

ECONOMICS: EUROPEAN PERSPECTIVES—JULY 2, 2010

Euro-Area Banks Reduce Their Borrowing from the ECB

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The crisis on the euro-area periphery has forced some banks to become increasingly dependent on borrowing from the ECB. However, this week’s voluntary reduction in overall borrowing from the central bank suggests that, for the system as a whole, liquidity conditions may be better than anticipated.

Despite considerable apprehension, this week’s expiry of the European Central Bank’s (ECB’s) huge €442 billion one-year longer-term refinancing operation (LTRO) passed without major disruption to the euro-area money market. Moreover, the fact that banks significantly reduced their reliance on ECB funding and are starting to shift their refinancing back towards the weekly main refinancing operation (MRO) suggests that the system as a whole may be under less stress than widely feared.

In order to provide a smooth transition from the expiry of the one-year LTRO on Thursday, the ECB held a three-month refinancing operation on Wednesday and a special six-day tender on Thursday. The latter allows banks to roll over into next week’s MRO, should they desire. As has been the norm since October 2008, both tenders were provided on a full-allotment basis, with the ECB guaranteeing to satisfy all bids in full. This means that the banks decide the size of the allocation.

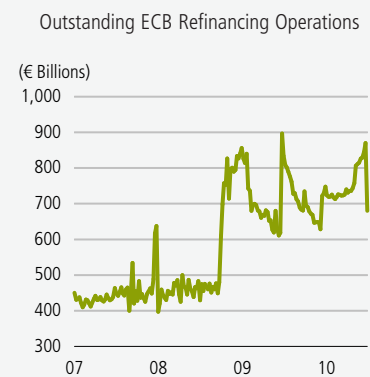
In the event, banks bid for €132 billion of

three-month funds and €111 billion of six-day funds. Set against the expiring €442 billion LTRO and an additional €2 billion tender maturing at the same time, this resulted in a net drain of €201 billion. It is important to note that this represents a reduction in the demand for liquidity rather than an ECB-driven reduction in supply.

As a result of these changes, the amount of liquidity provided to euro-area banks via ECB refinancing operations dropped from €881 billion on Wednesday to €680 billion on Thursday, the lowest since December 2009 (**Display 1**). This should result in a significant reduction in the amount of excess liquidity in the banking system and a contraction in the ECB’s balance sheet.

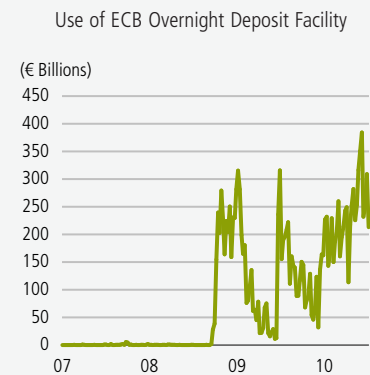
The full extent of the reduction in excess liquidity is unlikely to show up immediately. Last night, for example, banks placed €213 billion on overnight deposit at the ECB, just €96 billion lower than the night before (**Display 2**). But the amount held on overnight deposit varies widely during

Display 1
 Demand-Driven Drop in ECB Refinancing Operations



Source: European Central Bank and AllianceBernstein

Display 2
 Excess Reserves Set to Fall



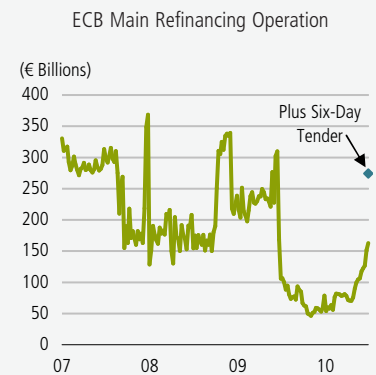
Source: European Central Bank and AllianceBernstein

the monthly reserve maintenance period, making it difficult to gauge the underlying level of excess reserves on any given day. All else being equal, the average level of excess liquidity should decline to around €100 billion in coming weeks from €295 billion in June. Importantly, this should be sufficient to prevent a significant spike in the overnight lending rate, which could have been misinterpreted as an unwarranted tightening of monetary policy.

As well as reducing total borrowing from the ECB, banks also seem to be shifting more of their refinancing needs back to the weekly MRO. Assuming that banks roll the liquidity from the special six-day tender into next week's MRO, the total amount of outstanding MROs would rise from €163 billion to €274 billion (**Display 3**). While this is a logical step given the increased flexibility offered by the MRO (compared to a three-month LTRO), it's encouraging that banks now have the confidence to take it.

Overall, we regard these developments as mildly encouraging. As other sources dry up, banks in some euro-area countries are becoming more and more dependent on borrowing from the ECB. But this week's voluntary reduction in overall liquidity and shift back towards the MRO suggest that system-wide stresses might be lower than anticipated. ■

Display 3
Banks Make More Use of the MRO



Source: European Central Bank and AllianceBernstein

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