

ECONOMICS: EUROPEAN PERSPECTIVES—JANUARY 20, 2012

European Central Bank Provides Breathing Space, but Solvency Concerns Remain

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Aggressive action by the European Central Bank has provided much-needed breathing space for the euro area by significantly improving liquidity conditions. Policymakers need to use this time to counter concerns about the solvency, and likely end-games, for several key euro-area countries.

After a difficult period at the end of last year, tensions in Europe's sovereign-debt markets have eased in the opening weeks of 2012—much as they did this time last year. So much so, that investors quickly brushed off S&P's decision to downgrade a number of euro-area countries and the European Financial Stability Facility (EFSF). Does this represent a decisive turn for the better in the sovereign-debt crisis or is it another brief period of calm before we move into another period of rising tension?

Liquidity Conditions Have Improved

It's important to recognize that there is a liquidity and a solvency dimension to the sovereign-debt crisis. And the European Central Bank's (ECB's) aggressive support for euro-area banks—offering three-year loans, or longer-term refinancing operations (LTROs), and easing its collateral criteria—has led to a dramatic improvement in the former.

As we noted in December, the ECB's huge injections of liquidity have reduced the risk

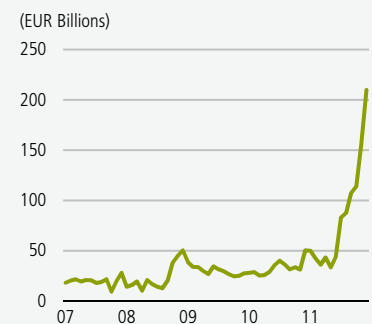
of an imminent banking-system seizure in the euro area and thus removed a major downside tail risk. But is this liquidity also allowing banks to boost their purchases of government bonds and indirectly supporting sovereign-debt markets?

Data from the Bank of Italy show that Italian-based banks raised their borrowing from the ECB to €210 billion at the end of December from €156 billion at the end of November (**Display 1**). Moreover, €161 billion of this was via LTROs, compared with €68 billion at the end of November, suggesting that Italian banks made heavy use of the three-year LTRO on December 21.

The Bank of Spain does not provide end-month data for refinancing operations. But it does publish average data for the month and these figures show that Spanish-based banks borrowed €132 billion from the ECB in December, up from €106 billion in November (€85 billion via LTROs from €52 billion in November). As the three-year LTRO did not take place

Display 1
Big Jump in Italian-Based Banks' Borrowing from the ECB

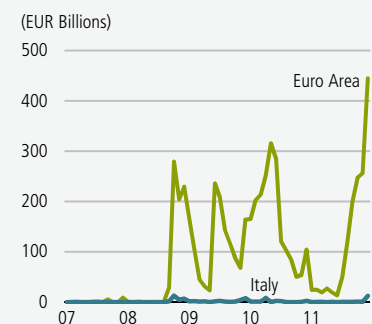
Use of ECB Refinancing Operations by Italian-Based Banks



As of December 31, 2011
Source: Bank of Italy and Haver Analytics

Display 2
Huge Increase in Excess Reserves, Although Not in Italy

Use of ECB Overnight Deposit Facility



As of December 31, 2011
Source: Bank of Italy, ECB and Haver Analytics

until December 21, the end-month figure for Spanish banks was probably far higher than the average for the whole month.

But what are banks doing with this money? Given the record level of excess reserves currently standing idle in the ECB's overnight deposit facility, it is tempting to assume that they are simply parking the funds at the ECB as a form of insurance. But, for the most part, this is not what is happening. Italian-based banks held just €12 billion on overnight deposit at the ECB at the end of December. This means most of the money lent by the ECB to Italian banks has moved overseas and is being deposited back at the ECB by banks based in other euro-area countries

(Display 2, previous page).

There are several ways in which this can occur. One is that Italian banks have borrowed funds from the ECB to offset deposit flight to other euro-area countries—which would otherwise require them to shrink their balance sheets (i.e., sell assets). This would be consistent with November data showing a big drop in Italian bank deposits.

But this is unlikely to be the whole story. ECB President Mario Draghi recently confirmed that there was a link between banks' bidding behavior at the three-year LTRO and their funding requirements in early 2012. This suggests that part of the increased borrowing may be pre-funding to help banks get through a very difficult refinancing period. However, borrowing this amount of money at 1.0% (the ECB's refinancing rate) and investing it at 0.25% (the ECB's deposit rate) is expensive. It is therefore reasonable to assume that some banks have, temporarily at least, invested money borrowed from the ECB in other assets—including short-dated government bonds.

In time, aggregate bank balance sheet data from the ECB will reveal the answer to these questions. Until then, though, it's difficult to know the extent to which the

three-year LTRO is being used as an indirect prop for sovereign-debt markets or how long this might continue—the ECB itself was unable (or unwilling) to provide any insights at its January press conference. Indeed, it is perfectly possible that banks' sovereign-bond purchases have been modest. However, one thing we do know is that there is another three-year LTRO at the end of February and that looser collateral criteria will then be in place. Another big injection seems likely.

But Solvency Concerns Remain

The improvement in liquidity conditions in the euro area is a significant development, and the near-term impact should not be underestimated. It is helping stabilize sovereign spreads and providing breathing space for governments. But liquidity alone will not provide an exit from the sovereign-debt crisis and hence is unlikely to stabilize markets on a sustained basis. For that, investors will need greater clarity on the solvency of several key euro-area countries.

While the ECB's actions have helped lower liquidity risks, governments have been less successful in countering solvency concerns. But this is no longer the fault of individual countries. With the exception of Greece, all euro-area member states plagued by major solvency doubts have put in place radical austerity and reform programs. They have also agreed to tighten the rules governing their future fiscal conduct.

We have always regarded these as crucial steps to resolving the sovereign-debt crisis. Without them, it will be almost impossible for creditor nations to extend additional financial support to the periphery and, ultimately, to accept greater collective responsibility for legacy euro-area debt. But the response of creditor nations has been disappointing—a point highlighted by Italian Prime Minister Mario Monti. It's hard to disagree with S&P's view that the euro area is displaying insufficient financial solidarity to make up for its shortcomings in other areas.

Convincing investors that the periphery is solvent is complicated by the ideological gulf that exists between (most) euro-area policymakers and (most) international investors. The conventional view of the euro-area authorities is that austerity in debtor countries is the key to restoring solvency and market confidence. While there is now a grudging acceptance that economic growth also has a role to play, the focus is very much on supply-side or structural reforms rather than demand stimulus.

Most investors see things very differently. Without monetary and/or exchange-rate flexibility, aggressive fiscal tightening is likely to be deeply deflationary and may prove self-defeating (as in Greece). There is also deep concern about intra-euro-area real exchange-rate misalignment and the lack of any real attempt to deal with these (other than deflationary internal devaluations in debtor nations).

Still Muddling Through

Overall, recent market developments are consistent with the cycle of market pressure and policy response that has characterized the sovereign-debt crisis since the outset. In other words, we may still be in a muddling through scenario, in which the ECB's aggressive intervention is currently helping to stabilize markets and provide much-needed breathing space.

But this is not a permanent solution. Policymakers need to use this period to address market concerns about the solvency, and likely end games, for large euro-area countries like Italy and Spain, and to improve barriers against contagion. This would help stabilize markets on a more permanent basis and provide much greater protection should any downside tail risks start to crystallize—the most immediate of these being the possible failure of a second Greek rescue package. Hopefully, governments have learned that it is easier to build on improving confidence than it is to stabilize market sentiment once it starts to deteriorate. ■

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