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Banks should learn to go it alone

By Lorenzo Bini Smaghi

With the €530bn lent to banks through its latest three-year longer-term refinancing operation, the size of the European Central Bank's balance sheet has increased to unprecedented levels, raising three separate concerns. Not all are justified.

The first is that sooner or later the increase in central bank money will lead to inflation. However, there is no empirical evidence – across countries and over time – that the size of the central bank balance sheet in advanced economies is related to inflation. Even though inflation is ultimately a monetary phenomenon – to paraphrase Milton Friedman – the quantity of money circulating in the economy also depends on the motives underlying the demand for money by the private sector, in particular by the banking system. If the increase in central bank money helps commercial banks to finance additional private or public consumption and investment, over and above the economy's productive potential, it may indeed fuel inflation. If, instead, the demand for central bank money reflects a change in the composition of financial market participants' portfolios, towards less-risky assets, the increase in central bank money is not inflationary. It contributes instead to preventing deflation.

The data show that market participants' current demand for central bank money does not reflect an intention to increase their balance sheets but rather their difficulty in accessing financial markets – the result of a generalised increase in risk aversion. Replacing market financing with central bank funding has prevented a sharp contraction in banks' liabilities, which would have induced a drastic deleveraging and possibly a credit crunch. Money and credit statistics in the euro area confirm that there are no inflationary pressures, while aggregate demand growth is expected to be modest, if not negative; and below potential for some time.

The large amount of liquidity will, of course, have to be mopped up once financial markets have recovered, to avoid fuelling inflationary pressures. The process will be partly endogenous, as commercial banks in the eurozone will request less central bank money as risk aversion subsides, or will reimburse existing loans in advance, as the three-year LTROs allow. The ECB can hasten this process, if needed, by raising the refinancing rate, by increasing the spread between the refinancing and the deposit rate, by adopting variable rather than fixed-rate tenders for its operations, or by issuing term deposits or certificates of deposit.

The second concern relates to the overall risk a large balance sheet may create for the central bank and its shareholders. This concern is mitigated by the fact that the ECB lends against

collateral. For a loss to materialise, the counterparty has to be insolvent and the collateral must be sold at a price lower than the central bank's valuation (market price minus a haircut). These events are unlikely to occur simultaneously. In fact, markets are concerned about the opposite issue – that the ECB has de facto acquired preferred creditor status. The recent Greek bonds swap, which allowed the ECB to avoid loss, has confirmed this status. Under these circumstances, the larger the central bank balance sheet, the larger the risk shifted to the remaining unsecured bondholders, who might be more and more discouraged from lending to banks as they would find it harder to return to market financing.

This raises a third, more serious concern: that cheap three-year funding creates a disincentive for eurozone commercial banks to restructure their balance sheets and strengthen their capital base, as they must to stand on their own feet once the crisis is over. Banks may become addicted to easy central bank financing and delay the adjustment indefinitely. This can be prevented only if supervisors put sufficient pressure on bank managers and shareholders to continue adjustment, and to use central bank funds only as a temporary, exceptional source of financing. However, supervision in the eurozone is implemented at national level, with little incentive to pursue these objectives rigorously and on a level playing field.

With the three-year LTRO, the ECB has helped to reduce systemic risk and avoided a credit crunch. To minimise the inefficiencies and perverse incentives that may result from the increase in its balance sheet, and to reduce counter-party risk, the ECB should be given a greater role in co-ordinating and overseeing supervision of the eurozone banking system. The euro area needs a supervisory and regulatory compact, as much as – if not more than – a fiscal compact.

The writer is a visiting scholar at Harvard's Weatherhead Center for International Studies and a former member of the ECB's executive board

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