Eurozone
The ECB acts again

■ As growth disappoints and inflation as well as inflation expectations decline further, the ECB decided to cut key policy and buy private sector debt securities.

■ Those measures favour a further depreciation of the euro.

■ Should conditions deteriorate further, the ECB will not have other options than buying sovereign debt securities.

Cutting rates and buying private debt securities

As inflation continues to surprise on the downside and markets begin questioning the ability of the ECB to maintain price stability in the medium term (inflation expectations at medium to longer term horizon have been declining), the Governing Council decided to lower further its key policy rates by 10 bp at its September meeting. The *refi* rate is now at the historical low of 0.05%, and the interest rate on the deposit facility at -0.20%. In addition, the Bank decided to adopt other non-standard measures, aiming at easing credit conditions for the real economy. The ECB will buy Asset Backed Securities (which will include RMBS) and will launch a third Covered Bond Program. Both programs will start in October (the modalities will be unveiled at next month's Governing Council meeting).

As interest rates are already close to zero, a cut of the *refi* rate alone would probably have had a much more muted impact on market rates. Clearly, cutting as well the *de facto* lower bound of the Eonia, that is the interest rate on the deposit facility, the impact on market rates is greater. The Eonia, which was traded at around 0.04% in July, is now traded marginally below zero. Should liquidity in the money market increase sharply after the conduct of the TLTROs, the Eonia might be traded well below 0%, and the reduction of markets rate be more pronounced. A sharper reduction of market rates would put greater downward pressures on the exchange rate, which would ease monetary and financial conditions and hopefully boost exports. Since June, the euro has depreciated by around 4% against the US dollar falling below the 1.30 threshold after the latest decisions.

No further policy rate cuts

At the September meeting, President Draghi unveiled other important messages for the monetary policy. First of all, these key policy rates cuts were the last. While after the June decision Mr Draghi had just mentioned possible technical adjustments, he was crystal clear in September: key policy rates have reached their lower bound. Not surprisingly these measures have been adopted ahead of the first TLTRO, which will be conducted in mid-September. Speculations of further rate cuts might have decreased demand at the first operation. The cost of the TLTRO, therefore, is now fixed and equal to 0.15%, (that is the *refi* rate plus a spread of 10bp). An interest rate fixed in advance in these special refinancing operations will contribute to strengthen the ECB forward guidance, keeping interest rates at low levels. Arbitrage conditions, indeed, will ease market rates on medium maturities as they will have to be equal to the interest rate fixed in the TLTRO. These conditions will favour further the depreciation of the euro.

■ ECB measures are easing the currency

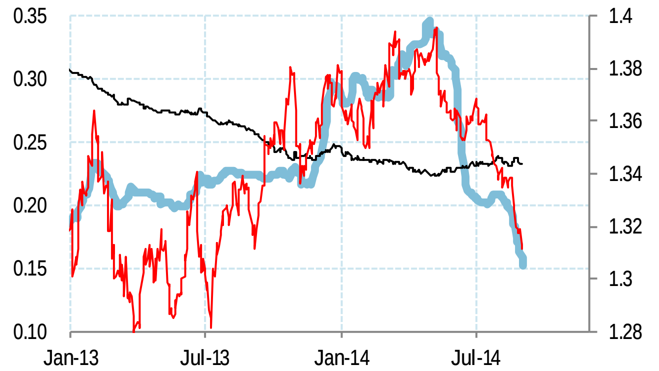

Chart 1 Source: Datastream

With these operations, the ECB aims at bringing its balance sheet back to levels prevailing in 2012. A large injection of liquidity in the market will further reduce interest rates, adding further downward pressures on the euro. However, it is worth stressing that the expansion of the ECB's balance sheet is still largely endogenous, as, with the only exception of the outright purchases of the ABS and Covered bonds, it is determined by liquidity demand of commercial banks. Yet, conditions attached to the TLTROs seem so appealing in terms of costs (0.15%) and duration (up to 4 years) that demand cannot be anything but huge.

Buying sovereign debt securities if needed?

Lastly, Mr Draghi repeated the previous statements "*the Council is unanimous in its commitment to using additional unconventional instruments*" if needed. Notice, however, that if the Council is *unanimous* in its willingness of adopting further measures should the economy need them, when it comes to which measures to adopt there is not always unanimity, as it was the case for the September decision for buying ABS. As interest rates have reached the lower bound the word "*conventional*" was removed from the statement. The Bank seems rather confident that the measures adopted so far will produce the desired effects as shown by the still relatively optimistic growth assumption over the coming years (1.6% in 2015 and 1.9% in 2016) despite the recently released poor data for confidence and activity. Yet, should conditions turn again for the worst, the ECB will not have other options available than to embark on a broad asset purchase scheme which would include sovereign securities. As we know the Council is highly divided on this point. Yet, as shown by this month meeting, the ECB can implement policy without unanimity within the Council.