FINANCIAL TIMES

Last updated: December 21, 2011 11:54 pm

85

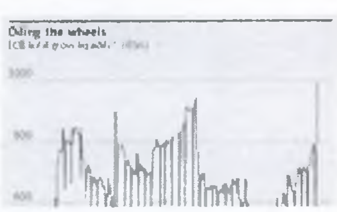
ECB unleashes a wall of money

By Ralph Atkins in Frankfurt and Tracy Alloway in London

Snowed under: an Occupy protester outside the European Central Bank in Frankfurt. The central bank has made €489bn available in three-year loans

If the answer to the eurozone crisis was a "wall of money", it was provided on Wednesday by the European Central Bank.

More than 500 banks borrowed a total of €489bn in three-year loans – equivalent to about 5 per cent of eurozone gross domestic product and the largest amount provided in a single ECB liquidity operation.



Click to enlarge

Under Mario Draghi, its president since November 1, the ECB has resisted political pressure to step up intervention in government bond markets. By instead flooding the financial system with funds, the bank hoped to achieve at least three objectives: to minimise the risk of a damaging bank collapse; prevent a "credit crunch" plunging the eurozone into a deep recession; and, in turn, relieve stress in government debt markets.

"The boldness was by the banks, but the huge amount the ECB lent was ironic given all the fuss about it buying a little bit of sovereign debt," said Erik Nielsen, chief economist at Unicredit.

Will the central bank's plan work? The largest chunk of the €489bn comprised funds that were switched from shorter term ECB lending facilities. Only about €190bn was fresh liquidity.

But the ECB hopes the longer time period will make a big difference, giving banks greater security and allowing them to think more strategically.

Initially, funds may simply be parked back at the ECB in its overnight deposit facility. But from early next year banks are likely to start using the low-cost ECB funds to substitute for the estimated €230bn of bank bonds that expire in the first quarter – especially those frozen out of normal funding markets or unwilling to pay the high rates demanded by nervous investors.

Mr Draghi warned in the European parliament on Monday that "the pressure that bond markets will be experiencing is really very, very significant, if not unprecedented". Without the ECB funds, the risk would have been of banks shrinking their balance sheets, in the process cutting off flows of credit to the real economy.

With their funding secured, banks' willingness to lend to the real economy could gradually pick-up. Gilles Moec, European economist at Deutsche Bank, said the previous largest ECB liquidity operation – which provided banks with €442bn in one-year loans in June 2009 – helped pave the way for a pick-up in lending the following year.

But he warned against expecting an immediate impact. "This is not going to help the eurozone economy at all before the end of the first half of 2012."

Banks would remain constrained by tougher regulatory requirements, while recessions in many eurozone countries would curb demand for credit from consumers and businesses.

By relieving pressure on banks, the wall of money unleashed by the ECB should ease some of the strains facing crisis-hit eurozone governments. The effects will probably be greatest in countries – such as Spain or Ireland – where problems were created initially by banks running into difficulties, rather than by weak controls over public finances.

Nicolas Sarkozy, French president, and Christian Noyer, the country's central bank governor, have suggested that funds borrowed by the ECB will be reinvested into government debt on a grand scale – a sort of "quantitative easing" by the back door. Mr Noyer has described the ECB's actions as the "big bazooka".

"This is not QE *stricto sensus,* but the effect on the market could be far from negligible," said Stephane Deo, economist at UBS.

Others are more sceptical, however.

The recent trend has been to run down holdings of debt issued by crisis-hit countries. European Union banks reduced exposure to eurozone "peripherals" from €497bn to €455bn between the start of the year to the end of September, according to European Banking Authority data.

Even in 2009 – before the eurozone debt crisis erupted – how much of the €442bn provided then by the ECB in one-year liquidity ended up in government bonds is hotly disputed by economists.

This time around the ECB has no illusion that it has provided a "game changing" response to the eurozone crisis. Nick Matthews, European economist at Royal Bank of Scotland, pointed out that "the bank-sovereign nexus has still not been successfully broken".

Eurozone politicians have a host of issues to address before investor confidence might return. But the ECB hopes it has at least nudged sentiment in the right direction.