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Buttress for Europe's fragilities

To appreciate the importance of the European Central Bank's Long Term Refinancing Operation, one must remember what conditions were like at the end of 2011. European banks had to refinance a wall of debt maturities. Lending in the periphery was contracting at an alarmingly fast pace. Yields on Italian and Spanish bonds were at perilously high levels, with investors fearing both for the solvency of these states and for the health of banks holding their debt.

The ECB's move to supply unlimited liquidity to banks at a very low interest rate for three years has made a huge difference. The first tranche of the LTRO – issued last December – eased their funding requirements. While it is hard to know the extent to which this money has trickled through to the real economy, at least banks have stopped cutting loans to the private sector. Although the LTRO was not designed to reduce the stress on sovereigns, the banks have used the cheap money to buy bonds, cutting the yields on Rome's and Madrid's paper.

It is therefore welcome that banks decided to tap copiously from Wednesday's second tranche of the LTRO. The total amount borrowed – €529bn – was only marginally higher than last year's tranche. But since Wednesday's total includes smaller rollovers of previous ECB loans, the net injection into the system is roughly €100bn higher this time round.

This may further ease the pressure on some of the peripheral sovereigns, notably Spain and Italy. But, hopefully, the new injection will also help to meet the stated objectives of the LTRO – to stabilise the banks and prevent a credit crunch. It is good that the ECB has relaxed collateral requirements as this has allowed an increase in the number of participating banks. This hopefully includes smaller banks, which can use the money to fund themselves and provide much-needed lending to small and medium enterprises.

It would be foolish to think that the LTRO will be the end of the eurozone's woes. There is a risk that banks may use the loans to apply plasters to wounded balance-sheets rather than treat the underlying ailment. Governments in the periphery may also have less incentive to undertake the reforms their economies need.

But it is for politicians, not the ECB, to deal with these issues. The fiscal compact they have agreed is not a sufficient answer to the challenges Europe faces. The ECB has the merit of buying governments some time. Wasting it could be an unforgivable mistake.

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