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Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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ECB As Market Maker of Last Resort

The European Central Bank (ECB) cut all of its policy interest rates last week. The market widely expected a 25 basis point cut in the main refinancing rate to 0.75% from 1.00%. More surprising, though, was the deposit facility rate cut from 0.25% to zero. We expect the deposit rate cut to carry with it unintended consequences, ultimately doing little to solve the problems in the euro area.

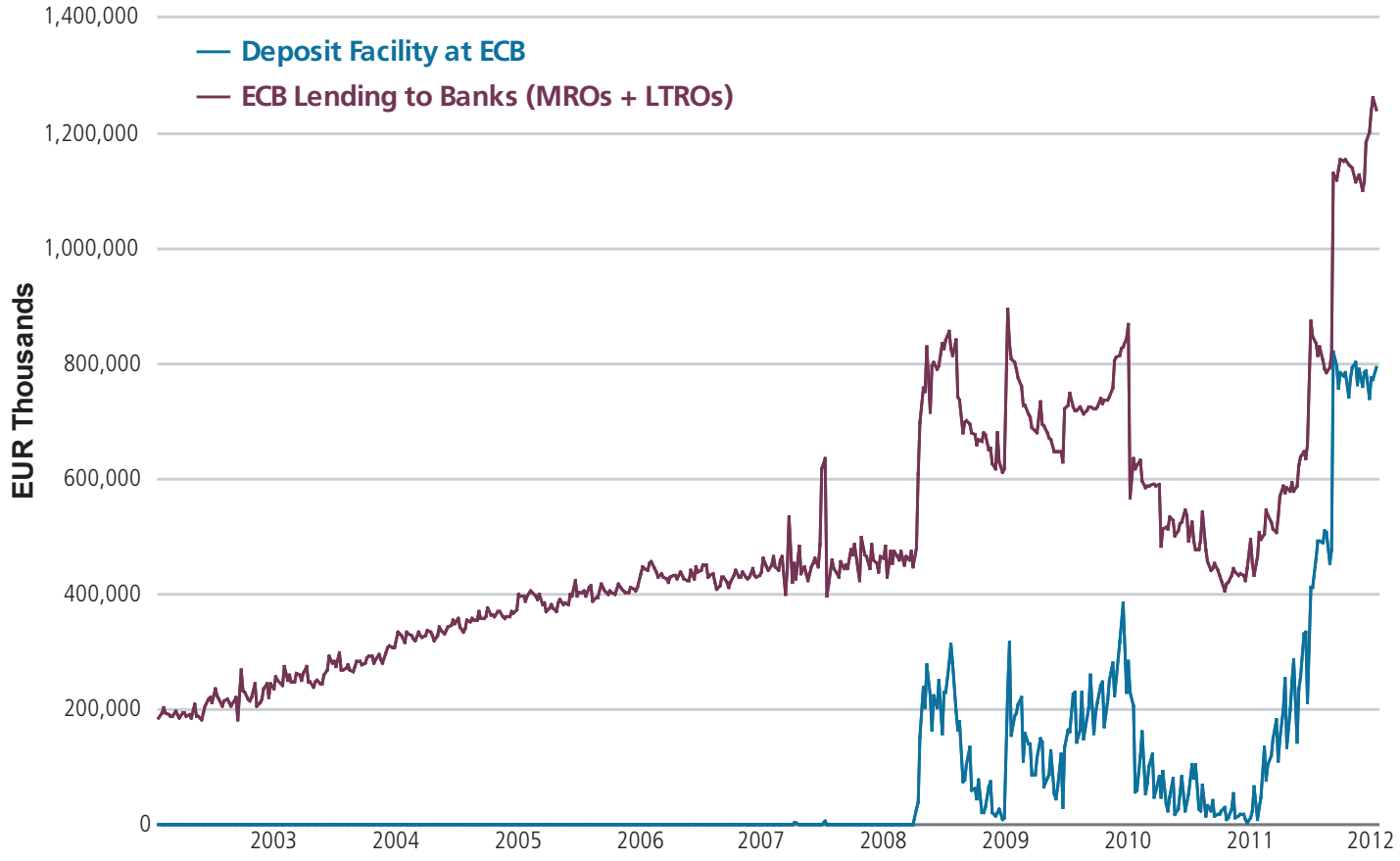
Asymmetric Liquidity Problem

Banks in the euro area face an asymmetric liquidity problem: some banks need liquidity (periphery), while others face a liquidity glut (core). This asymmetry arose as interbank lending in the euro area collapsed--from EUR2.3 trillion pre-crisis to less than EUR800 billion in Q1. Banks hesitated to lend to each other, either due to questionable collateral available for borrowing purposes or counterparty risk aversion.

We think the modern central bank's role is as "market maker of last resort". When the interbank market freezes, the ECB *should* stand in the middle: making available safe, risk-free deposits for banks with excess liquidity on the one hand and lending to liquidity-constrained banks on the other side.

In practice, to a large extent, this is *EXACTLY* what the ECB is doing. As the ECB steps in to allocate liquidity (via the main refinancing operations and longer-term refinancing operations--MROs and LTROs), they replace the private interbank market. Meanwhile, banks hold about EUR800 billion on deposit at the ECB (***see chart below***). And that is why hysterical claims of money printing, surging inflation and debt monetization resulting from the ECB's actions miss the point entirely. These operations undertaken were not meant to inflate the money supply or bail out governments, but were meant to correct the asymmetric liquidity between banks in the euro area.

DEPOSITS REFLECT LIQUIDITY INJECTED BY ECB, NOT BANK "HOARDING"



Sources: ECB

Misguided Faith in the "Money Multiplier"

But, with last week's deposit rate cut, we fear that the ECB has moved away from playing "market maker of last resort" and into stimulus mode. Policymakers seem to believe that, by cutting the deposit rate, they can spur banks to lend to businesses and households instead of "hoarding money". But this is the product of a misguided faith in the "money multiplier" (the idea that banks with reserves create new lending). While we acknowledge that lending to the private sector is contracting in the euro area, we doubt deposit rate policy will ignite bank lending. Why? It's not as if banks have the opportunity to make new business loans or buy Spanish government bonds but decide instead, due to the 25 basis points offered at the ECB deposit facility, to sit on the cash.

Get Your Euros Out of Here!

As a result, reducing remuneration at the deposit facility may force banks to find other places to park short-term, risk-free money to earn incremental yield. And it's not just the banks. Non-banks (like insurance corporations, pension funds, investment funds, money market funds, securities dealers, etc.) hold 48.5% of total financial assets in the euro area. These non-banks institutions lend overnight on a secured basis (repo) to banks earning incremental yields. By reducing the deposit rate, the ECB eliminated the profitability of these trades as banks can no longer earn 25 bps placing funds on deposit at ECB. As a result, banks will hoard "good collateral", repo rates hover near zero or below zero for various types of collateral (e.g., German government bonds) and trading activity between banks and non-banks declines. Further, those non-banks entities must "hunt for yield" elsewhere, pushing the entire structure of rates lower.

Indeed, we already see evidence of this rippling across global markets: ever lower yields on German government bonds (from 0.10% to -0.02% on 2-year maturities), lower Eurepo rates (1-month Eurepo rates went from 0.9% to 0.2%), a surge in bidding at the ECB on its term deposit facility (EUR424.8 billion last week versus EUR211.5 billion allocated) and money moving cross border into Switzerland and Denmark (the SNB is buying hundreds of billions of euros to maintain its euro peg and Denmark cut its certificate of deposit rate below zero to stem the flood of euros), leaving a weaker EUR/USD exchange rate (1.25 to 1.22).

In short, the modern central bank *should* provide safe deposits/assets for those with excess liquidity and allocate liquidity to those facing a shortage—a "market maker of last resort". Instead, the ECB is stifling markets with its deposit rate policy. We doubt a rebound in private sector lending will follow.