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ECB Exit Strategy Faces its First Real Test

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The ECB's exit strategy faces its first major test when a massive €442 billion refinancing operation matures at the beginning of July. Despite market concerns, we believe the central bank has the necessary tools to handle this transition smoothly.

In recent months, the European Central Bank (ECB) has taken the first tentative steps towards unwinding the unconventional measures introduced at the height of the credit crisis. These have passed largely unnoticed, but this is unlikely to be the case with the massive €442 billion refinancing operation expiring on July 1. With this operation accounting for over 50% of the liquidity provided to the euro-area banking system, it is crucial that the ECB manages this transition smoothly.

As with other central banks, the ECB's approach to the credit crunch evolved as the crisis deepened. Its initial response, in August 2007, was to inject short-term liquidity into the money market. After that, it started providing greater-term liquidity by lifting the size and maximum maturity of its long-term refinancing operations (LTROs). At the same time, however, the ECB reduced allocations at its weekly main refinancing operation (MRO) so that total liquidity was little changed **(Display 1)**.

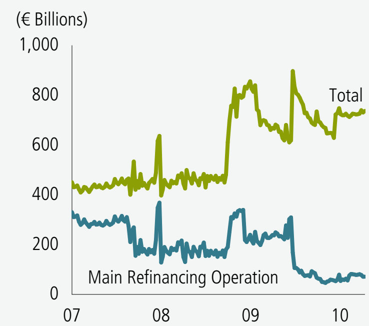
Total liquidity only really started to rise after the collapse of Lehman Brothers in September 2008. The main driver was the ECB's decision to guarantee full allotment at its subsequent refinancing operations. In other words, subject to satisfying minimum collateral requirements (which were widened at the time), banks could help themselves to as much cheap liquidity as they wanted.

This had a dramatic impact. Banks were so concerned about liquidity that they bid for more funds than they needed. The excess cash was then placed back on overnight deposit at the ECB **(Display 2)**. In order to create this buffer, banks were willing to pay the spread between the rate charged at refinancing tenders and the (lower) rate paid on the ECB's deposit facility.

Not surprisingly, this flood of liquidity had a huge impact on money-market rates. In normal times, the overnight rate tends to be anchored to the ECB's refinancing rate. But with the market awash with cash, the overnight rate moved below the refinancing rate towards the deposit rate, which

Display 1
Gradual Evolution in Liquidity Support

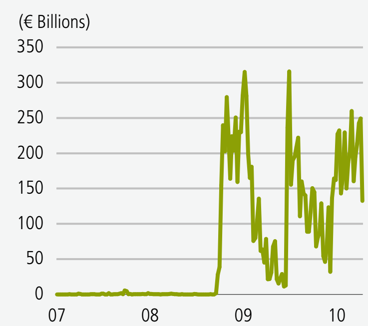
ECB Liquidity Provided to Euro-Area Banks



Source: European Central Bank and AllianceBernstein

Display 2
Excess Liquidity

Use of ECB Deposit Facility



Source: European Central Bank and AllianceBernstein normally sets the floor for money-market rates in the euro area **(Display 3)**.

The ECB revealed its final steps to support the banks in the second quarter of 2009, when it announced that it would hold three full-allotment LTROs with maturities of one year (before this, the maximum maturity had been six months). At the same time, the ECB unveiled a €60 billion covered bond purchase program.

This promise of cheap one-year finance was too much for the banks to resist. At the first one-year tender on June 25, the banks bid for €442 billion of funds. Not only did this keep the overnight rate anchored close to the deposit rate, it also drove the three-month interbank rate below the key refinancing rate **(Display 4)**.

The way in which the ECB has chosen to support the banking system makes it relatively easy to unwind. That's because most of the liquidity has been injected through repurchase agreements that roll off automatically. The only outright purchases have been under the covered bond purchase program, but that is relatively small.

At present, we are still in the early stages of the exit strategy. The ECB has already announced that there will be no more six-month or one-year tenders and that new three-month LTROs will be at variable rates (i.e. they will not be full allotment). However, to ensure a smooth transition, the weekly MRO and one-month LTROs will continue to be full allotment tenders for as long as is necessary (and at least until the middle of October). The ECB is trying to wean banks off their reliance on central bank support slowly.

But that still leaves the LTRO maturing on July 1 **(Display 5)**. Some of this money is likely to roll-off automatically. Indeed, it's worth noting that average recourse to the ECB's deposit facility this year has been €190 billion. Some of this structural excess liquidity should disappear after July 1.

Banks will also be able to roll over their borrowing into the weekly MRO.* This facility currently accounts for just €71 billion, or 9%, of the liquidity provided by the ECB to the euro-area banking system. In the first half of 2007, before the onset of the credit crisis, the MRO accounted for an average €290, or 67%, of liquidity.

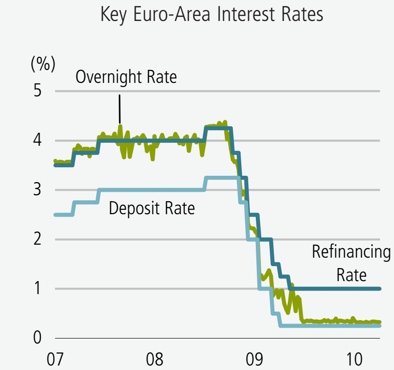
The ECB's decision to satisfy all bids at its shorter-term refinancing operations until at least the middle of October provides an important safety net for euro-area banks. But by scaling back on longer-term refinancing operations, the ECB will become a much less important supplier of cheap term money. This is likely to put upward pressure on money-market rates.

The immediate impact on the overnight rate is less obvious. However, if underlying money-market conditions have improved, there should be a lower demand for excess reserves and this should lead to a gradual re-convergence of the overnight rate on the refinancing rate.

So what does this mean for monetary policy? Throughout the credit crisis, the ECB has drawn a clear distinction between liquidity support and monetary policy. By injecting huge amounts of excess liquidity, its actions have driven money-market rates down to levels consistent with a lower refinancing rate than the current level of 1.0%. But the ECB argues that this is a result of its actions to improve liquidity rather than a deliberate easing of policy.

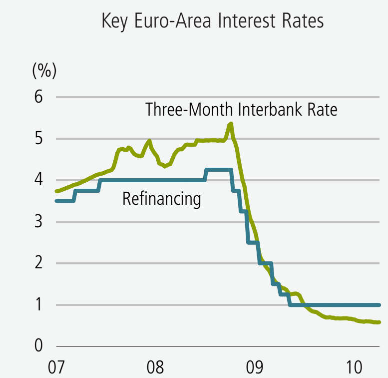
Likewise, the ECB will argue that any rise in interbank rates as it starts to withdraw support from the banks does not constitute a tightening of policy. As the ECB actually raised rates in the middle of the credit crisis, confirming the separation between monetary policy and liquidity support, we are inclined to accept this explanation. This also means we should pay close attention to the ECB's warning that a complete withdrawal of unconventional measures is not a prerequisite for tighter monetary policy.■

Display 3
Overnight Rate Moves to ECB Floor



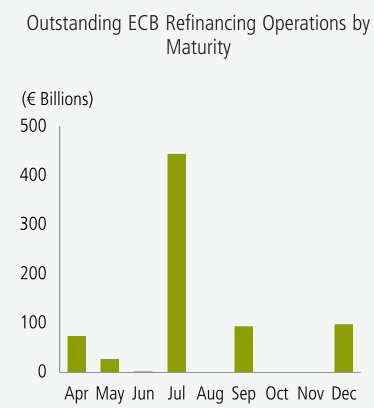
Source: Bloomberg and AllianceBernstein

Display 4
Three-Month Money Moves Below the Refinancing Rate



Source: Bloomberg and AllianceBernstein

Display 5
ECB Refinancing Operations



Source: European Central Bank and AllianceBernstein

*The ECB has already announced a six-day fine-tuning operation to bridge the gap between July 1 and the next MRO on July 7.