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# Managing negative rates and abundant liquidity

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Source for all charts: Barclays Research, unless otherwise stated

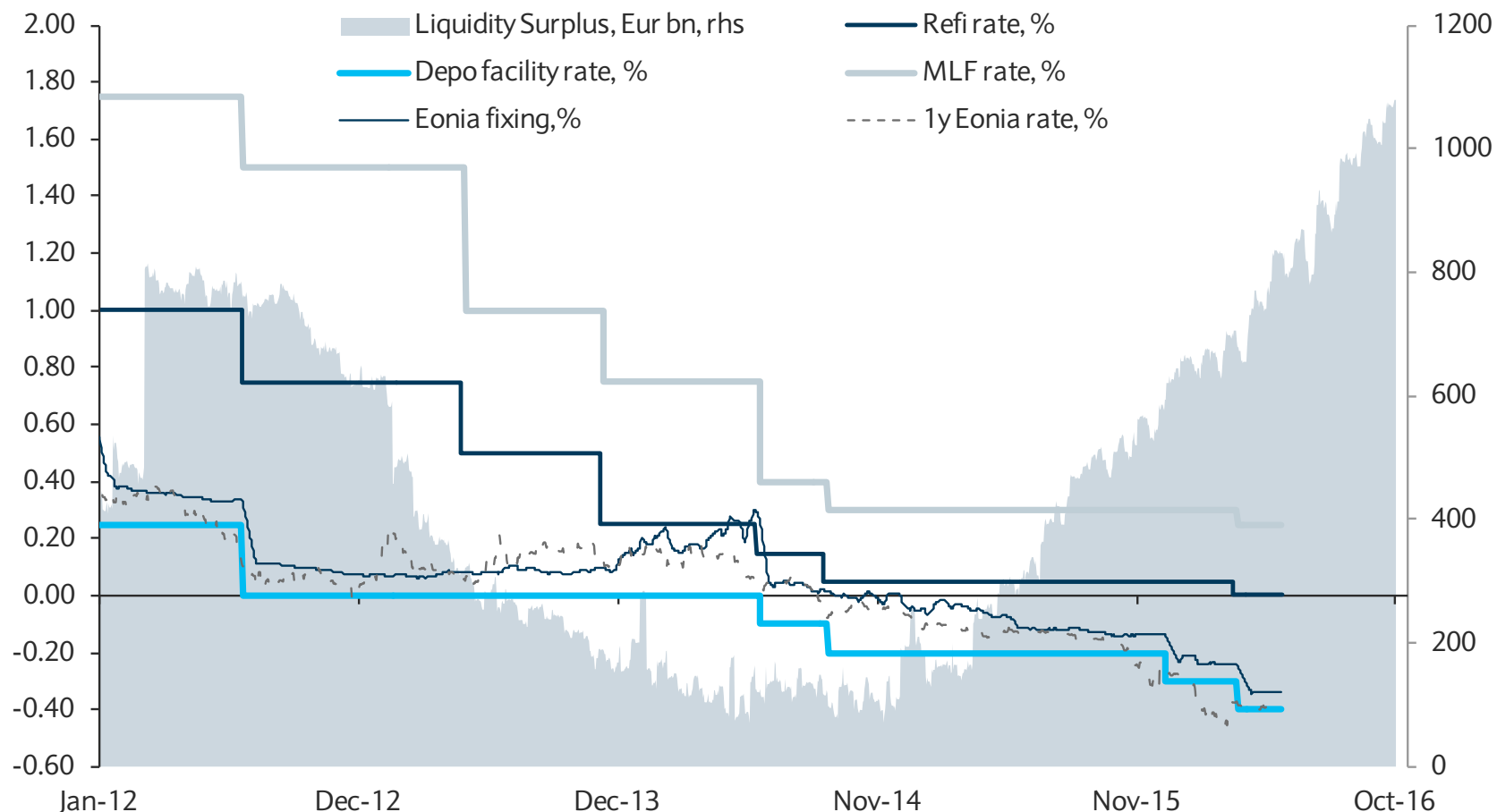
# Agenda

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- Combined effect of negative policy rates and abundant liquidity on short rates.
- Market impact: weaker euro, short-term yields in negative territory, flat curve, compression of credit spreads.
- Impact on banks' profitability.
- Market management of negative rates and abundant liquidity: so far so good, but sustainability remains the key issue.

# Combined effect of negative policy rates and abundant liquidity on short rates

## Negative policy rates, liquidity surplus and evolution of short rates (Eonia)

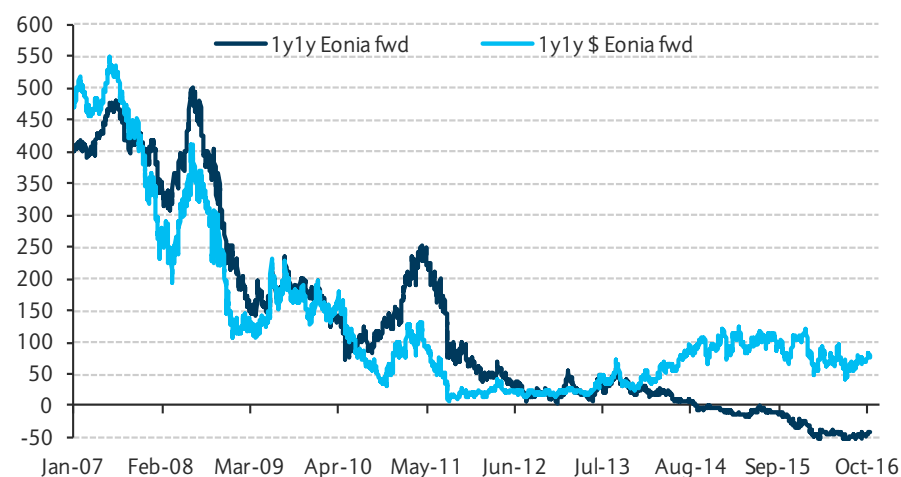


Source: ECB, EMMI, Barclays Research

- Eonia's decline into negative territory on a sustained basis started not when the ECB decided to reduce the depo rate below zero (June 2014), but only when excess liquidity rose well above €200bn (in January 2015).

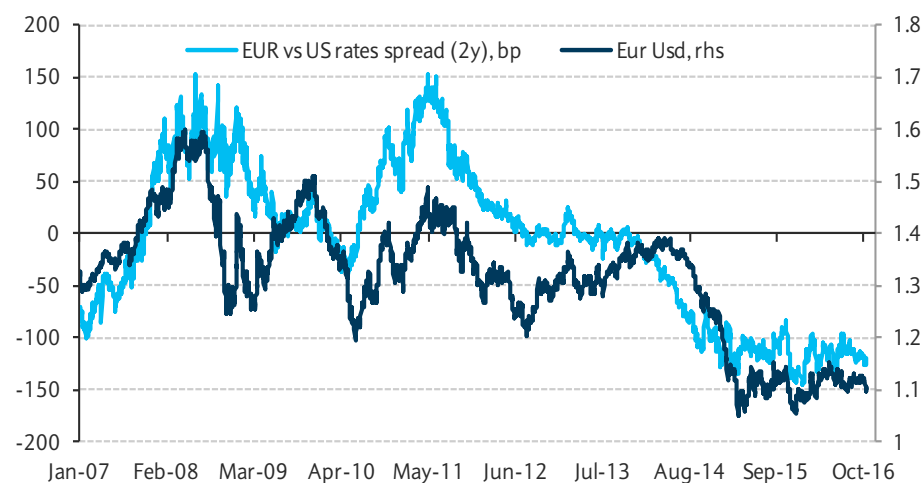
# Market impact (I): weakening of the euro

## Evolution of short rates in the US and in the Euro Area (bp)



Source: Barclays Research

## Evolution of the short rates differential and EUR/USD

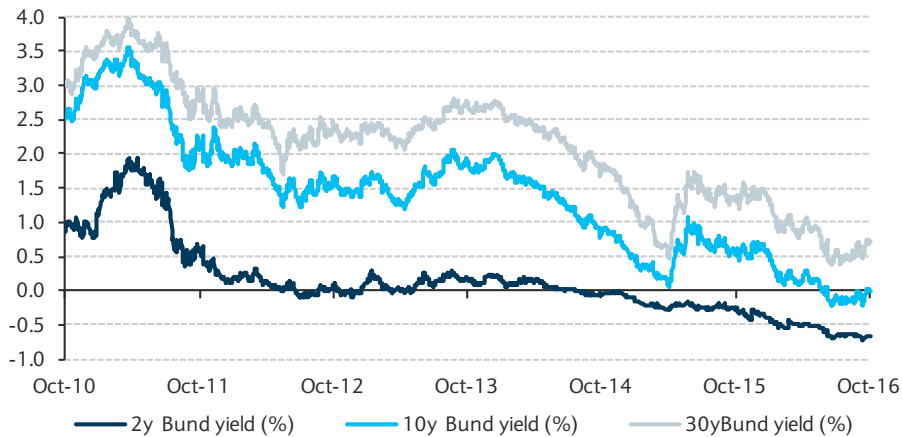


Source: Barclays Research

- The evolution of the EUR/USD is closely correlated to the short rates differentials EUR vs. USD.
- Therefore, the widening of the differentials, as a result of ECB's decision to drop the depo rate into negative territory, has helped to fuel weakening pressure on the euro.

# Market impact (II): sharp reduction in yields, flattening of the curve and compression of the credit spreads

## German Government Bonds yields



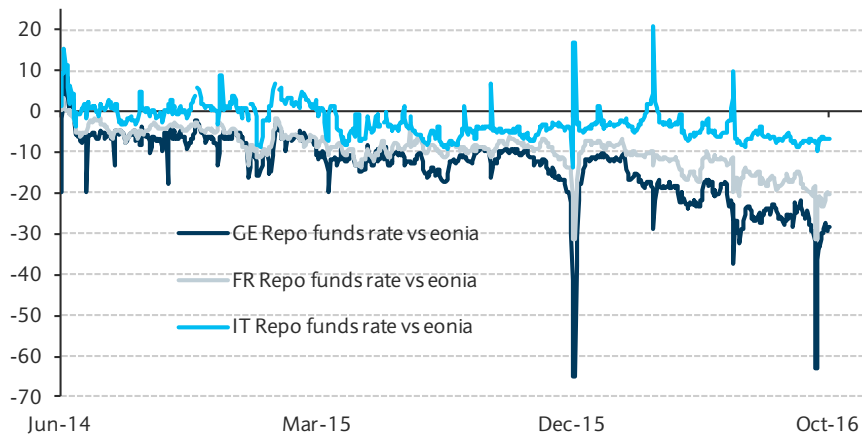
Source: Barclays Research

## Italian Government Bonds yields



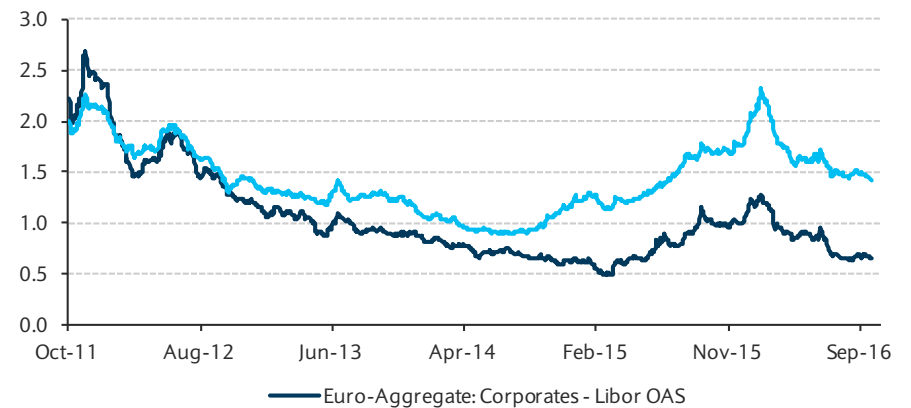
Source: Barclays Research

## The cost of secured liquidity (repo) has also moved in negative territory



Source: ICAP, Barclays Research

## Corporate spreads vs. swaps (%)



Source: Barclays Research

# Impact on banks: higher cost of liquidity deposit at the ECB

## Estimated country distribution of liquidity surplus and cost of reserve management (€ bn) - August 2016

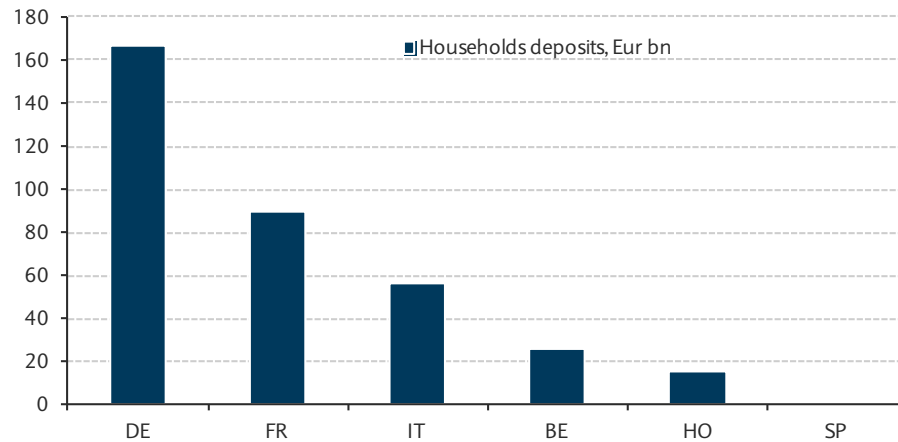
|              | Liquidity deposits (A) |                | Liquidity Surplus (B) |                           | Cost of reserve management (Eur bn), (C) |                                     |                     |                                      |                                      |
|--------------|------------------------|----------------|-----------------------|---------------------------|--|-------------------------------------|---------------------|--------------------------------------|--------------------------------------|
|              | Depo facility          | Excess Reserve | Eur bn                | % Tot. Eurosystem Surplus | Required Reserves (0.00%)                | Excess Liquidity deposited at -40bp | Total Cost (Eur bn) | Surplus at Eur 1.3trn; depo at -40bp | Surplus at Eur 1.3trn; depo at -50bp |
| Germany      | 92                     | 210            | 302                   | 30%                       | 0  | -1.21                               | -1.21               | -1.60                                | -2.00                                |
| Ireland      | 6                      | 9              | 16                    | 2%                        | 0  | -0.06                               | -0.06               | -0.09                                | -0.11                                |
| France       | 130                    | 139            | 269                   | 27%                       | 0  | -1.07                               | -1.07               | -1.38                                | -1.72                                |
| Spain        | 0                      | 15             | 15                    | 2%                        | 0  | -0.06                               | -0.06               | -0.08                                | -0.10                                |
| Belgium      | 26                     | 3              | 29                    | 3%                        | 0  | -0.12                               | -0.12               | -0.07                                | -0.08                                |
| Greece       | 0                      | 1              | 1                     | 0%                        | 0  | 0.00                                | 0.00                | 0.00                                 | -0.01                                |
| Netherlands  | 49                     | 140            | 189                   | 19%                       | 0  | -0.75                               | -0.75               | -1.02                                | -1.28                                |
| Italy        | 0                      | 17             | 17                    | 2%                        | 0  | -0.07                               | -0.07               | -0.09                                | -0.12                                |
| Luxembourg   | 26                     | 31             | 57                    | 6%                        | 0  | -0.23                               | -0.23               | -0.30                                | -0.37                                |
| Austria      | 1                      | 15             | 16                    | 2%                        | 0  | -0.06                               | -0.06               | -0.09                                | -0.11                                |
| Portugal     | 0                      | 0              | 0                     | 0%                        | 0  | 0.00                                | 0.00                | 0.00                                 | 0.00                                 |
| Finland      | 24                     | 52             | 76                    | 8%                        | 0  | -0.30                               | -0.30               | -0.46                                | -0.58                                |
| Cyprus       | 0                      | 1              | 1                     | 0%                        | 0  | -0.01                               | -0.01               | -0.01                                | -0.01                                |
| Others       | 2                      | 1              | 3                     | 0%                        | 0  | -0.01                               | -0.01               | -0.02                                | -0.02                                |
| <b>Total</b> | <b>356</b>             | <b>634</b>     | <b>990</b>            | <b>100%</b>               | <b>0</b>                                 | <b>-3.96</b>                        | <b>-3.96</b>        | <b>-5.20</b>                         | <b>-6.50</b>                         |

Source: ECB, National Central Banks, Barclays Research

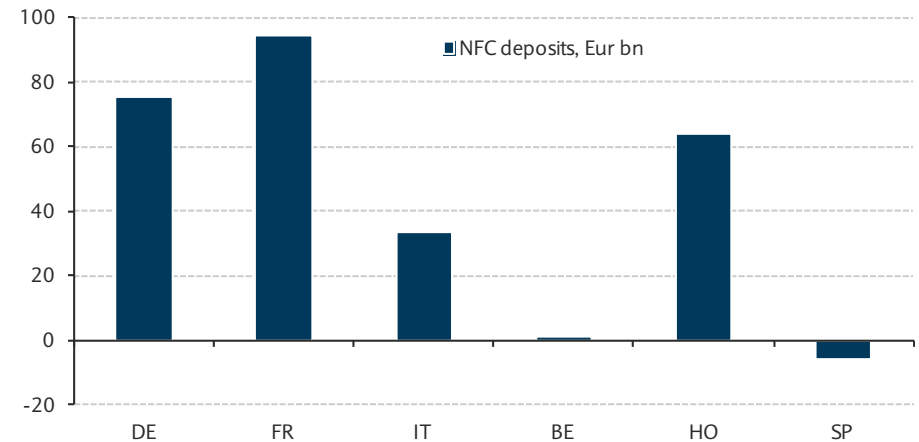
- Banks with excess liquidity have been affected by the ECB's negative depo rate and the increase in the liquidity surplus that amplifies the effect of negative rates on the liquidity management.

# Increase in banks' deposits and MMFs inflows since the introduction of negative depo rate

## Change in deposits since the introduction of negative depo rate (June 2014) - households and non-financial corporates

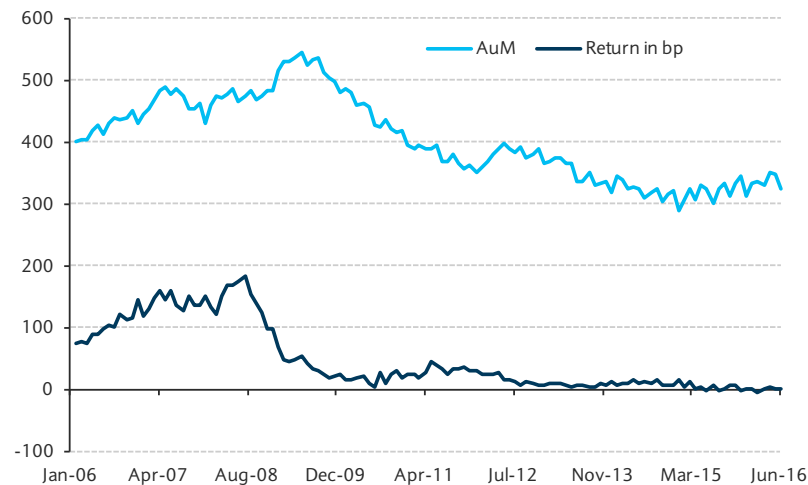


Source: ECB, Barclays Research



Source: ECB, Barclays Research

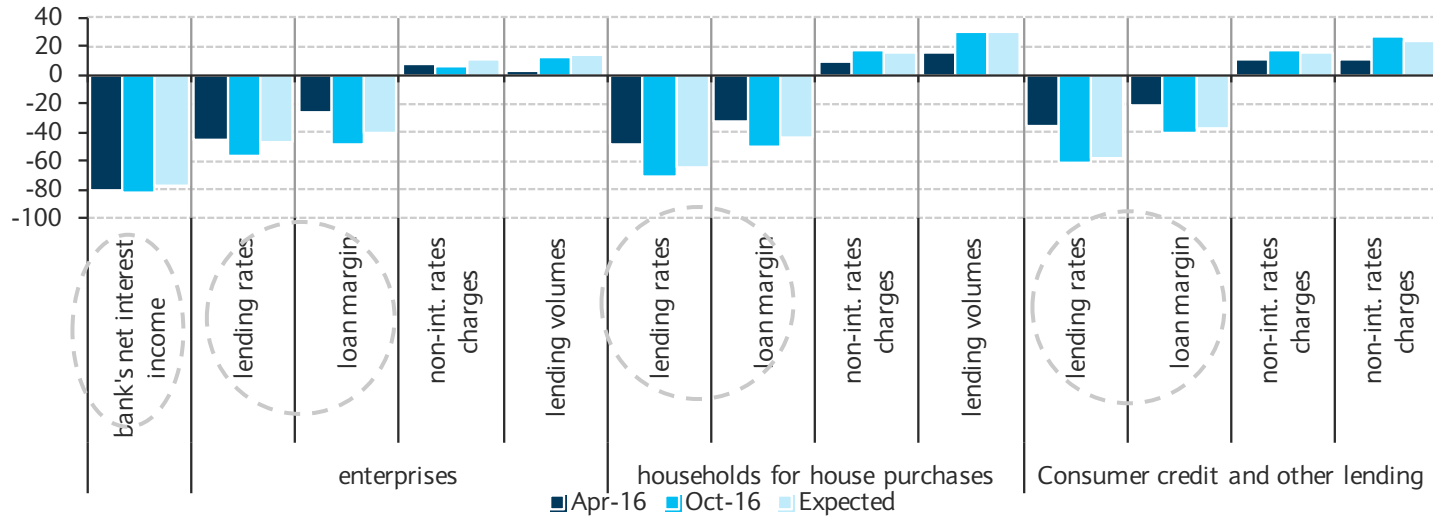
## French MMF - € bn



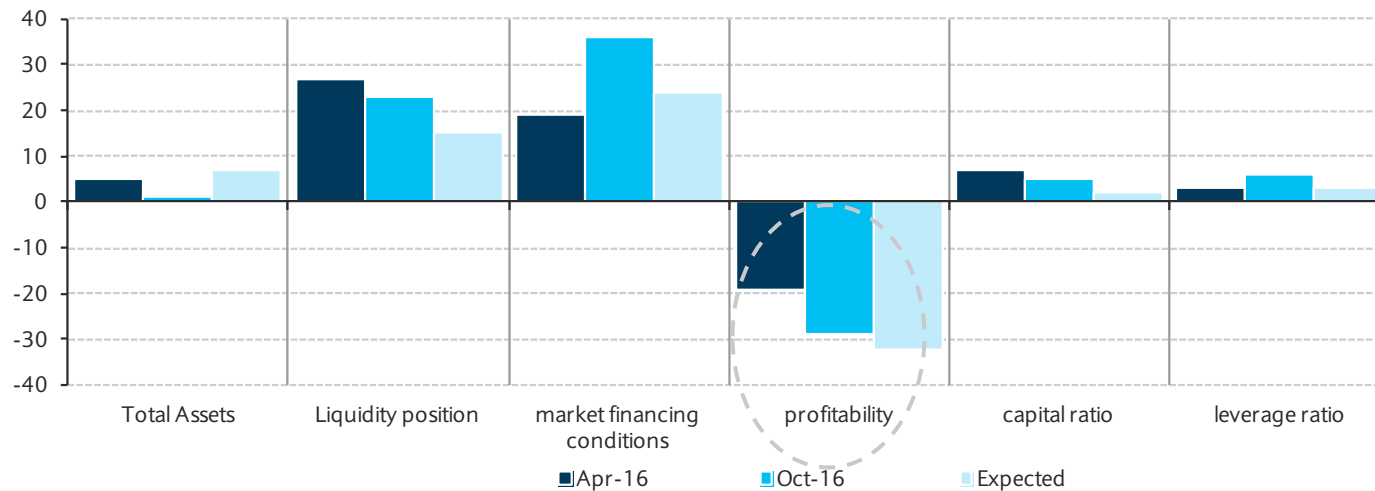
Source: Central Bank of France, Barclays Research

# Negative depo rate and PSPP have affected banks' profitability

## Impact on banks from negative depo rate...



## ...and from PSPP

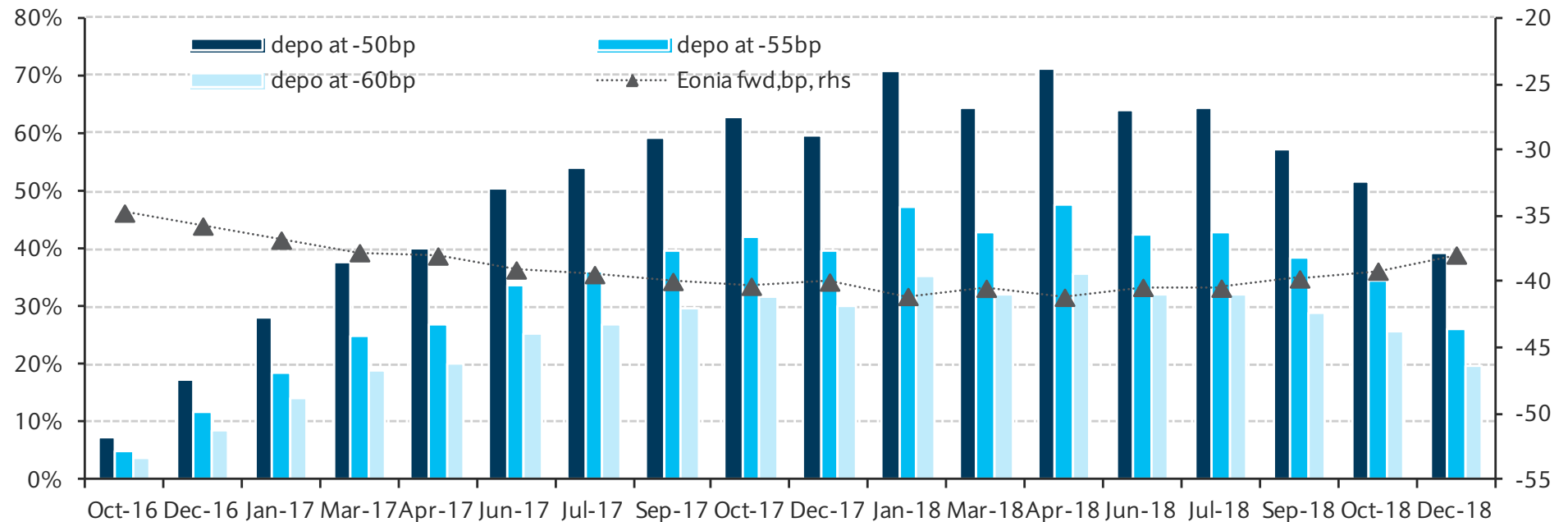


Source: for both charts: ECB – Bank lending survey; Barclays Research



# Money markets do not rule out the possibility of another cut, but without strong conviction

## Estimated probabilities of further depo rate cuts currently priced into the ECB-dated Eonia forward curve



Note: estimates based on the assumption of 'fair level' of Eonia fixing at depo orate + 6bp; Source: Barclays Research

- Markets are pricing in just 15% chance of a 10bp cut at the December meeting. The highest probability of 10bp depo rate cut is priced in at about 70% not before the beginning of 2018

# How investors have managed negative rates so far

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- **Yield hunting:**
  - ✓ Increase in duration exposure...
  - ✓ ...and in Credit exposure
- **More efficiency in cost management**
- **Change in banks' business models: more focus on fee-based services**
  
- **The key issue is the sustainability of a long period of negative rates and abundant liquidity**
  - ✓ The ECB is expected to maintain an accommodative approach (policy rates at the current level and abundant liquidity) for a long period
  - ✓ Profitability for banks and other investors (pensions funds, insurance companies) likely to continue to be severely affected
  - ✓ Risks on financial stability

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