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MACROCOSM

New Battle, Old Weapons?

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Lorcan Roche Kelly

Europe bans short-selling again, but that does not mean a repeat of 2008.

An extraordinarily volatile week produced a co-ordinated response as short selling bans were introduced in France, Italy, Belgium and Spain -- shall we call them the FIBS? -- last night. This led the Stoxx 600 Europe banks index higher, up over almost 4% on the day.

- European policy makers have learned some lessons from 2008, as this time the short selling ban is co-ordinated across several different markets, rather than the previous approach where national regulators acted unilaterally.
- However, they have not learned that their weapon of choice cannot reverse banking selloffs that are motivated by fundamentals. It can only slow them, as shown by the price action of UK banks following the short selling ban introduced there in 2008 (please see chart below).

FTSE All-share Banking Index

Source: DataStream, TrendMacro calculations

- This has not stopped Germany following the FIBS lead by suggesting a Europe-wide short selling ban today.

The language used by European politicians today is probably overly emotive, but it does give a useful insight into the mindset of those decision makers.

Update to strategic view

EUROPE MACRO, EUROPE FINANCIAL STOCKS: European policymakers and regulators are using the same weapons they deployed during the crisis of 2008 -- rhetoric and short selling bans -- to fight the speculators they feel are responsible for the financial market turmoil in the past week. However this does not mean we are due for a re-run of 2008's travails. The ECB is a more experienced organization with battle-tested liquidity tools -- and European politicians continue to slowly move towards the Federal Europe that is needed to ensure the survival of the Euro.

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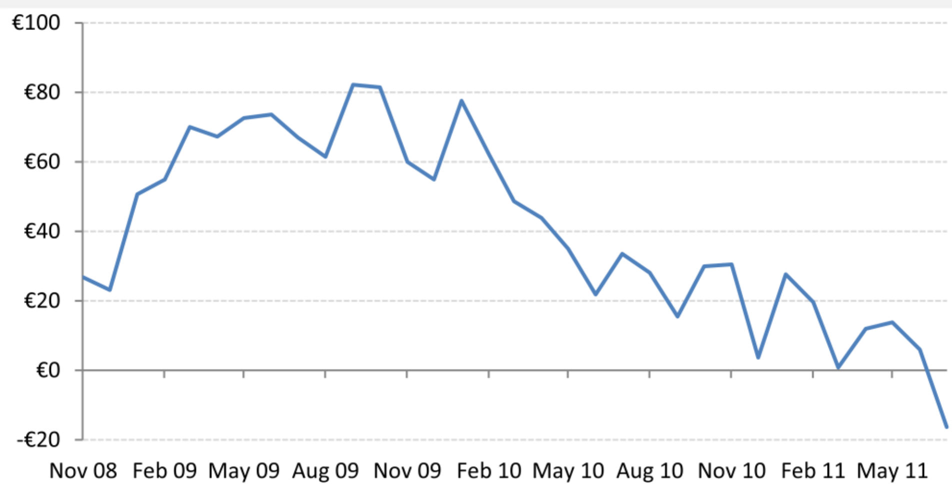
- The German finance ministry said today that banning naked short selling is the only way to counter "destructive speculation."
- The French securities regulator recalled World War II, saying "They [the market] wanted to test French resistance. This is our response, as always very determined, and it will be so for all those who want to put us to the test."
- The European Securities and Markets Authority (ESMA) said that short-selling combined with rumor-mongering created a strategy that was "clearly abusive."

With European politicians and policymakers relying on rhetoric and previously failed tactics to curtail speculative attacks, it's easy to leap to the conclusion that we are in for a re-run of the catastrophic second half of 2008. But this analysis ignores one critical -- and game-changing -- difference between 2008 and now. That difference is the European Central Bank.

- In 2008 the ECB was slow to provide the liquidity needed as inter-bank lending dried up. Now the ECB is providing liquidity on a full-allocation, fixed rate basis -- that is, any amount to whomever needs it.
- Already there are signs of banks under pressure making greater use of this facility. Most critically, Italy's Target2 balance -- its central bank's position in the Eurosystem-wide clearing network that channels ECB liquidity-provision -- turned negative in July, indicating greater reliance of Italian banks on ECB funding (see chart below).

Target2 balance, Banca d'Italia € billions



Source: Banca d'Italia

- The ECB has also intervened in the sovereign debt market by buying bonds in its Securities Market Programme (see "Downgrade: At Least the News is Out" August 8, 2011), in an attempt to break the bank/sovereign risk cycle that came to the fore in 2008. Both Italian and Spanish 10 year yields have hovered

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around 5% since the ECB intervened on Monday, off more than a full percentage point from the worst levels in both cases.

- The sudden drop in both the yields and volatility of those sovereign debt markets this week shows how effective the ECB can be when it chooses to act.
- Overall, funding stress in the Euro area remains far below where it was at the worst of the 2008 crisis, as evidenced by today's elevated but still relatively tame euro LIBOR/OIS spread (please see the chart below).

Source: Bloomberg, TrendMacro calculations

The ECB's liquidity provisions offer a very important safety net for banks suffering liquidity crises, but since 2008, national central banks have also developed tools to support insolvent institutions -- both extraordinary liquidity assistance (ELA) and other maneuvers (see "Europe, Living on the Edge" August 1, 2011). While use of these facilities -- which amount to *ad hoc* quantitative easing -- on a wider scale and on a sustained basis would be damaging to the Euro, they do prevent Lehman-style disorderly collapse of institutions.

This is not to say that we expect this morning's short-selling ban to lead to a sustained recovery in European financial stocks. Previous European policy moves -- such as the recent European Banking Authority (EBA) stress tests -- only led to brief rallies. ECB policy is about preventing disorderly bank failures in the Euro area, it is not about supporting bank share prices.

What is needed to support bank stocks is implemented European responses, on a political level, that address the fundamental problems within the Euro area. French President Nicholas Sarkozy and German Chancellor Angela Merkel are meeting on Tuesday to discuss closer ties on European governance and to accelerate ratification of the enlarged EFSF deal announced in July (see "Whatever It Takes" July 22, 2011). The ratification by European national parliaments cannot occur until European politicians return from vacation in September, so there will not be much more than a "renewal of vows" on Tuesday. We do not expect a major announcement from the meeting -- on Eurobonds, for example -- but any statements after the meeting will be worth following to see if they point towards a softening of German opposition to closer financial integration.

The speculative attacks have occurred, with the attacks on sovereigns effectively dealt with by the ECB -- all as we predicted (again, see "Whatever it Takes") -- and the attacks on the banking sector attacks less effectively dealt with by rhetoric, failed stress tests and, perhaps, a misconceived short selling ban.

To repeat a point we have made many times, it remains in the interest of the market to cause the deployment of all of the European rescue mechanisms where they are available (See "Europe Gropes toward Stress-Tests" July 12, 2010). The market has succeeded in forcing the ECB to reactivate its dormant Securities Markets Programme -- we will learn the size of the deployment under the ECB' web site's "Monetary policy portfolios" tab next Monday. It will again show the futility of short selling bans as it puts European financial stocks under renewed pressure in the coming weeks.

The only solution remains closer European integration -- a single federal Europe for the Euro currency. Each baby-step closer to that outcome is being driven by the markets, and we expect this trend to continue.

Bottom line

European policymakers and regulators are using the same weapons they deployed during the crisis of 2008 -- rhetoric and short selling bans -- to fight the speculators they feel are responsible for the financial market turmoil in the past week. However this does not mean we are due for a re-run of 2008's travails. The ECB is a more experienced organization with battle-tested liquidity tools -- and European politicians continue to slowly move towards the Federal Europe that is needed to ensure the survival of the Euro.