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Economics Group

Special Commentary

ECB Preview: The Loan Time is Running Out (TLTRO)

Executive Summary

- The ECB will probably downgrade its GDP and CPI forecasts at its announcement on Thursday. We do not expect any changes to forward guidance on interest rates. We will also be watching closely for any news on Targeted Long-Term Refinancing Operations (TLTROs).
- Our base case scenario is that the ECB will not announce a new round of TLTROs this week but that it will leave the door open to announcing more loans at a later date.
- Meanwhile, we do not expect any changes to interest rate guidance until the June ECB announcement, and still expect the first deposit rate hike in December.

What to Watch For

The European Central Bank (ECB) announces policy on Thursday, and we think there are three key things to watch:

1. Changes to GDP and CPI forecasts
2. Potential changes to forward guidance
3. Any updates on a potential new package of TLTROs

Regarding ECB economic forecasts, policymakers are widely expected to lower estimates for GDP and CPI for 2019. Our estimate for GDP growth in 2019 is 1.5%, although we see risks as tilted to the downside. Meanwhile, regarding forward guidance, we do not expect that the ECB will make any changes to its interest rate guidance at this meeting. Its current language that rates will remain at present levels “at least through summer 2019” affords it flexibility to wait until subsequent meetings (probably June) to make adjustments to that language. Instead, we think the most interesting element of the meeting to watch will be any updates on the ECB’s long-term lending program.

Long-Term Loans Become Short-Term Focus

A number of ECB policymakers have recently stated in public comments that the central bank will be discussing possible adjustments to its TLTRO program ahead of its upcoming policy announcement this week. As a refresher, let us briefly remind our readers what the TLTRO program is and explain why the ECB is discussing it again.

TLTROs are, in short, a means for the ECB to provide low-cost long-term funding to commercial banks in the Eurozone, ultimately as a means of encouraging those banks to lend to the private sector, particularly non-financial corporates. Indeed, commercial banks must meet a minimum lending target to receive these loans for the full timeframe. The last round of TLTROs (TLTRO II) was allotted in four disbursements during 2016-17, and loans allotted during the first of those disbursements are set to start expiring in June 2020. While that is still more than a year away, the potential decline in liquidity could be dramatic if the ECB does not offer a new round of TLTROs and if the loans are simply allowed to expire (Figure 1). For reference, the current amount of TLTROs outstanding represents about 40% of excess liquidity in the Eurozone and about 6% of GDP. Moreover, that liquidity reduction could begin sooner than June 2020 if banks start to repay
those loans in size before they are due to expire. Meanwhile, aside from potential liquidity concerns, the Eurozone economy has weakened considerably in recent months, and lending activity has shown signs of modest slowing. Accordingly, ECB policymakers are starting to consider whether a new round of TLTROs is warranted.

Why Do More Loans?

Let us first consider why the ECB might announce another round of TLTROs. One reason that might seem obvious is to address the potential liquidity drain that is set to occur starting in June 2020 if the loans are simply left to expire. However, that is more than a year away, and it seems too early in our view for the ECB to announce new loans to help banks refinance some or all of the old ones. What if banks repay those loans early and the liquidity reduction happens earlier than June 2020? That is a legitimate concern because Eurozone commercial banks may be motivated to repay their loans early—specifically, one year before maturity—for regulatory reasons which are beyond the scope of this report. However, the ECB has explicitly stated that it will not do another round of TLTROs for regulatory reasons.

Instead, we think the main reason the ECB would announce another round of TLTROs at this time would be for monetary policy purposes, including spurring increased bank lending and sending accommodative policy signals to support a weaker economy. Thus, if the ECB decides to announce TLTROs later this week, we expect markets to read it as a signal that the ECB is not confident in the current state of lending activity or the domestic economy more broadly.

Still, the details of any announcement will matter. The last round of TLTROs were offered for four years at a fixed rate of -0.40% to 0.00%. Yes, under TLTRO II, banks could effectively be paid by the ECB to lend if they reached certain lending thresholds. We doubt the ECB will offer funding at quite such attractive levels under any new TLTRO program, but even if they allot funding at a fixed rate of 0.00%, that would probably be considered generous and read as dovish. More austere would be a variable rate offer based on an average interest rate over the life of the loan—these were the terms of the original Long-Term Refinancing Operations (LTRO) in 2011. The term of the loans will also matter—three or four years will probably be seen as fairly dovish, while two years or less should be taken as more hawkish.

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1 Banks can start to repay these loans two years ahead of the maturity date. The first three rounds of TLTRO II are now eligible for early repayment, while the fourth round becomes eligible on March 27.
What if the ECB does not announce TLTROs next week? As usual, the message will matter, and Draghi will certainly do what he can to massage expectations. The most hawkish scenario would be one in which Draghi says it will not do a new round of TLTROs either now or at subsequent meetings. We see no reason for the ECB to be so aggressively hawkish, particularly given the weakness in the economy, and instead expect the central bank to keep the door open to announcing more TLTROs at a later date. Our base case scenario is that the ECB does not announce TLTROs at its meeting this week but leaves the door open to a new round of loans at subsequent meetings.

Recent data show lending to non-financial corporates in the Eurozone has slowed, but not dramatically, and we think the ECB will opt for a wait-and-see approach amid tentative signs of stabilization in the economy.

Overall, while our base case is that the ECB will not announce a new round of TLTROs this week, we still think rate hikes are a long way off (we expect the first deposit rate hike in December). The June meeting seems to be the most likely candidate for its next rate signal, and thus could be the key one to watch in assessing whether the euro is in fact eventually headed higher on a more sustained basis.

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