have a bearing on the ECB's monetary policy. The Eurosystem used the refinancing window to provide as much liquidity to banks against eligible collateral as was necessary to keep the EONIA (Euro Overnight Interest Rate Average) rate close to the ECB's policy target rate.

But the role of these operations has changed since the crisis; monetary and liquidity management policies are not necessarily distinct any longer. Longer-term refinancing facilities have become a key tool for the ECB. As we can see in the chart above, the assets of the central bank held under 'long-term refinancing operations' (LTROs) has increased since the GFC.

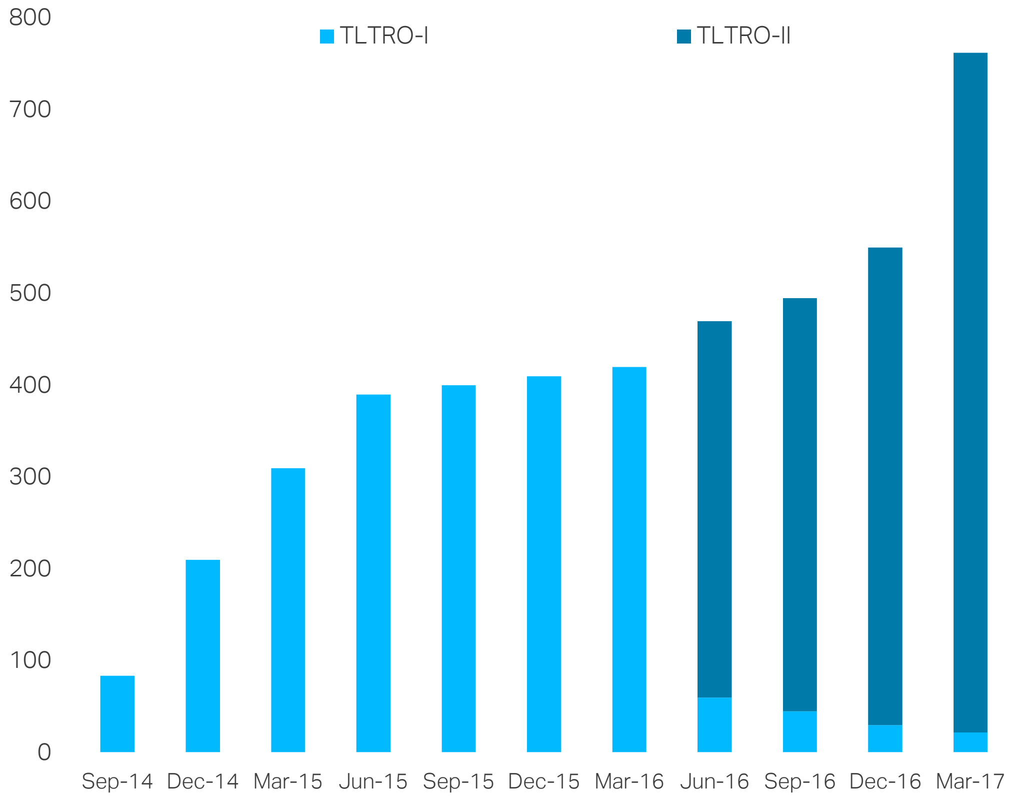
The first step towards using liquidity provision tools on a larger scale was in October 2008, when the ECB introduced fixed-rate full allotment (FRFA) refinancing. Under FRFA, banks can access unlimited reserves against eligible collateral for longer periods. The ECB also widened the range of eligible collateral to include riskier assets. Thus, the size of the ECB's balance sheet is determined primarily by demand of its counterparties for liquidity.

In December 2011, the central bank announced FRFA LTROs with a three-year maturity. The interest rate was fixed at the average lifelong rate of the ECB's main refinancing operations (MROs). In the interim, the ECB has extended the FRFA tender procedures for its MROs and three-month LTROs till at least the end of 2019.

TLTROs - a brief history

TLTRO borrowings

Banks' gross TLTRO borrowings, EUR bn



In June 2014, the central bank announced targeted longer-term refinancing operations (TLTROs) to provide funds to banks for up to four years at an attractive interest rate with the aim of boosting lending to the real economy. The rate was set at the MRO rate plus a fixed spread of 10 basis points; this spread was subsequently scrapped. Banks whose net lending to the euro area non-financial private sector, excluding loans to households for home purchases, was below the benchmark between May 2014 and April 2016 were required to repay their borrowings in September 2016.

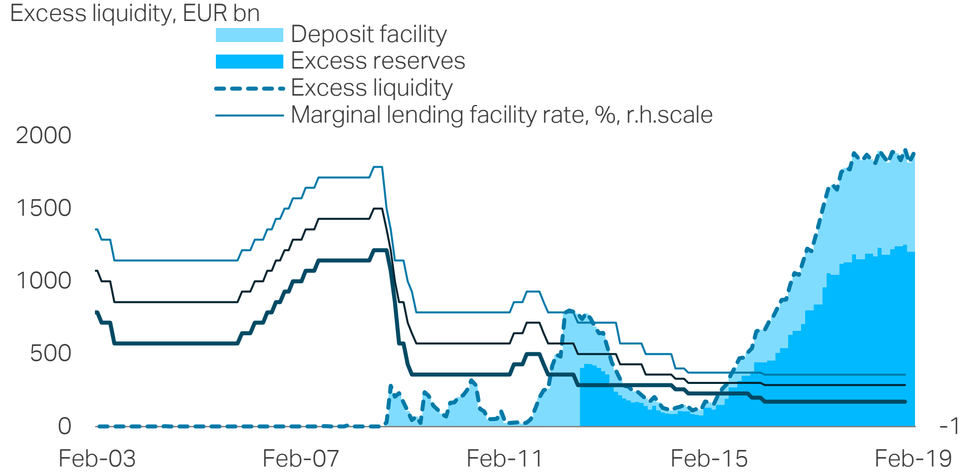
A second round of TLTROs (TLTRO-II) was announced in March 2016 on more generous terms and at lower interest rates than the first round. Banks could borrow up to 30% of the value of their stock of eligible loans. While the average cost of TLTRO-I funding was around 10bp, the maximum rate on TLTRO-II funding was zero (the MRO rate). Crucially, unlike TLTRO-I, which penalised banks that failed to meet lending targets, TLTRO-II provides rewards in the form of lower interest rates: banks whose eligible net lending exceeds their benchmarks can borrow for as little as −40bp.

Thus, TLTRO-II enabled banks to roll over their TLTRO-I borrowing on more favourable terms, sparing them liquidity pressure when the first programme expired. It is not surprising, then, that when the first round of TLTRO-II operations was conducted in June 2016 (€399bn), it largely reflected shifts out of TLTRO-I. Total outstanding borrowing under TLTRO-II was €724bn as of January 2019.

In short, the ECB has increasingly used liquidity operations to improve the transmission of monetary policy and boost credit growth by providing funds at generous rates – even paying banks to borrow from the Eurosystem- and by accepting lower-rated assets as collateral.

TLTROs, excess liquidity, negative rates and fragmentation

Excess liquidity, EUR bn

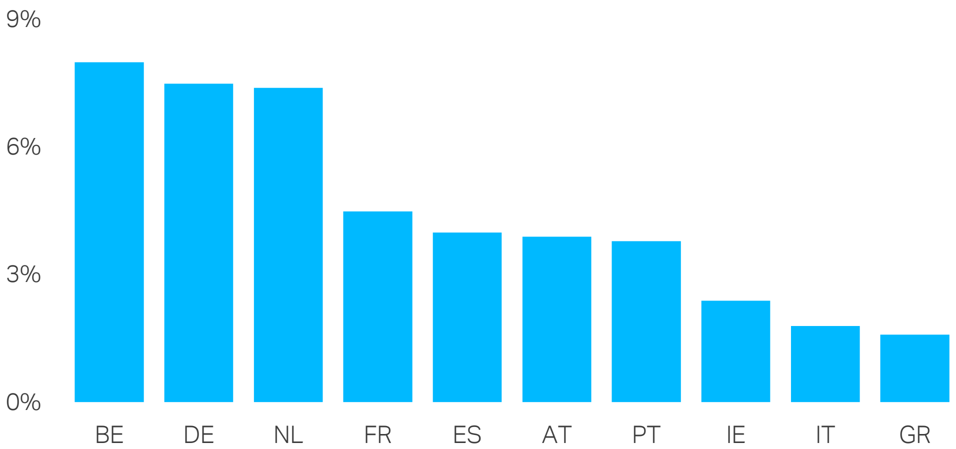


TLTRO-II was the ECB's most generous credit-easing scheme. It was announced to ease the pain for banks of policies that were reducing their net interest margin. For instance, the ECB cut the deposit facility rate (DFR) further to *minus* 40bp in March 2016. In other words, banks would have to *pay* the Eurosystem 0.40% to park their excess liquidity with the central bank. The ECB also beefed up its monthly asset purchases to €80bn from €60bn, beginning April 2016, causing excess liquidity to swell further (chart above). As a result, the drag from negative rates on banks' margins intensified with Germany, the Netherlands and France coming under greater strain (chart top right).

According to the ECB's Bank Lending Survey, a small share of lenders indicated that the negative DFR had a positive impact on their loan volumes, although the boost faded in subsequent surveys. A much larger percentage of banks reported a fall in their net interest income (chart bottom right)

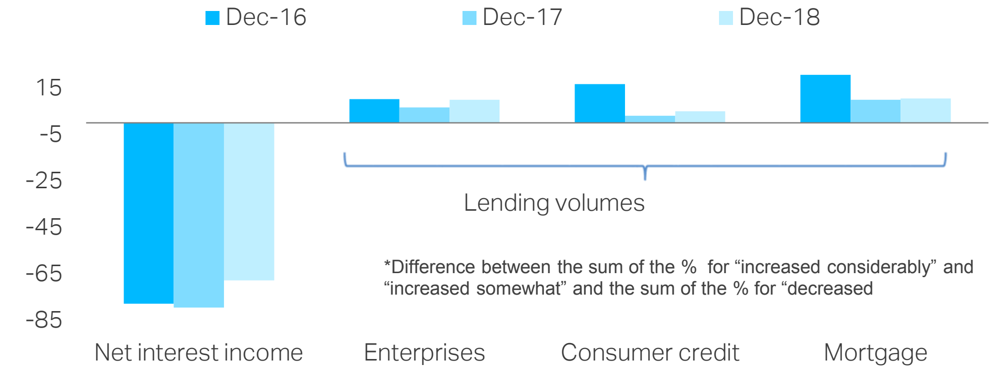
Disparate distribution of excess liquidity

Holdings of excess liquidity by country, ratio to banking system assets, 2018



Impact of negative rates on banks

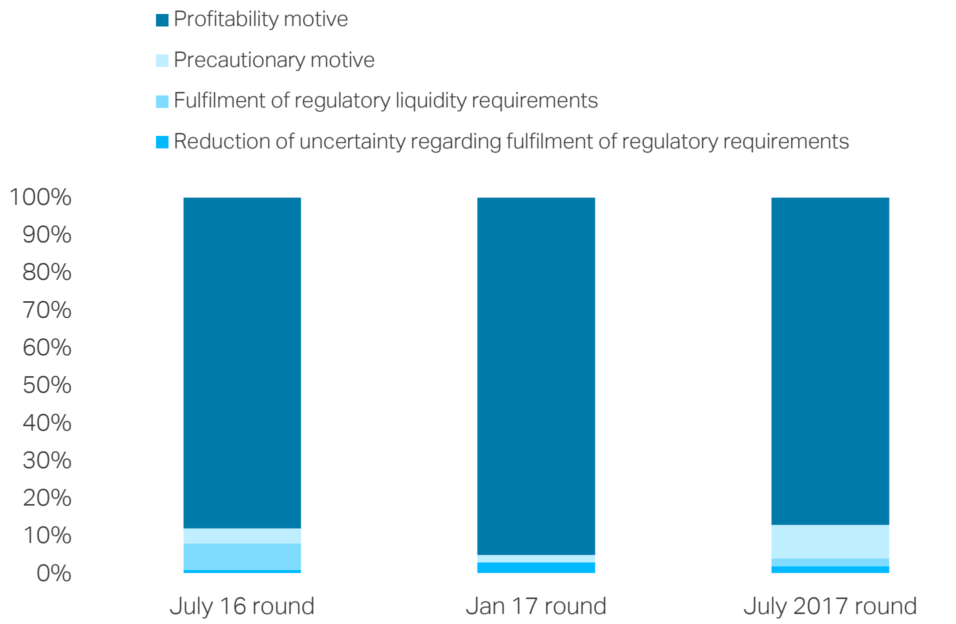
Impact of the negative deposit facility rate on banks' net interest income and lending



TLTROs and profitability

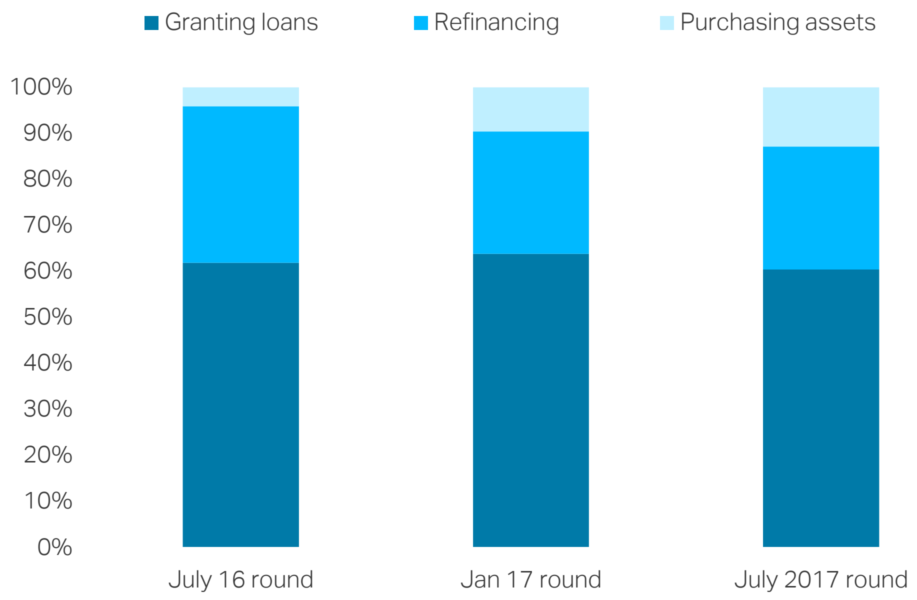
Reasons for participation in TLTRO

% of banks that said they participated



Use of funds from past TLTROs

% of banks that said they participated



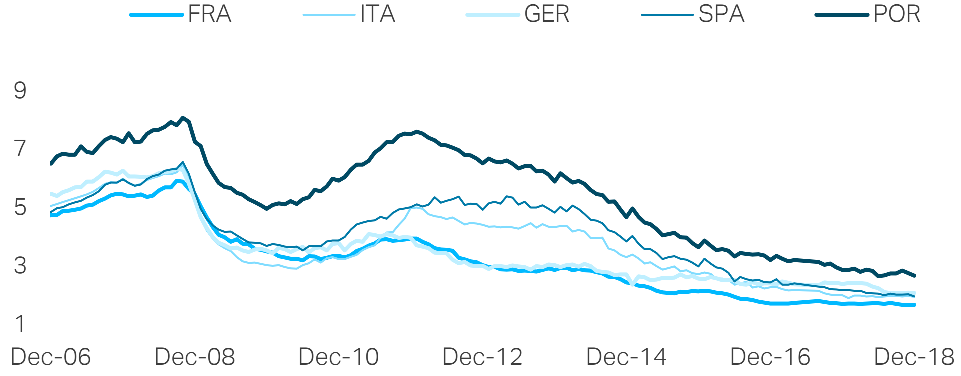
It is not surprising, then, that up to 95% of banks surveyed by the ECB used funds borrowed under the TLTROs to boost profitability (see chart above).

Although a large share of banks that participated in the ECB survey – up to 60% of lenders – said that they used TLTRO borrowings to extend credit (chart above), up to a third said they used the loans to meet their refinancing needs.

TLTROs and fragmentation

Reduced fragmentation in EA

Interest rate on corporate loans up to €1 million, per cent



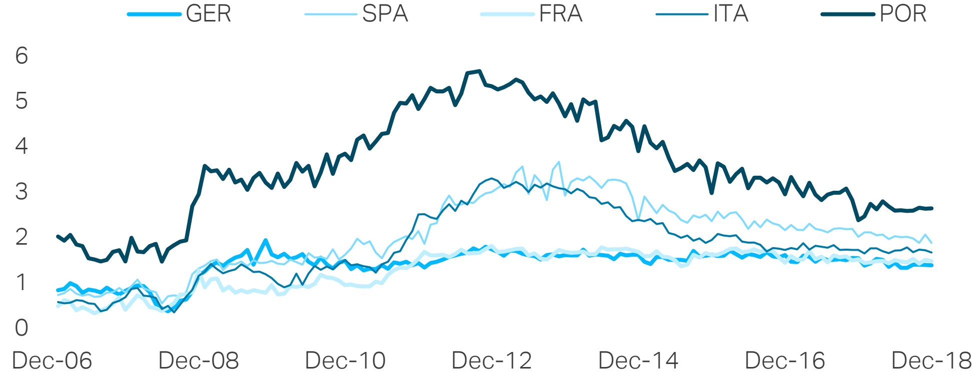
One of the key motives behind TLTROs has been to strengthen the transmission of monetary policy across the euro area, especially by reducing fragmentation between the periphery and core countries. The ECB has succeeded in this aim: the spread between lending rates in the core and periphery has narrowed considerably since the EA sovereign debt crisis (charts above).

But it is difficult to disentangle the extent to which TLTROs alone were instrumental in reducing funding stress within the EA. These refinancing operations coincided with various ECB policies, including an expanded asset purchase programme and enhanced forward guidance.

The ECB's bank lending survey offers some insight. In vulnerable countries, a larger share of surveyed banks said that past TLTROs had a net easing impact on their credit standards and terms and conditions (right-hand chart at the bottom).

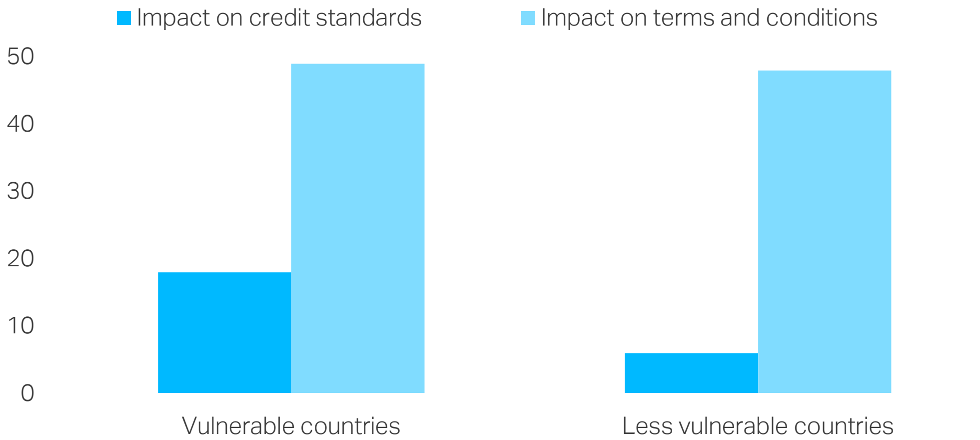
Lending spreads compress in the eurozone

Corporate lending spread, percentage points over swap rate



'Vulnerable' countries gained more from TLTROs

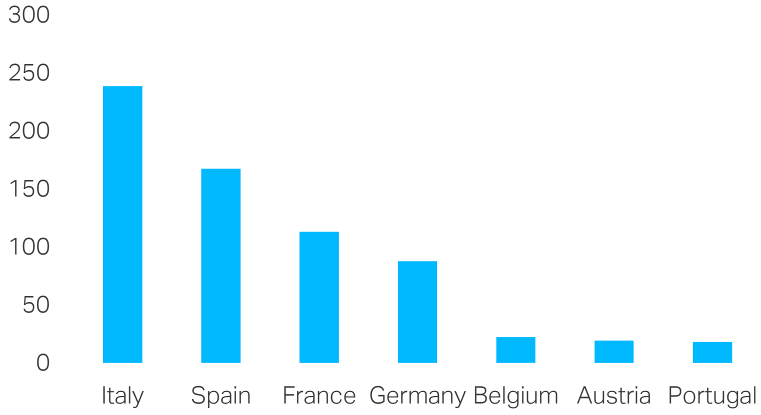
% of surveyed banks indicating that TLTROs made a net positive contribution to easing credit



The key takers

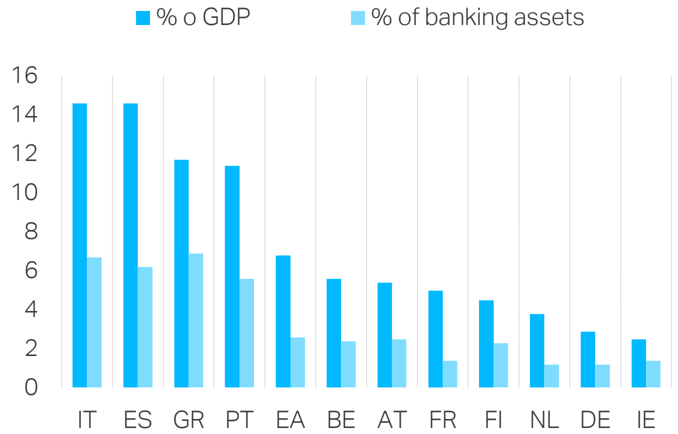
Italy's extensive reliance on TLTROs

Long-term refinancing operations, EUR bn, December-18



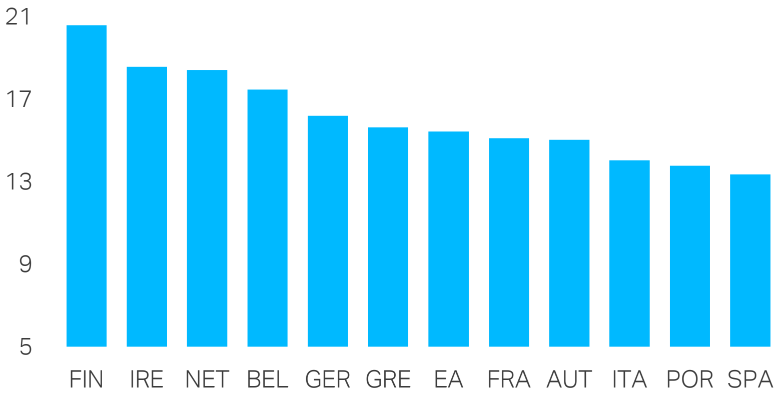
TLTRO borrowings

Long-term refinancing operations, EUR bn, May -18



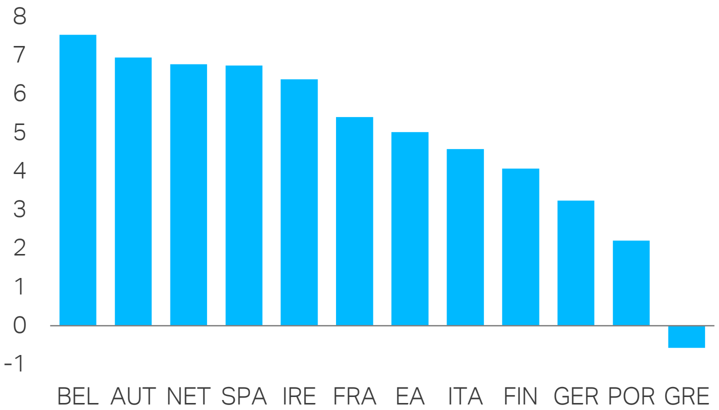
Bank capital ratios

Tier 1 capital ratio, domestic banks, Q3 2018



Bank profitability

Return on equity, domestic banks, Q3 2018



Banks that have weak capital ratios, suffer from poor profitability and face higher funding costs stand to benefit disproportionately from TLTROs.

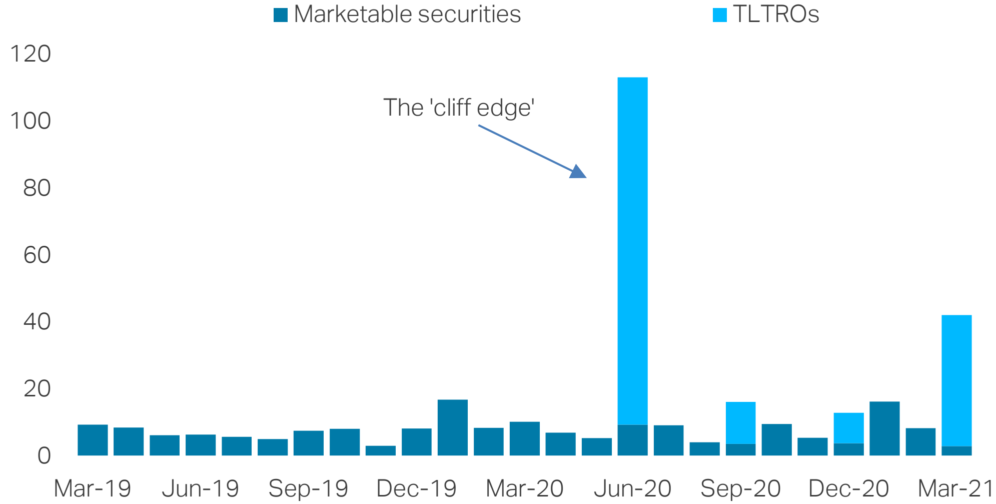
Italian lenders alone – whose balance sheets and returns on equity are among the weakest in the EA – took up just over a third of TLTRO borrowings. This amounts to 15% of Italian GDP and 6.7% of Italian bank assets.

But, as we show in later slides, the large take-up of TLTRO funds by Italian banks has not resulted in a boost to lending to the private sector. Italian banks also continue to suffer from poor profitability and weak liquidity buffers. Credit supply and demand in Italy remains among the weakest in the EA. In the most recent ECB survey, lenders reported a net tightening in standards for business loans last quarter and expect standards to tighten for small firms over the next quarter.

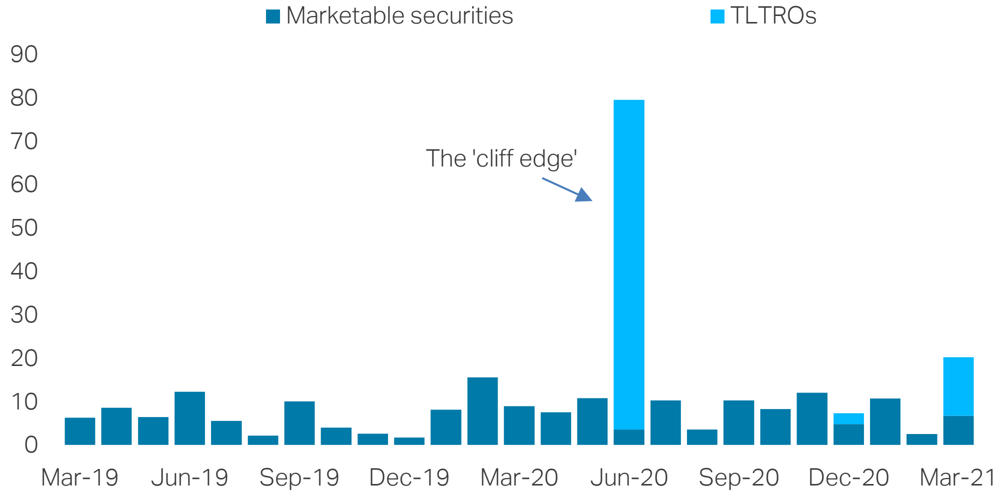
Besides Italy, Spanish banks also stand out as big borrowers of TLTRO funds. But bank lending in Spain also remains weak.

Why a new round of TLTROs is becoming important

Italy
Financial debt* repayment schedule (includes principal and interest), EUR bn
*We include the 9 largest banks by assets



Spain
Financial debt* repayment schedule (includes principal and interest), EUR bn
*We include the 8 largest banks by assets



We have been making the case that fresh TLTROs – or an extension of the repayment deadline for TLTRO-II borrowings – is critical and that an announcement could come this month or in June at the latest.

The ECB allotted its last round of TLTRO-II loans in March 2017. TLTRO-II borrowings have a maximum maturity of four years, so the first repayments are due in June 2020. But under new Basel banking regulations, lenders will start to feel the pressure from mid-2019. Their long maturity meant these TLTRO loans counted towards banks' liquidity requirements, such as the Net Stable Funding Ratio (NSFR). However, borrowings with a residual maturity of less than one year have a much lower weighting in calculating a bank's NSFR. As a result, lenders will have to replace cheap TLTRO liquidity with more expensive sources of funding.

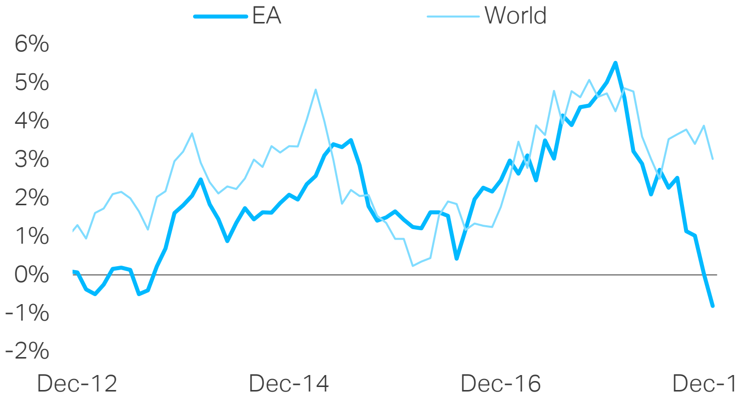
As we highlighted in the previous slide, Italian and Spanish banks have been among the largest borrowers of TLTRO funds. As a result, they could experience a significant funding squeeze as the repayment date approaches (see charts above).

This is especially true for Italian borrowers because a higher political risk premium could keep their wholesale borrowing costs and spreads under strain. Italian growth prospects appear dismal. The economy entered a technical recession last quarter. Most hard data and survey results suggest that the economy could contract this quarter as well. As a result, Italian spreads could widen rapidly as we get closer to the repayment deadline, raising concerns about the transmission of ECB policy.

EA growth running out of steam

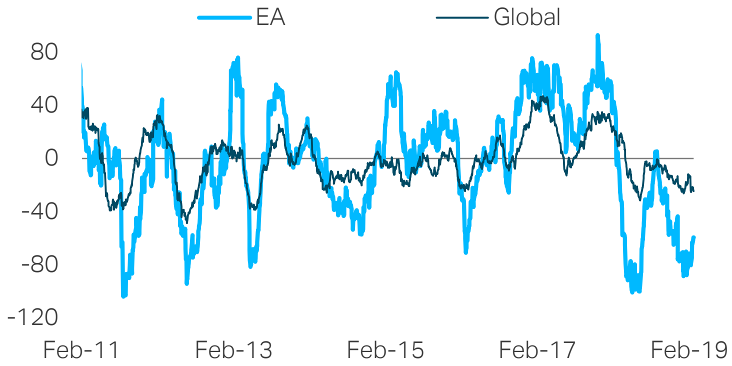
EA exports worse than global exports

Export volumes, %y/y, 3MMA



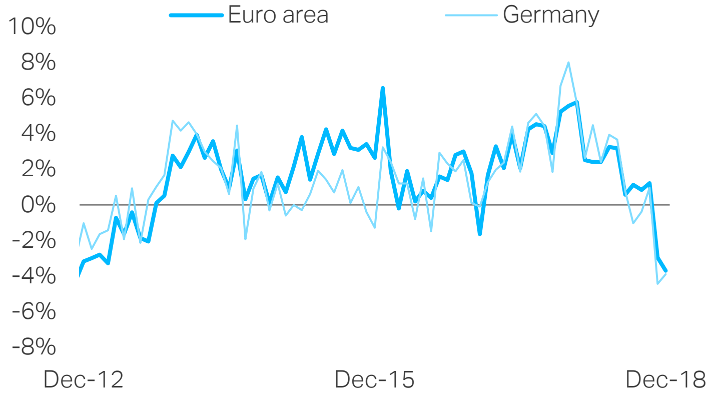
EA data misses larger than in rest of the world

Citi Economic Surprise Index



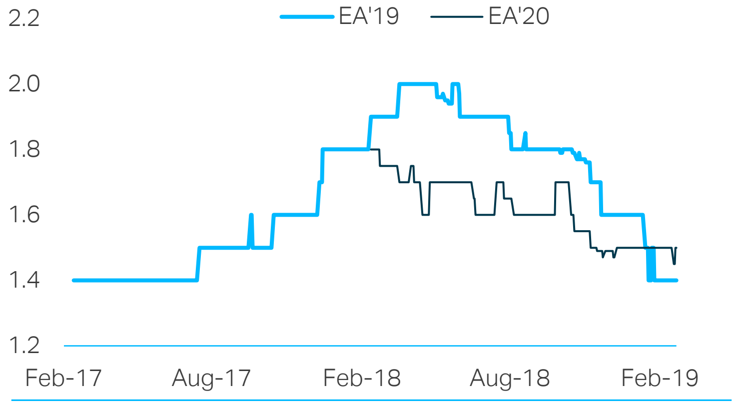
EA manufacturing plunges

Industrial production, manufacturing, % annual change



Analysts revise lower their EA growth forecasts

Real GDP growth forecasts, %y/y, Bloomberg survey



The looming funding squeeze from TLTRO repayments comes against the backdrop of a much weaker EA growth outlook.

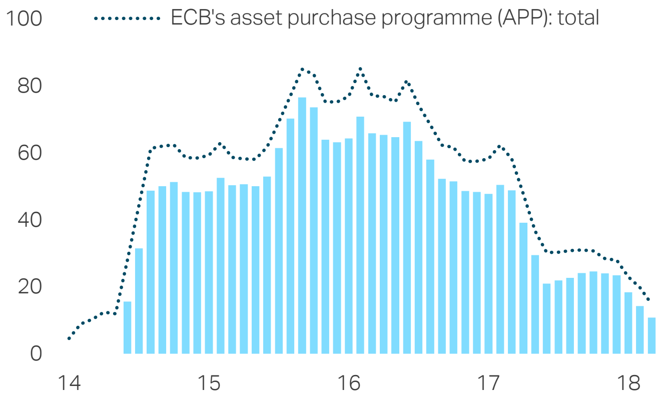
EA manufacturing ended last year in recession. Idiosyncratic factors – new vehicle emission testing standards in particular – were clearly a drag. But slower global growth and policy uncertainty have been stiffer headwinds and they are unlikely to drop quickly. Global growth is set to remain weak, at least in the first half of this year, weighing on the EA economy. The region still has a large inventory overhang and new orders, especially export orders, remain weak.

Consensus EA growth expectations for 2019 have been revised lower from 2% in May 2018 to 1.4% in February and we see scope for more downgrades. We expect EA real GDP growth to come in just above 1% this year. More worrying is Italy, where growth could slow to 0.2%.

Monetary indicators point to further slowdown

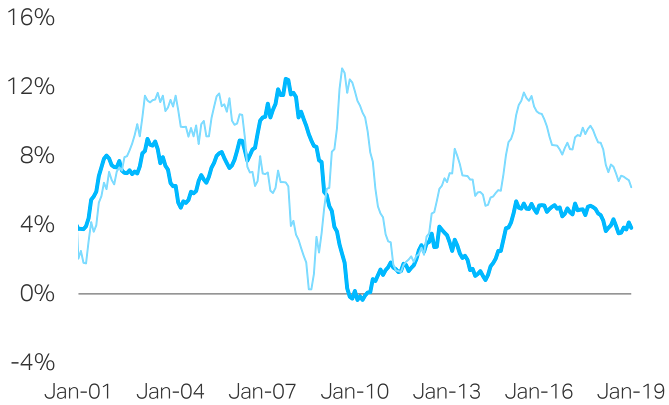
End of ECB QE

ECB's asset purchases, EUR billion, 3MMA



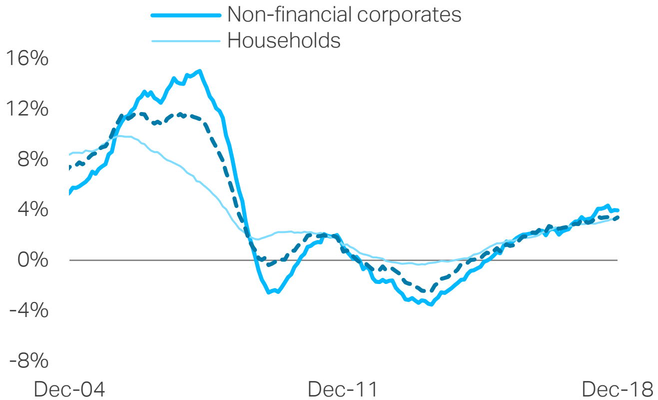
Money supply slows rapidly

% annual change



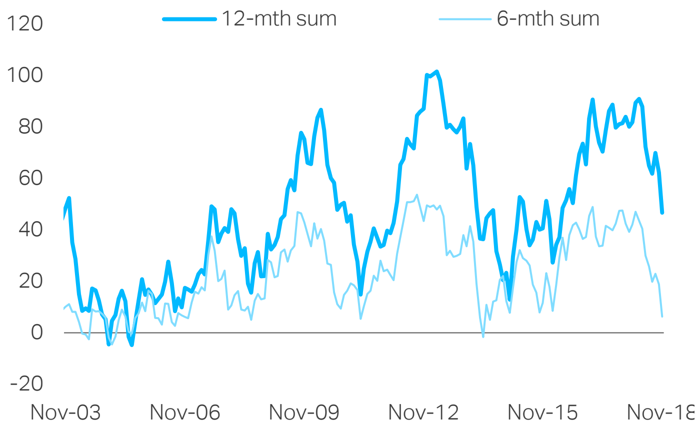
Credit growth plateauing at relatively low levels

% annual change



Debt issues plummet

Debt issues by non-financial corporations (NFCs), EUR bn



Meanwhile, the injection of liquidity through the ECB's €2.6trn asset purchase programme ended in December. The ECB's exit from QE has come at a particular difficult time for the EA.

Many analysts point out that the tapering of the central bank's bond-buying scheme has led to a sharp slowdown in the EA's monetary aggregates - a signal that economic growth could weaken further.

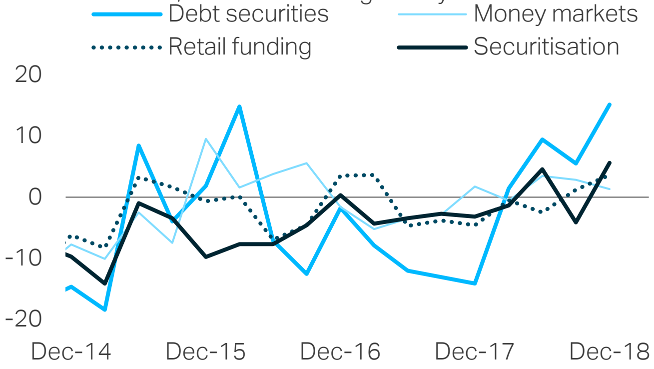
Worries that the end of ECB QE is stifling money supply growth and weighing on financing conditions and the overall economy are not misplaced. Narrow money supply growth has dropped from a high of 11.7% in 2015 to 6.2% in January. Broad money supply growth has also fallen from 5.4% in April 2015 to 3.8%.

But our analysis suggests that the deceleration in headline money growth does not adequately capture the weakness in spending that could lie ahead. Specifically, our estimates show that precautionary demand for money is on the rise. In other words, firms and households are building up their liquidity buffers, which does not augur well for spending plans. What this means, in effect, is that stripping out this increase in precautionary demand for money, the monetary aggregates are deteriorating even more rapidly. In turn, this suggests the drag from the fall in transaction demand for money could be greater than meets the eye.

Deteriorating funding conditions, but limited policy options

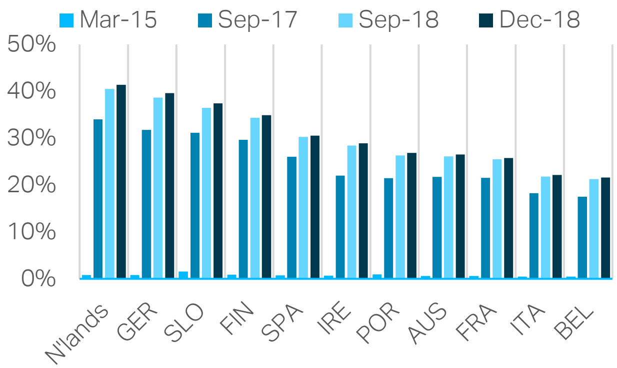
EA banks face deteriorating funding conditions

Net percentages of banks reporting a deterioration in market access, ECB bank lending survey



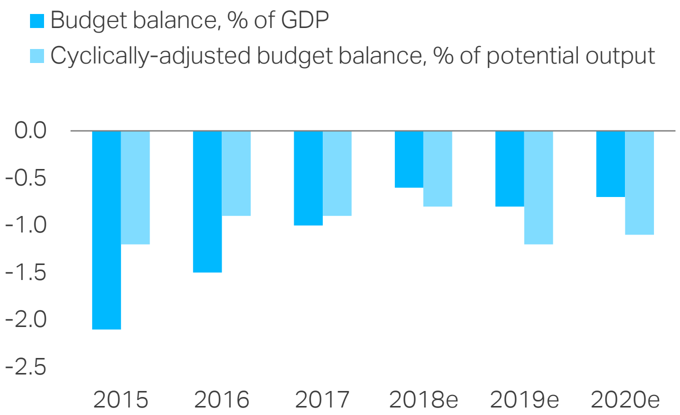
Eurosystem's holdings of EA sovereign paper surges

ECB holdings under PSPP as a share of central government bonds with maturity 1-30 years



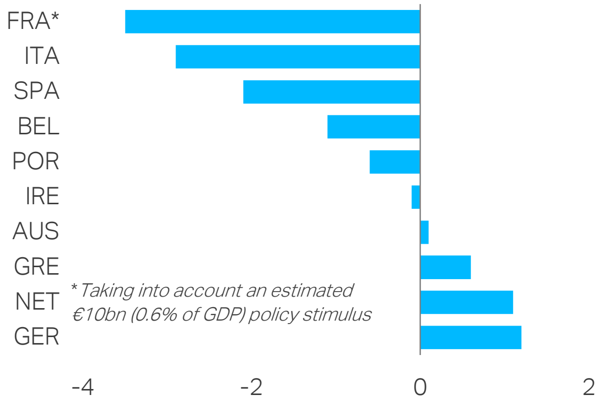
Only a modest fiscal stimulus to kick in

EC Autumn 2018 forecasts for



Large German fiscal surplus

Budget balance, % of GDP, 2019 forecasts, EC 2018



Meanwhile, funding costs are rising: the share of banks reporting a net deterioration in access to funding through debt securities and securitisation is greater than it has been since the EA debt crisis (first chart). Debt issues by non-financial firms have plummeted and bank lending growth has plateaued at relatively low levels (charts at the bottom on the previous page). Banks expect credit standards to tighten next quarter and credit demand to slow further.

The ECB's chief economist, Peter Praet, has also raised some of these concerns. He highlighted that the financial sector often tends to act pro-cyclically, i.e. banks lend when the economy is performing well but hold back credit when growth is faltering.

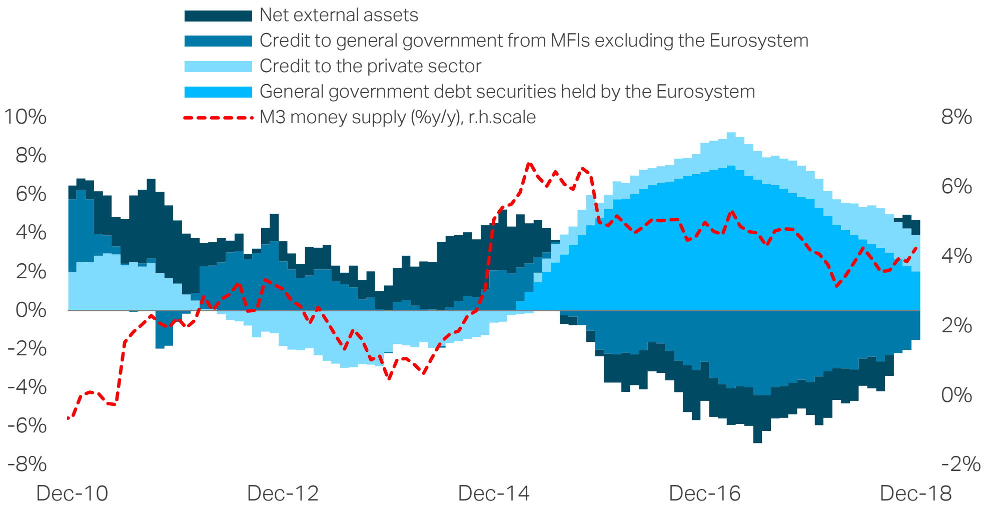
But the ECB's policy options are limited. The deposit facility interest rate is already at a *negative* 40 bps. The ECB also faces a scarcity of assets that it can buy due to self-imposed, politically sensitive constraints – principally that it must buy securities according to a country's share of the bank's capital.

Monetary policy options are further restricted due to the limited boost from fiscal policy, not least because it reduces the quantity of assets that the central bank could buy. Take the case of Germany for example. The economy escaped a recession last quarter by a whisker. Growth is likely to remain lacklustre this year, especially in H1. And yet, the budget balance remains in surplus. As a result, some form of TLTRO or an extension of TLTRO-II seems increasingly likely.

TLTROS and QE

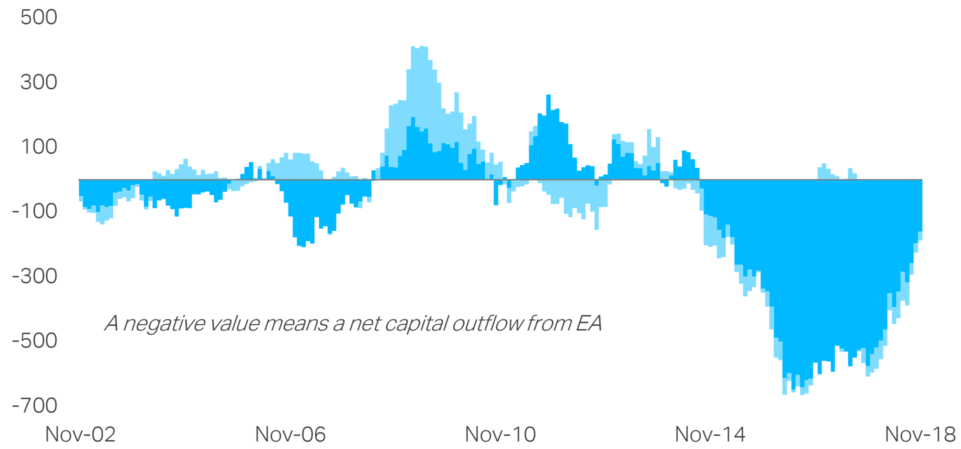
The drivers of broad money growth: a component story

%-point contribution to annual M3 money supply growth



ECB QE led a surge in portfolio outflows

Net portfolio flows, 12-month sum, EUR Bn



Some argue that TLTROs could be even more powerful than QE. But TLTROs are a credit-easing tool that works through the banking system. The liabilities incurred by borrowing from the ECB remain on bank balance sheets. On the other hand, QE works largely by side-stepping the banking system. To the extent that the central bank buys assets from non-banks, it injects money directly into the economy. The associated portfolio rebalancing effects are much more powerful. Crucially, by driving EA yields lower, ECB QE also led to historically large net portfolio outflows from the EA and a weaker euro.

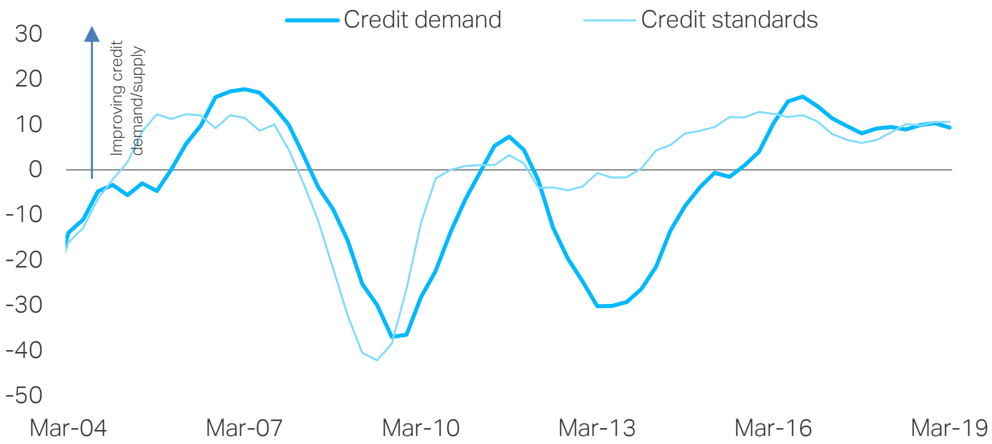
Having said that, there is some merit to the argument that TLTROs could be more powerful than QE. This is because of the restrictions that the ECB has placed on its QE programme and limited fiscal easing in the euro area.

In many ways, TLTROs combined with negative deposit interest rates constitute a form of backdoor fiscal transfer within the EA. The programme is designed in such a way that it helps economies with greater funding needs and higher borrowing costs (such as Italy) at the expense of those (such as Germany) with ample excess liquidity. If the ECB were to stick to its QE rules and if there continues to be no genuine fiscal easing, TLTROs – and negative rates – could be among the very few policy options left open to the ECB.

Credit demand a bigger drag on bank lending

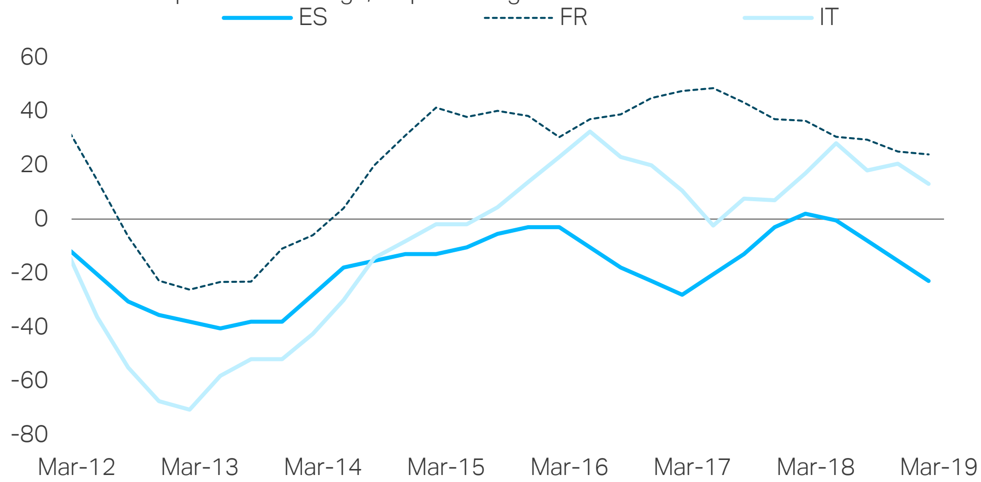
Paucity of demand is a bigger problem

ECB Bank Lending Survey; net share of respondents reporting improving credit demand and supply for small firms; change from pre-crisis averages



Weaker credit demand for capex

Net % of banks reporting an increase in credit demand for business loans for fixed capex, difference from pre-crisis average, 4-qtrs average



Clearly, the more generous and lengthy the new refinancing operations are, the greater the liquidity boost will be to banks, especially in periphery countries. The more important issue, however, is how effective TLTROs are in boosting economic growth. Our analysis suggests less room for optimism on this front.

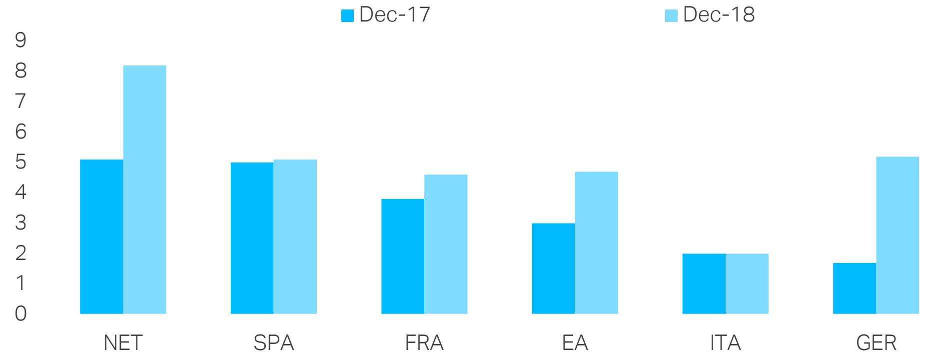
Credit easing measures such as TLTROs are helpful when banks are constrained in their ability to meet demand for credit. But it is mainly weak demand that has held back bank lending in the EA in this cycle. For instance, the net fall in demand for loans from small firms was much sharper than the tightening of credit standards (chart above). While credit supply recovered swiftly, demand struggled for longer in spite of significant pent-up needs.

Even in the case of periphery Europe, which gain disproportionately from the ECB's longer-term refinancing operations, credit demand remains weak. Banks report a net fall demand for business loans for fixed capex in Spain. Demand for business investment loans is also weakening in Italy. This largely reflects a deterioration in firms' capex plans even though EA investment during this cycle has been weaker than in past cycles and has undershot capex in most developed economies. Thus, even if the ECB continues to provide cheap unlimited funding to banks to encourage them to extend credit, the boost to lending will be limited if there is not much demand.

EA firms more worried about deteriorating economic outlook

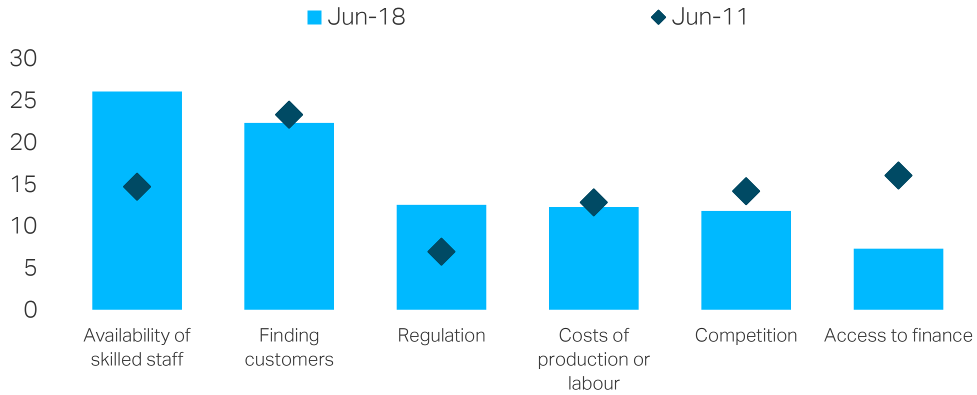
More firms reporting credit constrains

% of manufacturing firms reporting financing as a constraint on production



Problems faced by SMEs

What is the most pressing problem faced by SMEs, % of respondents

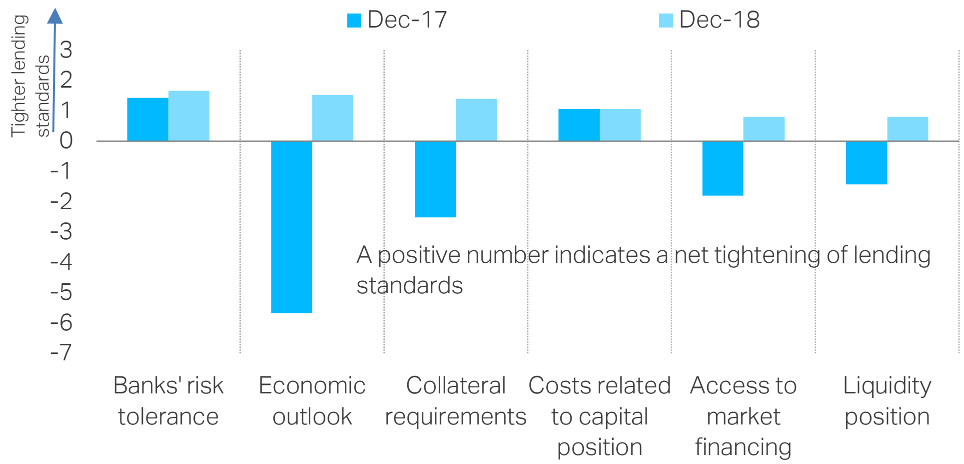


Surveys of manufacturing firms, especially small and medium-sized enterprises, also reveal that weakness in demand is a bigger constraint on production plans than tighter financing conditions. To be sure, more firms are reporting that financing is a constraint on their production plans (chart above). But on a relative basis, SMEs see access to financing as one of the least important deterrents (top chart on the right). This is in sharp contrast at the start of the decade, when a large share of firms reported access to finance as the most pressing problem. Meanwhile, finding customers continues to be one of the biggest constraints since the survey on the access to finance of enterprises in the euro area (SAFE) began in 2009.

Liquidity conditions and access to financing are clearly weighing on credit standards, but they are a less punitive drag on credit supply than banks' diminished risk tolerance and a much dimmer view of economic prospects (bottom chart on the right).

What's weiging on banks' credit standards

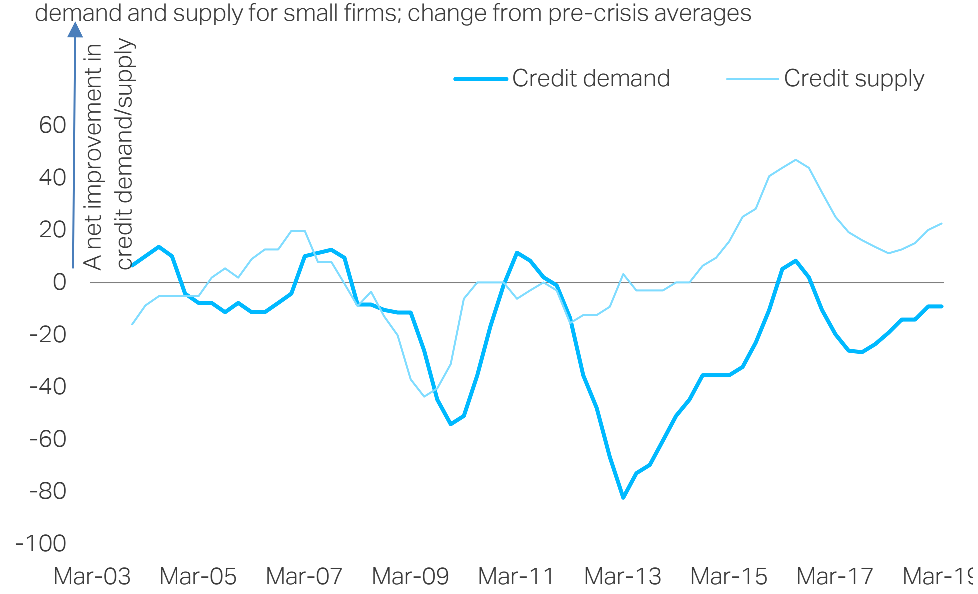
Net percentage of banks reporting tighter lending standards for loans to firms



Credit demand particularly weak in Italy

Weak credit demand in Italy

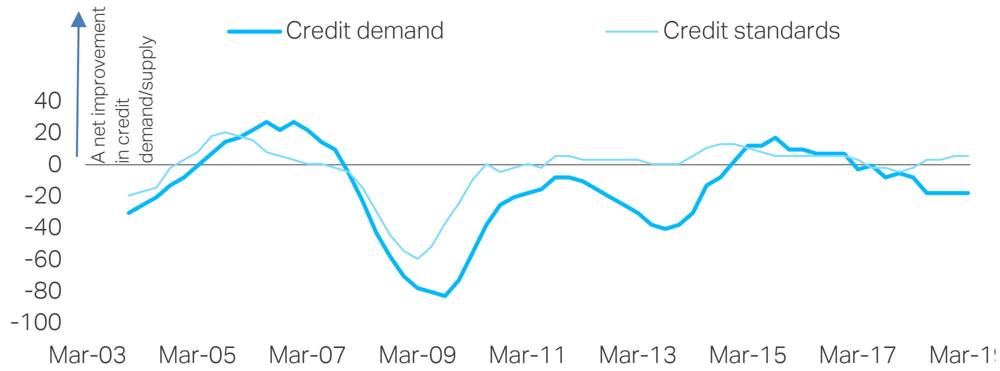
ECB Bank Lending Survey; net share of respondents reporting improving credit demand and supply for small firms; change from pre-crisis averages



The paucity of demand – compared to pre-crisis averages – is particularly striking at Italian banks, tempering expectations of how effective a new round of TLTROs is likely to be in boosting lending and economic growth (chart above). Demand for loans is also weakening in Spain and France. But credit standards seem easier relative to pre-crisis averages.

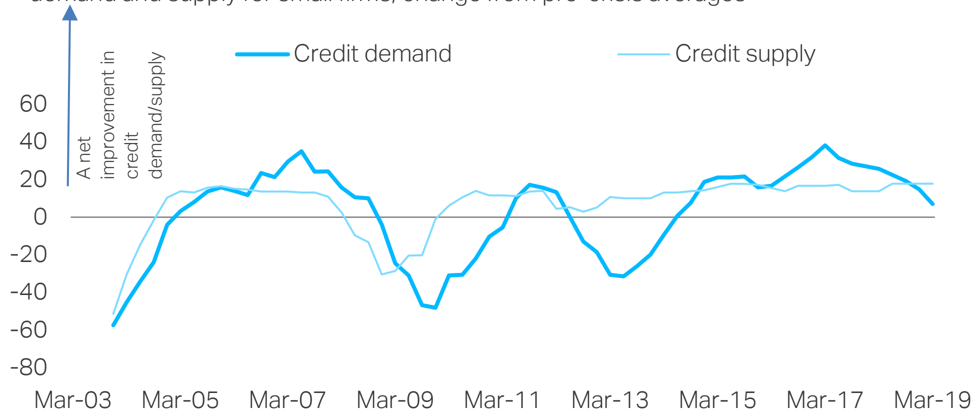
Deteriorating credit demand in Spain

ECB Bank Lending Survey; net share of respondents reporting improving credit demand and supply for small firms; change from pre-crisis averages



Slowing credit demand in France

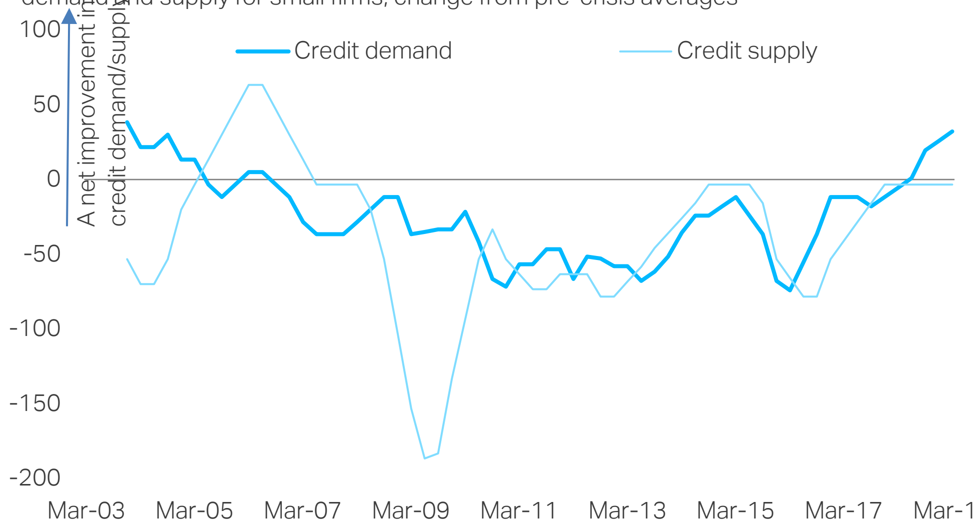
ECB Bank Lending Survey; net share of respondents reporting improving credit demand and supply for small firms; change from pre-crisis averages



5a. Credit demand a bigger drag on bank lending

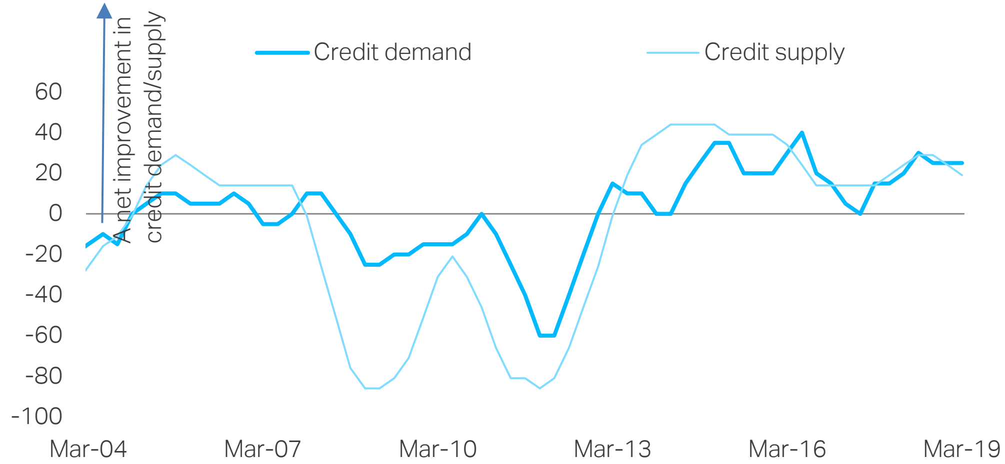
Credit demand shows some momentum in Greece

ECB Bank Lending Survey; net share of respondents reporting improving credit demand and supply for small firms; change from pre-crisis averages



Portugese banks see imporving credit demand and supply

ECB Bank Lending Survey; net share of respondents reporting improving credit demand and supply for small firms; change from pre-crisis averages



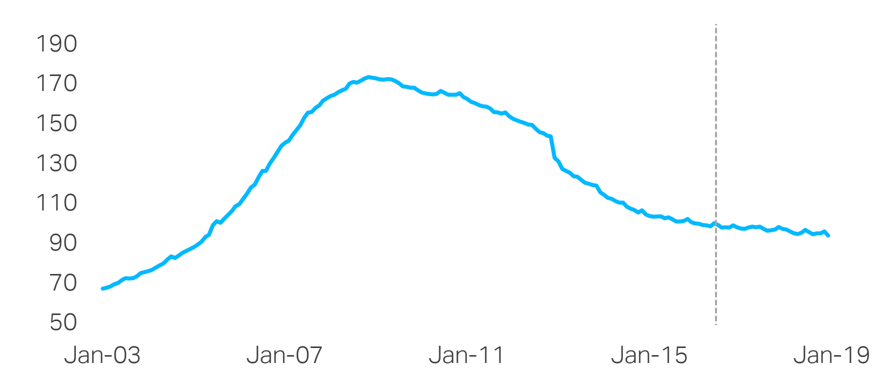
Interestingly, Greek banks could be among the beneficiaries of new TLTROs as demand for credit is finally showing some momentum.

Portugal could also be one of the larger beneficiaries as credit demand is picking up while the cost of holding excess liquidity is limited.

Cheating the system

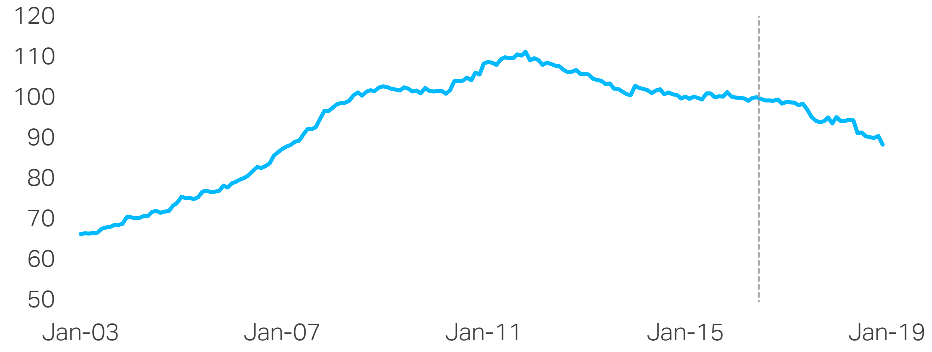
Spain credit remains weak

Loans to Spanish non-financial corporations and households (excluding mortgage); Jan-16 = 100



Credit continues to contract in Italy

Loans to Italian non-financial corporations and households (excluding mortgage), Jan-16 = 100



The latest round of TLTROs had very generous terms. A CEPS study estimates that the ECB interest rate subsidy to banks through TLTRO-II was around 20%. And yet, lending by Spanish and Italian lenders in particular – some of the biggest borrowers of TLTRO funds - has *contracted* since the first TLTRO-II loans were made in June 2016. Meanwhile, credit growth in Germany and France has been relatively buoyant. One of the main reasons for the disparate trends in credit growth across the EA is that there is plenty of room to 'cheat' the already generous conditions under TLTRO-II to qualify for the lowest borrowing rate.

Under TLTRO-II, the ECB paid banks up to 40bp to borrow from the Eurosystem, depending on whether their lending to households (excluding mortgages) and non-financial corporations met modest benchmarks.

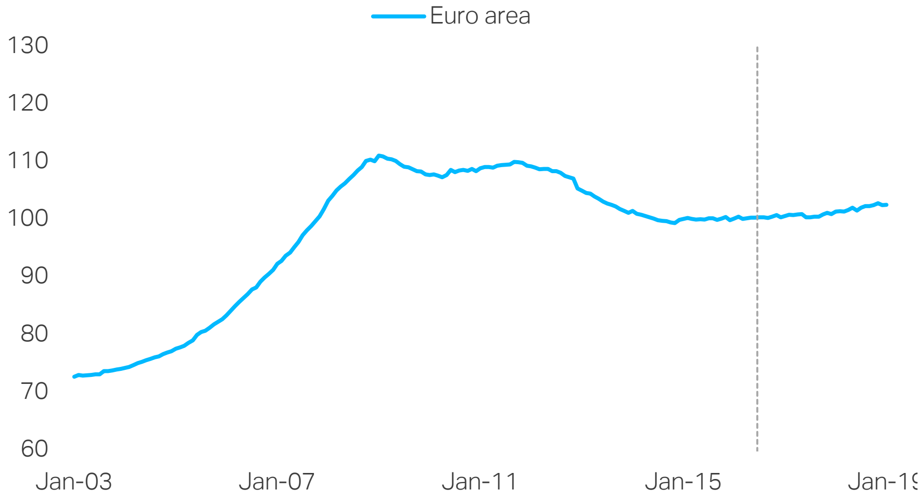
Specifically, if a bank's net lending between January 2016 and January 2018 exceed a certain benchmark by 2.5%, it would qualify to borrow funds with a four-year maturity at a *negative* 40bp.

The benchmark is determined by whether a bank's loan book was contracting or growing in the 12 months to January 2016. For banks with positive net lending during that period, the benchmark is zero. For those with negative eligible net lending, the benchmark is equal to the amount by which net lending contracted in that period. Thus, as the CEPS study shows, actual net lending would need to grow by much less than 2.5% even if all banks qualify for the interest rate reduction, since for many banks, the benchmark is falling.

Cheating the system

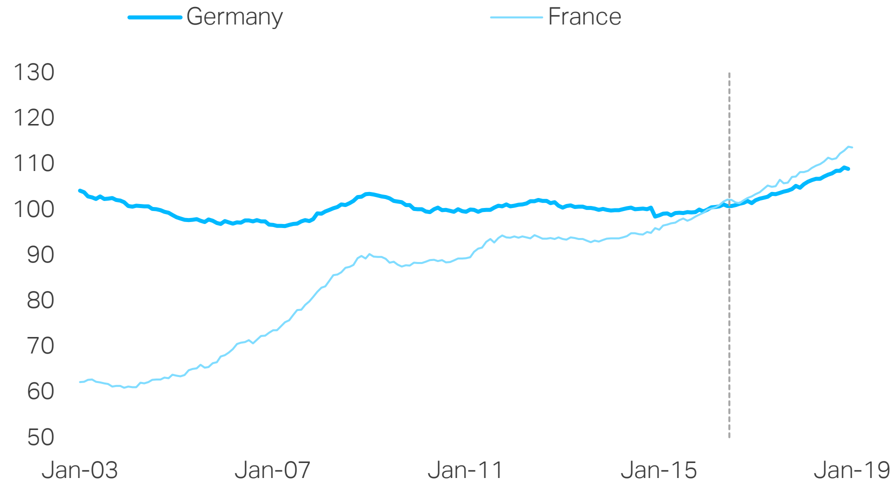
EA credit growth muted

Loans to EA non-financial corporations and households (excluding mortgage); Jan-



German and French credit outperform the EA

Loans to non-financial corporations and households (excluding mortgage); Jan-16 = 100



Crucially, **banks can window-dress their loan book** to avail themselves of the interest subsidy without actually extending credit. The CEPR study shows that some banks extend loans for working capital at zero interest rate to a company which is then required to put the proceeds in a blocked account as collateral.

What's more, **TLTRO-II allows banks to form groups** to qualify for the interest subsidy. As a result, within any group, those banks just under the benchmark (2.5%) may benefit from the net lending of others which are well above the threshold. They thus qualify for the subsidy without boosting overall loan growth by much.

The benefit of generous refinancing schemes is further diluted **by banks using TLTRO borrowings to engage in carry trades**. For instance, given the lack of demand for credit and inadequate compensation for taking credit risk, Italian banks could borrow funds from the ECB at the highest rate – the MRO rate of 0% - and invest in BTPs, thus netting a decent yield pick-up. This could explain why Italian banks, despite having exceeded 80% of their TLTRO–II borrowing limit (the highest in the EA), continue to report a sharp contraction in credit.

ECB's policy options

We expect the ECB to announce a new round of TLTROs in March or by June at the latest. A mere extension of the repayment deadline for the funds borrowed under previous TLTROs would disappoint markets, which expect an offer of fresh funding. With the ECB's policy ammunition limited and fiscal support constrained, new TLTROs are critical to prevent a liquidity squeeze at Italian banks in particular. The size and design of the TLTROs will be key to assessing the potential effect on lending and liquidity. Unless the ECB makes considerable concessions on the scale of refinancing, the impact on the transmission of monetary policy – notably, the narrowing of spreads between EA core and periphery – will be muted. After all, Italian and Spanish lenders' TLTRO borrowings are already very close to their 'allowance'.

Separately, some have advocated raising the deposit facility rate (DFR) to address the pressure on banks' profitability. Clearly, the negative DFR has become increasingly punitive for banks. The stock of EA banks' excess reserves has ballooned from just below €500bn in June 2016, when the first series of TLTRO-II loans was allotted, to just above €1.2trn in January. Capital gains on banks' fixed income portfolios are waning. A one-off technical adjustment to the DFR would help address the squeeze from negative rates on banks' net interest margins and profitability. Specifically, the ECB could raise the DFR by 10-15 bps to make the gap between the marginal lending facility rate, the main refinancing operation rate and the DFR symmetric.

However, the big risk is that such a move could lead to an unwanted tightening in wholesale funding costs. The central bank will want to avoid this danger, especially against the current backdrop of slowing global and EA growth. The ECB could accompany a DFR hike by altering its forward interest guidance. It could make it explicit that the DFR increase was a technical, one-move off and push expectations of additional rate rises further out. But with markets already discounting no change in rates before mid-2020, the risk is that the ECB may fall short of expectations.

Thus, it is unclear whether the ECB will opt for a technical hike in the DFR. A rate increase this year is not our base case because of the communication risks involved, which may cause an unwarranted tightening in market funding. As it is, the EA economy has lost momentum rapidly and the ECB has ended QE, partly because of a scarcity of eligible assets for it to buy.

As a result, a new round of refinancing operations appears to be one of few politically palatable policy options available to the ECB to mitigate liquidity risks. But TLTROs are not a magic wand. Refinancing operations do not address the paucity of EA credit demand, which has generally been a bigger drag on loan growth than credit supply. Crucially, unless the ECB finds a clever way to limit the carry trade of Italian lenders (using their TLTRO borrowings to invest in higher-yielding BTPs, for instance), the doom loop between the sovereign and banks could worsen.

Authors

Shweta Singh
Managing Director,
Global Macro and
Europe Economics

Davide Oneglia
Economist