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Data show ECB loan spur for bond rally

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Italian and Spanish banks accelerated their sovereign debt purchases by a record monthly amount in January, underlining how the use of cheap funding from the European Central Bank has contributed to a bond rally among peripheral eurozone countries.

The ECB's longer-term refinancing operation, a three-year loan programme, was introduced in December to avert a liquidity squeeze that could have cut bank lending to European companies. More than 500 banks borrowed €489bn in December and the ECB is set to announce how many banks have tapped a second offering on Wednesday.

With banks using the 1 per cent money to refinance debt and buy bank bonds, the extent to which LTROs were helping to support sovereign bond auctions or increase lending to companies had been a matter a speculation.

But ECB figures published on Monday showed that Spanish banks increased their government debt holdings by more than €23bn in January while Italian banks bought nearly €21bn – both record monthly increases. Over December and January, Italian and Spanish banks increased their holdings by 13 and 29 per cent to €280bn and €230bn respectively.

The figures support forecasts from many banking analysts that suggested that the use of the LTRO by Italian and Spanish banks had been a major contributor behind a rally in government bonds since the start of the year.

The ECB bought no sovereign bonds for the second week in a row, sparking speculation among some market participants that the programme to support eurozone bond markets was now being run down because of the success of the LTROs.

Yields on Italian short-term debt fell to their lowest levels in more than a year after Rome sold more than €12bn in bills. Italy sold €8.75bn in six-month treasury bills, with a gross yield of 1.202 per cent, down from 1.969 per cent in September 2010. It sold a further €3.5bn of bills, expiring in December 2012, with a gross yield of 1.290 per cent. Both auctions saw strong demand for the short-term paper.

Italy's cost of borrowing has fallen sharply since the end of last year when yields on the country's 10-year bonds were hovering at about 7 per cent. The government of Mario Monti, Italy's technocrat prime minister, has worked hard since then to cut public spending and liberalise the economy.

Investor sentiment will be tested further on Tuesday when Italy will attempt to sell a clutch of bonds.

In another indication of the improved sentiment in the market, the rate at which banks in Europe lend to each other fell below the ECB's main refinancing rate for the first time in more than a year. Three-month Euribor hit 0.997 per cent on Monday. The ECB's main refinancing rate currently stands at 1 per cent.

Meanwhile, ECB data on the flow of bank loans to companies, showed a fall of €1bn in January compared with a €35bn fall in December. Mr Draghi admitted at the weekend that it was "hard to say" whether the first LTRO had made a difference to lending to the wider economy but signalled an expectation that more of the funds to be made available this week would find their way into loans.