FINANCIAL TIMES

Last updated: December 21, 2011 8:48 pm

Demand for ECB loans rises to €489bn

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By Tracy Alloway and Ralph Atkins in Frankfurt

The European Central Bank has stepped up its response to the eurozone crisis by providing €489bn in unprecedented three-year loans to more than 500 banks across the region.

The stronger-than-expected demand, a record for the amount allocated in a single ECB liquidity operation, came after banks were urged by policymakers to take the funds as part of a concerted effort to ease severe strains across the financial system.

The offer of unlimited three year loans, announced this month, comes ahead of a crucial first quarter of 2012 for the eurozone when a large volume of bank and government debt is due for refinancing.

The outcome was initially cheered by markets, with the euro and equities surging on hopes it would help ease banks' stretched balance sheets, but enthusiasm later waned.

Sebastien Galy, senior currency strategist at Société Générale, said the operation had provided "a sugar-rush" in financing support for banks. But it "does not, of course, resolve the deep-seated issues facing Europe".

Markets have been debating whether the banks will use the cheap loans to buy higher yielding government debt in a classic "carry trade" rather than finance existing assets.

Banks used about half the €442bn allocated in one year loans in June 2009 to buy higher-yielding sovereign debt, mostly Greek and Spanish government bonds.

The ECB has sought to reduce banks' funding difficulties in the hope of averting a dangerous "credit crunch" that would drive the eurozone into a deep recession.

Q&A - ECB's three-year loans

So the ECB is offering three-year loans with a 1 per cent interest rate. That sounds like a

But some ECB policymakers have gone further, urging banks to use the funds to support struggling eurozone government bond markets pretty good deal to me. Where do I sign up?

The ECB gave no details but analysts said demand for the loans was likely to have been heaviest from the crisis-hit peripheral countries.

In Madrid, bankers said take-up by Spanish banks was likely to have been substantial. "If everyone does it, the stigma goes away," said one, referring to the reputational risks previously associated with accessing ECB liquidity.

One Spanish bank board member described the use of central bank financing to buy government debt as "natural and normal".

He added: "If the sovereigns go down, then so do the commercial banks . . . so they are really defending their own interests."

S&P downgrades Hungary

Standard & Poor's cut Hungary's long-term credit rating by a notch to BB+ on Wednesday, citing unpredictable government policies, and said there was a one-in-three possibility of another downgrade in the coming year, **Reuters reports**.

The ratings agency said changes to the Hungarian constitution, central bank and constitutional court had raised questions about the predictability and credibility of government policy and complicated the investment environment.

Moody's downgraded Hungary to junk status in November.

"In our view, this is likely to have a negative impact on investment and fiscal planning, which we believe will continue to weigh on Hungary's medium-term growth prospects," S&P said.

French banks were encouraged by the Bank of France to take advantage of the new ECB facility.

BNP Paribas, France's largest bank, was understood to be among the banks taking part, although it and its main rival Société Générale declined to comment.

But one bank official said the funds would be used to finance clients in the "real economy" – not to load up on sovereign debt.

The single currency gave up gains shortly to trade slightly down against the US dollar at $1.3035. Italian 10-year bond yields rose 17 basis points to 6.78 per cent and Spanish yields jumped 21bps to 5.27 per cent.

However, yields are much lower than at the end of November before the ECB announced its plans for three-year liquidity to replace a previous offer of one-year loans.

Additional reporting by Victor Mallet in Madrid, Hugh Carnegy in Paris and David Oakley in London.