Europe

Draghi's disappointment

In his last press conference, **the European Central Bank (ECB) president Mario Draghi stated that that he would like the ECB's balance sheet to return to its mid-2012 level, or expand by a net €1 trillion.** This is to be achieved through a combination of the Targeted Long-Term Refinancing Operations (TLTROs), Asset Backed Securities (ABS) purchases and Covered Bond (CB) purchases programmes announced in recent months. With just under €400 bn from the previous LTRO programme still to be paid back by European banks by early 2015, the ECB's new programmes will have to expand the balance sheet by a gross of almost €1.4 trillion to hit the net €1 trillion target (see chart 6).

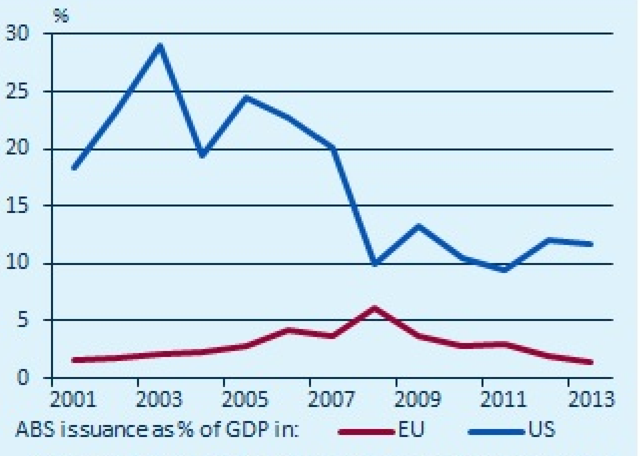
The ECB made an inauspicious start last week when they revealed that **the first TLTRO had a take-up of only €82.6bn, well below the median analyst expectation of €174bn** in Bloomberg's pre-announcement poll. Of the 382 institutions that were eligible to participate, 255 bid for the cheaper funding. Most of those were from the Eurozone periphery, Italy and Spain in particular, where the need for lower funding costs is especially acute. With banks paying back €35bn of LTRO financing so far in September, the net expansion of the ECB's balance sheet this month will be under €50bn. The result of the first TLTRO is even more disappointing when one remembers that the ECB cut its benchmark interest rates earlier this month, and confirmed that rates are now at their lower bound. That should have increased the incentive for banks to participate in the first operation. The most credible explanation for the low take-up is that banks are still waiting for the ECB's comprehensive bank assessment to be completed in October, as well as the details of the ABS purchase programme, before deciding on precisely how much additional funding to bid for. It is critical that the take-up in the December operation is much larger because the combined size of the first two TLTROs will determine how much banks can borrow in subsequent operations.

The main worry for the ECB will be that they have overestimated banks' incentives to tap the cheaper funding. Liquidity is already abundant in the Eurosystem and banks facing weak loan demand from businesses, as well as potentially high default rates and capital charges on new loans, could conclude that it would not be wise to take on too much funding. Even if there is a high take-up of the second TLTRO, the success of the programme is far from guaranteed. **Besides the aforementioned weakness in underlying credit demand, there is a lot of uncertainty about how much additional cheap funding is necessary to induce greater loan supply.** The ECB's working assumption is that €3 of cheap funds is necessary to generate an additional euro of loans but that estimate could be a long way out. Meanwhile, because ABS and covered bond issuance is small, and mostly issued by the wrong countries, those programmes are unlikely to make a large difference (see chart 7). Perhaps that is why Benoit Coeure and Jorg Asmussen jointly wrote an opinion piece last week reiterating Draghi's call at Jackson Hole for fiscal policy and structural reforms to do more of the work to lift the Eurozone out of its malaise. We do not expect much on either front in the near-term, which is why we still expect the ECB to announce a full-blown QE programme in the first half of 2015.

Chart 6: Growing the balance sheet again

Source: Eurostat (as of August 2014)

Chart 7: ABS issuance is very modest



Source: AFME, World Bank, Standard Life Investments (as of 2013)

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