What options for the European Central Bank?

By Paul Hubert

All eyes are now on the ECB, whose recent statements indicate that it is concerned about the risk of deflation in the euro zone. The further downturn in inflation in May to 0.5% year on year is a reminder that this risk is increasing. This could lead the ECB to take action at the monthly meeting of the Board of Governors being held today, or in the months to come. This post provides a brief summary of the possible options available to the ECB.

1. To lower the key interest rate (main refinancing operations rate, the MRO rate), which is currently 0.25%. The consensus in the financial markets is for a reduction of around 10 to 15 percentage points, which would further cut financing costs for banks that are still dependent on ECB liquidity. However, this would have a marginal impact on the rates of refinancing operations (MRO and long-term refinancing operations, or LTRO), which would not have much influence on financing conditions and thus not much benefit for Spanish and Italian banks (the main users of this option).

2. To lower the deposit facility rate from zero to a negative rate (again by 10 to 15 percentage points). This option has been largely anticipated by the financial markets. A negative interest rate on deposits should also be accompanied by a change in the policy on the ECB's excess reserves by capping the amount of commercial banks' excess reserves on the ECB's balance sheet or by applying the same negative rate to excess reserves. Otherwise the banks would simply transfer their funds from deposit accounts to excess reserves. A combination of these two policies should lead to a lower Euro OverNight Index Average (EONIA) rate of between zero and 0.05%. The

incentive for banks to keep their cash at the ECB would thus be reduced, thereby stimulating the distribution of credit to the non-financial sector.

3. An extension of the policy of providing liquidity in unlimited amounts at a fixed rate (fixed-rate full allotment) from mid-2015 to late 2015 or even mid-2016 is considered by most to be an easy and quick option that would provide additional assurance on the markets before the LTRO deadlines in early 2015. This kind of measure would ensure the liquidity of the banking system but its impact on activity and inflation could be limited, in so far as the banks would prefer to place their cash with the central bank.

4. An ECB announcement of the end of sterilization through the Securities Markets Programme (SMP), a programme for purchasing the sovereign bonds of euro zone countries in difficulty. The markets seem divided on this issue. The ECB has not managed to attract sufficient demand to completely sterilize this operation in the last eight weeks. This would add 164.5 bn euros (the SMP target amount) of liquidity to the system and take the EONIA rate to zero or even into negative territory, and could reduce the volatility that has appeared in recent months. This measure would therefore also cut the interbank refinancing rate, which would more or less amount to the first option.

5. A conditional and targeted LTRO programme could see the light of day. This would consist of copying the Funding for Lending Scheme (FLS) set up by the Bank of England, in which cheap financing is arranged for banks in exchange for granting new loans to the real economy. However, it would take time to implement this, and even more before there is any real impact on the economy. It would nevertheless probably be the most effective way to stimulate activity, because it would go beyond interbank operations in influencing refinancing conditions.

In any event, the economic situation in the euro zone for both the business outlook as well as for the situation on the labour market calls for a strong response from the ECB so as to ensure that the euro zone does not incur deflation. The effect of the signal may be just as important as the measure actually implemented by the ECB. By demonstrating in today's meeting that it is active, the ECB would show its determination to fight against the risk of deflation, which could at least change agents' expectations. While any action by the ECB would be welcome, it is still the case that the current economic situation is also the result of the restrictive fiscal policies that have hit activity (see here).