

Behind the ECB's Wall of Money

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Throughout the crisis period, the European Central Bank's behavior has been conditioned by the tension between what it can do and what it is allowed to do.

The ECB is the only institution in the European Union that is able to provide unlimited funding to governments, but its governing statute prohibits government bailouts. Nonetheless, the ECB has provided large amounts of liquidity to the financial system, indirectly softening the pressure on government debt refinancing. For 18 months, it has been buying government bonds – worth more than €200 billion (\$254 billion) – on secondary markets under its Securities Market Program. Moreover, it has provided loans to the banking sector, recently launching a three-year refinancing operation that generated demand from eurozone banks for €489 billion.

In his early December address to the European Parliament, ECB President Mario Draghi stressed his commitment to unlimited support of banks to avert the risk of a credit crunch. The wall of money unleashed by the ECB just before Christmas should be seen as a measure matching that commitment.

Draghi left it up to national banks to decide whether to use the liquidity to buy high-yield government bonds. French President Nicolas Sarkozy and France's central bank (a member of the ECB) were less timid; they urged Italian and Spanish banks to buy their governments' debt.

The political logic behind such a plea is straightforward. If the banks proceed with purchases of their own government bonds, all public debt will be progressively renationalized, along with loans to the private sector, which undercapitalized banks have recently been providing only locally. The so-called "Sarkozy carry trade" is no solution to the systemic consequences of a sovereign-debt meltdown, but it would resolve a politically delicate situation, in which vulnerable eurozone governments hold foreign banks in just few countries to ransom. Greece taught France a lesson.

Worryingly, the evidence so far is that banks have not used the cash, instead parking it at the ECB. The bank's overnight deposit facility rose from €250 billion to €400 billion just after the extraordinary refinancing operation – and to €480 billion in recent days. That behavior reflects banks' uncertainty, but leaving the money with the ECB is a loss-making operation that cannot be sustained indefinitely. Sooner or later, the banks will use the cash. The question is how.

Banks' immediate interest is to adjust to the new capital requirements and restore their balance sheets to financial health, which implies that they will use the ECB money in a way that enables them to meet this objective most cost effectively. So, for example, if they use the cash to continue financing the private sector, they will ensure that loans go to creditworthy customers.

This means that, like credit provided by Italian and Spanish banks over the last several months, most of the new cash will be lent locally to safe households and large established firms. That will allow bank markets to continue functioning, but it is unlikely to inject the type of stimulus that European economies now require.

The alternative is the one urged by Sarkozy and the Banque de France: purchases by Europe's banks of their countries' government bonds. Of course, it is difficult to imagine that banks will use all of the money to buy the same assets that some of them have been trying to sell over the past few months. But that does not mean that they won't buy any of them. In fact, some of the €489 billion already has been used for that purpose.

This should not come as a surprise. Italian and Spanish banks, which received funds from the ECB at a very low rate, can



profit greatly from the high yields that their governments' bonds now offer. These investments can stabilize financing for governments while strengthening banks' balance sheets.

There is a caveat, though. Banks have bought only short-term assets, mainly with maturities of about three years (to match their liabilities with the ECB). This means that there is no appetite for supporting governments beyond what the ECB itself is willing to do. More importantly, the ECB is de facto the lender of last resort, while foreign banking systems are sharply reducing their exposure to risks abroad.

The ECB's wall of money is likely to support the real economy only mildly. By contrast, if banks use the money now parked at the ECB to continue buying short-maturity government bonds, that wall of money would have a large impact on eurozone countries' financial inter-linkages. Instead of falling on foreign banks in just a few exposed countries, a default would land mostly on the ECB's balance sheet, whose losses are distributed to all eurozone central banks – a soft form of debt socialization that may well prepare the ground for Eurobond-type solutions.

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