80% of QE money has not been put to use so far! We think that the ECB shall twist its monetary infusion

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EMU banks are extended credit lines at the ECB from ST and LT loans plus outright securities purchases. However, as long as excess reserves are hoarded, and not used to provide loans to the public, monetary transmission stays halted.

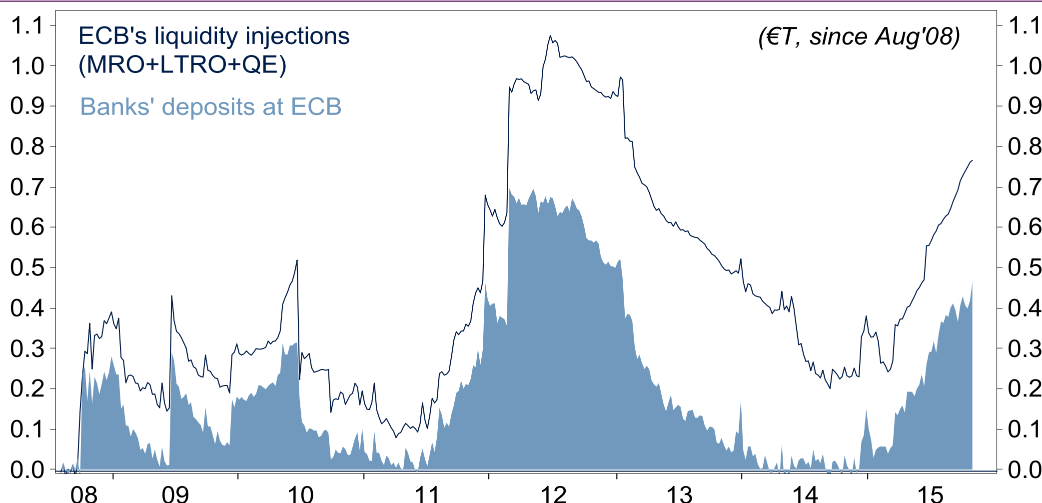
- While on average since 2008, 65% of the liquidity injection provided by the ECB is kept by private banks in Frankfurt as excess liquidity, this share has jumped to 80% since March 2015 when the QE program was initiated.
- ECB programs are nonetheless on tracks: T-LTROs represent today 400 B€ of LT collateralized secured funding, and the implementation of the QE program looks mastered. The real economy gear is the missing piece of the puzzle.

We expect Mario Draghi to deliver on some of his promises at the Dec 3 meeting.

- The deposit rate could be cut further to deter hoarding and incentivize more lending.
- Regarding QE, we see as unlikely an increase of EGBs purchases (sourcing is still tight and majority constraints are nearing). An extension to other asset classes looks possible. The de-facto boundless of the program (until inflation targets are in sight) will most likely be insisted upon.

The monetary stance foreseen to remain particularly accommodative has us comfortable with our slight overweight recommendation on EMU equity.

Since March 2015, the ECB has added 500 B€ of liquidity, banks have put 100 B€ to use



Source: ECB, Macrobond, Lyxor AM

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RESEARCH BY LYXOR

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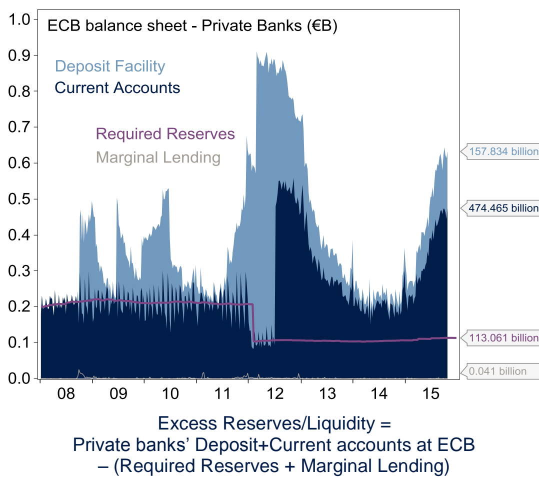
On the one hand, the ECB seems to have improved its QE implementation process despite the heightened volatility in markets that lack depth, and through the seasonality of bonds issuance. On the other hand, broad economic re-leveraging in the EMU remains far below ECB's hopes, which is perfectly illustrated by the build-up of excess reserves.

HUGE EXCESS RESERVES QUESTION THE ECB'S EFFICACY

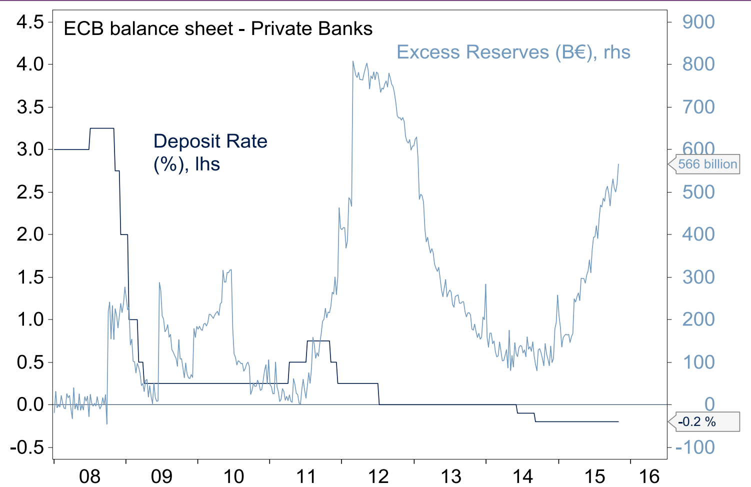
The crux of the ECB's liquidity injection objective is to improve the banking backdrop and support lending to the economy. We detail in appendix the channel of monetary transmission, emphasizing that MRO, LTRO and QE function similarly as far as building up the credit lines (at the ECB) extended to private banks. However liquidity looks stuck in excess reserves (ER).

Banks' deposits net of required reserves at 566B€



Source: ECB, Macrobond, Lyxor AM

A pile of cash costing banks more than 1 B€ per year



Source: ECB, Macrobond, Lyxor AM

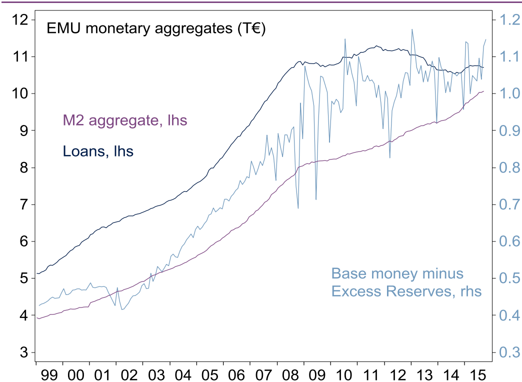
Since end-2008 65% of ECB's injections is still in Frankfurt; 80% since March 2015

Money creation is halted when excess reserves are hoarded at the central bank and not decreased by an acceleration of lending to the economy. As of today, excess reserves amount to 566 B€, which costs more than 1 B€ per year to private banks (given the -20bps deposit rate).

Beyond the massive excess reserve distortion, money creation works as theory states

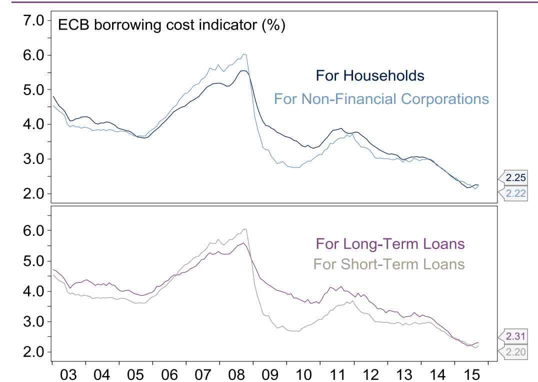
Nevertheless, once correcting for the excess reserve distortion, monetary transmission appears to be still working properly. Indeed the M2-money multiplier computed as M2 money over Base money net of Excess Reserves fares at its historical level of about 9.

Money multiplier still x9 once netting out ER



Source: ECB, Macrobond, Lyxor AM

Lending rates have been crushed

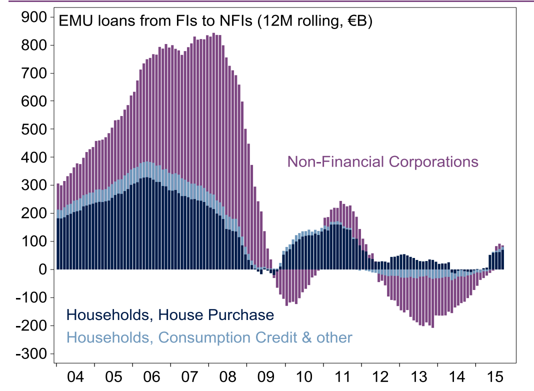


Source: ECB, Macrobond, Lyxor AM

Despite crushed interest rates, re-leveraging has much more room to go

While the acceleration in credit uptake (the credit impulse) stays supportive of EMU growth, the re-leveraging of the economy is still very far from achieved. Household loans for house purchases are timidly leading the way, but corporations are lagging.

Timid acceleration of borrowing/lending



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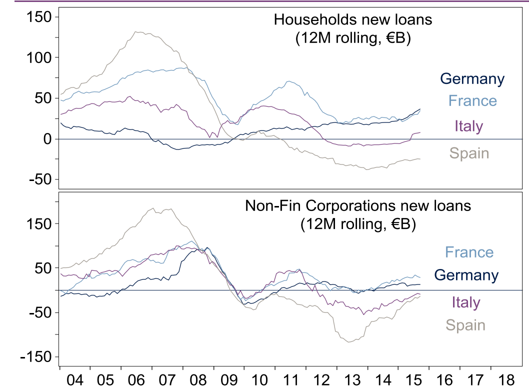
Convergence Core/Peripherals



Source: ECB, Macrobond, Lyxor AM

Why do agents not borrow more? Growth and deflation scares?

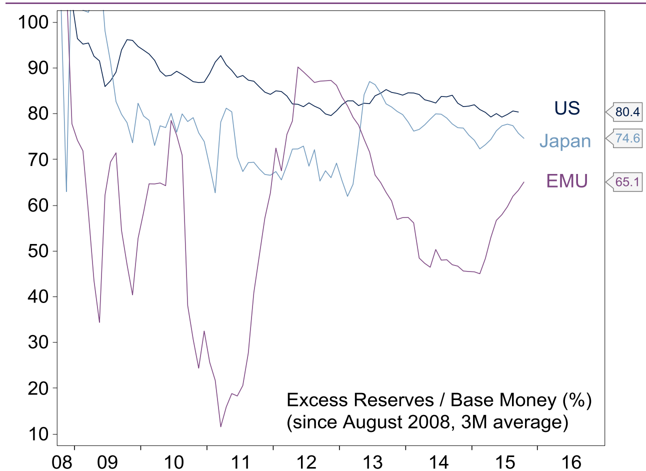
Given EMU-wide interest rates crushed at historical lows, some deeply rooted deflationary and growth scares could justify the lack of enthusiasm in real estate and entrepreneurial investment. Unless credit access is restrained by lenders with paramount guarantees required.

Why do banks not lend more? Capital constraints, profitability?

While seated on a pile of costly cash at the ECB, EMU banks still argue that issuing loans bears a sizeable capital cost (increased by the new Basel III rules), while the balance of risk and (tiny) returns is no incentive at all.

WHAT COULD BE THE ECB'S NEXT MOVE?

Since 2008, excess reserves swallow liquidity injections



Source: ECB, Macrobond, Lyxor AM

Difficult to reduce the excess reserve at once

If other geographies are any guide, the scope of hoarding in the US and Japan going through similar easing program would indicate that banks could be comfortable with keeping excess reserves worth 70%-80% of the monetary base. However the ECB is the only central bank that imposes negative (-20bps) deposit rates! ERs are remunerated 25bps by the Fed, and 10bps by the BoJ.

As witnessed in 2012, one may expect to see excess reserves drawn upon with a lag

Between mid-2011 and mid-2012, following the inception of the LTRO program, liquidity provision boosted ERs (and overshot the ratios recorded in the US or Japan). However, the pace of liquidity withdrawal accelerated progressively to reach a net 350 B€ in early 2013 (see p.1), 40% of the ECB provision. Patience will tell, but meanwhile the ECB may press the gas pedal.

Several options

After President Draghi insisted on the QE program to be “re-examined” in December, we think that further easing is likely (yet, maybe less than markets have priced-in, in a context where the Fed is expected to initiate its normalization later in December).

On Dec 3, the ECB could:

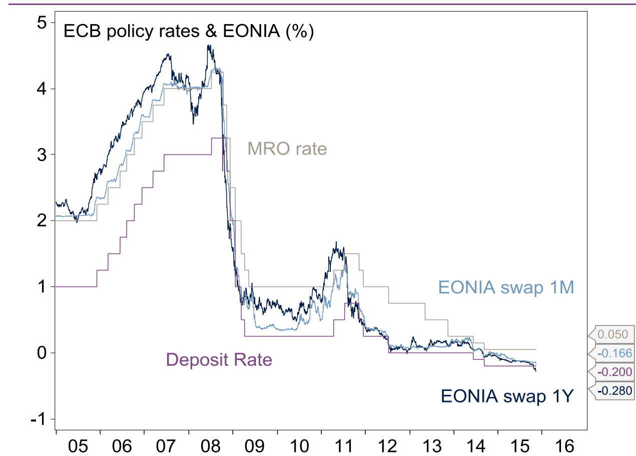
1- Cut the deposit rate

2- Increase QE purchase amounts

3- Lengthen the QE program

4- Widen the span of purchased assets within the QE program.

Deposit rate likely to be pushed lower



Source: ECB, Macrobond, Lyxor AM

Our forecast:
i) regarding QE, unlikely increase of sovereign bonds purchases, but possible extension to other asset classes, while time-boundless reminded;
ii) very likely cut of the deposit rate.

We agree with the markets (where the 1Y EONIA swap is faring at -28bps) that further cut of the deposit rate is probable. A 10bps cut is our base-case. We think it would be perfectly warranted as an incentive for excess reserves to be worked down from more lending to the economy. It would add some slope to the maturity transformation yield curve contemplated by banks and render loan issuances more attractive.

Regarding QE, we think that the sourcing of European government bonds is already today very cumbersome and that tapping further a very illiquid and volatile market may not be opportune. All the more when considering the fact that for LCR purposes sovereign bonds and excess reserves are equivalent: forcing banks into selling their bonds would have them trade HQLA into ER and mechanically have zero impact on lending.

On the other hand, an extension of purchases to corporate bonds (which face collateral haircut similar to that of covered bonds, ie considered risk-equivalent by the ECB) or other asset classes would appear more stimulating. The main implementation hurdle on this front would be the lack of depth of most of these markets as of now.

Finally, we do not see President Draghi forced to give a precise new date for the target end of the QE program. The conditionality based on resumed growth and inflation on track to the official target should suffice to orally remind that the program is today virtually open-ended.

APPENDIX

The high-level structure of central banks (CBs) and private banks balance sheet is universal. A simplified version can be sketched as:

CENTRAL BANK *Assets*	*Liabilities*	PRIVATE BANKS *Assets*	*Liabilities*
Gold	**Currency outstanding**	Vault cash	**Deposits of private sector**
Foreign exchange	**Deposits of Private banks**	**Deposits at Central Bank**	(checkable and time deposits)
		Loans to other banks	Loans from Central Bank
Loans to Private banks	Deposits of Government	**Loans to Private sector**	Loans for other banks
Government securities	Deposits of Foreign CBs	Government securities	Loan Loss Reserves
		Private securities	Commercial Paper
Other assets		Other assets	Bank Capital

Money creation, a textbook example

To grasp the logic, let's consider an open market purchase of 100 by the central bank.
The papers are sourced from domestic banks (including market purchases which are always inter-mediated by a market maker). The CB credits the private bank deposit account of the amount due; no money is reacted/printed at this stage, but excess reserves increase (by 100).
The private bank in question may then extend new loans, worth for instance 100 (grey line in the table), and credit the deposit account of its customers.
Private borrowers would then require to withdraw a fraction of this cash to perform economic transactions (we assume a third of the credit line). This need for new banknotes has the central bank release more currency to the private bank, which hands it to the customer. Only at this final stage new money is printed. The new money will circulate in the system.

CENTRAL BANK *Assets*		*Liabilities*		PRIVATE BANKS *Assets*		*Liabilities*	
Gvt. securities	+100	Deposits priv. banks	+100	Government securities	-100		
				Deposits at CB	+100		
				Loans to priv. sector	+100	Deposits priv. sector	+100
		Currency	+33.3	Deposits at CB	-33.3	Deposits priv. sector	-33.3
		Deposits priv. banks	-33.3				

With new customer deposits of 66.6, the bank has required reserves increased by 0.666 (EMU required reserves are 1%). At the end of this cycle, excess reserves have been reduced by 34. More rounds of lending would allow the private bank to work down excess reserves fully.

Current dynamics in the EMU seem to indicate that the second stage of the process is hampered.

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