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# On the ECB Monetary Policy Decisions

Thursday, December 8, 2011

**Lorcan Roche Kelly and Donald Luskin**

**The ECB met expectations, but dashed hopes. But spillovers may mean *de facto* Fed QE3.**

Mario Draghi's second European Central Bank monetary policy meeting as president, and his second 25 bp rate cut, completes the unwind of his predecessor's ill-advised rate hikes in April and July of this year (see "EUicide" April 7, 2011 and "On Europe's July Rate Decisions" July 7).

Sadly, quantitative easing still gets a big "nein" from the ECB. Markets should never have expected it -- we certainly didn't (see "QE Nein" November 23, 2011). Nevertheless, this is surely what has poisoned sentiment across the world's markets today in the wake of Draghi's press conference.

- Ironically, ECB policy is exerting a spillover effect that will potentially lead to *de facto* QE3 by the Fed in the US. We will turn to that topic later in this report.

Draghi poured cold water on the hope that the ECB would buy distressed sovereign debt provided that a set of fiscal rules for the Euro area were to be agreed at tomorrow's European summit.

- He expressed surprise at the press reaction to his comments during a speech to the European Parliament last Thursday, where he said "other elements might follow." He clarified his meaning by saying the stability mechanism he prefers is the EFSF -- though truth be told, it seems nearly moribund at this point (see "Saved by an Acronym" November 30, 2011).

We have recently highlighted the possibility of the IMF being used as a bailout fund, with the necessary financing coming from national central banks within the Euro area under the doctrine of Emergency Liquidity Assistance (again, see "Saved by an Acronym"). Draghi poured cold water on that, too, although he did not fully rule it out. He did say that NCBs can lend to the IMF general fund but could not lend for specific Euro area bailouts. Press reports late in the day now suggest that the NCB/IMF solution is still seen as a serious contender.

With the ECB continuing its dogmatic adherence to its primary mandate of inflation-fighting, markets must turn to European political leaders for the

**Update to strategic view**

**ECB, US FED:** The European banking system is going from bad to worse, with indicators revealing new funding stresses. The ECB today moved to provide ample liquidity to the system to forestall a major credit hard-stop. However, it has once again ostensibly washed its hands of any responsibility for solving the sovereign debt crisis, putting world markets under pressure again. At the same time, though the ECB continues to eschew QE, a spillover effect of Europe's banking stresses is triggering de facto QE3 from the Fed.

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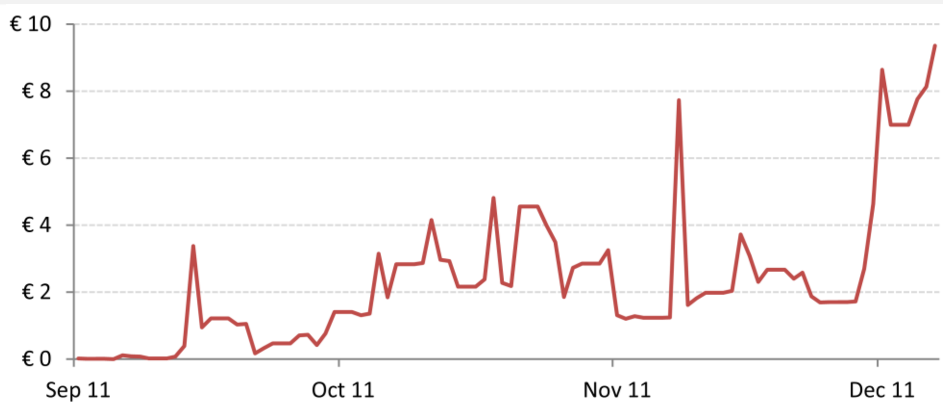
way forward in the present crisis. European Commission meetings are being held today and tomorrow -- with suggestions they may go into the weekend -- to finalize the route to fiscal integration of the Euro area.

For all that Draghi dashed the market's hopes, let's look at the details of what he did do to at least meet the market's expectations. The rate cut was expected by all. So were many of the new liquidity measures announced today. But now we know the details:

- The ECB will conduct two 36-month Longer Term Refinancing Operations (LTRO). The first of these operations will be launched on December 20, and will be due to mature on January 29, 2015. These operations will be on a full allocation basis, with the rate the average refinance rate across the life of the operation. In other words, liquidity provided on demand in unlimited quantities.
- Collateral availability for ECB refinancing operations will be increased by allowing lower-rated asset-backed securities (single A second rating -- down from previous AAA second rating) to be used.
- National central banks will be able to provide liquidity against performing bank loans. Each NCB will be responsible for its own lending under this program. This sounds on the surface like Extraordinary Liquidity Assistance (ELA), but it is not -- it will operate within the framework of the ECB's refinancing operations (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011).
- The fine-tuning operations carried out at the end of each reserve maintenance period have been cancelled, and the reserve ratio has been dropped from 2% to 1%.
- These liquidity measures are welcome -- but the fact that they are needed points to continued dislocations in the bank funding market. One of our favorite indicators of short-term liquidity problems is use of the ECB's Marginal Lending Facility -- ECB overnight lending to banks at penalty rates (please see chart below). This has remained at high levels since the start of December, pointing to a bank, or banks, in the Euro area having extreme difficulty accessing funds.

**ECB Marginal Lending Facility borrowings, € billions**




Source: ECB

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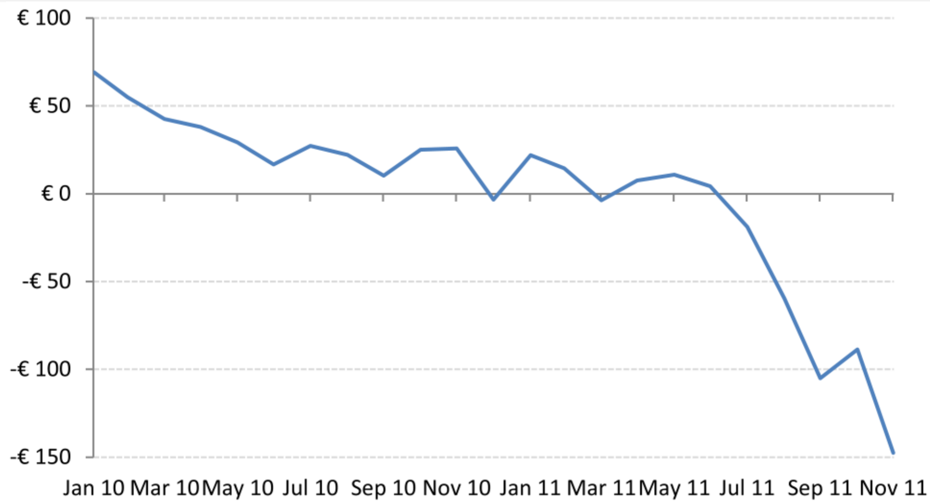
Further, the continuing sovereign debt crisis is forcing increasing reliance on ECB funding for banks in Italy. At the end of November, ECB liquidity provided to banks in the Euro area totaled €641 billion. Of this, €153 billion went to banks in Italy -- 24% of the total liquidity provided. This increase in Italian reliance on the ECB for funding is reflected in Italy's TARGET2 liability to the Eurosystem (see chart below) which has jumped to €147 billion (see the chart below and "New Battle, Old Weapons" August 12, 2011). This data is from the Bank of Italy's latest monthly report which also shows Italian bank usage of the MLF at €1.4 billion, which may point to our troubled bank being an Italian one, as the Bank of Italy data is only to end November.

**Italy's TARGET2 liability to the Eurosystem, € billions**




Source: Bank of Italy

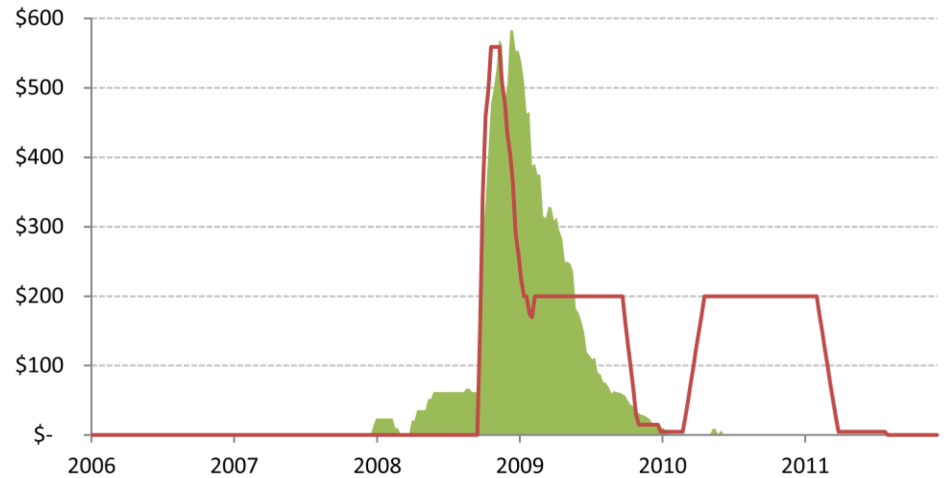
Will we have yet to see what the demand for -- or the effect of -- the new operations will be. But again, the fact that such extraordinary programs have had to be put in place implies great need. We are already beginning to see large utilization of the cheaper dollar swap arrangement announced last week.

Uptake of $50.6 billion at Wednesday's auction of the ECB's dollar liquidity facility enabled under this arrangement has potentially profound implications for the US Federal Reserve -- it could result in something that would be, in effect, QE3.

- When a European bank borrows dollars through the ECB, the ECB obtains those dollars from the Fed, swapping euros for them.
- These euros become an asset on the Fed's balance sheet, just like Treasury bills or bonds, MBS, gold or any other. Like all assets, the euros must be funded by an offsetting liability.
- In 2008 and 2009, the last time the Fed made dollars available to non-US central banks in large scale, the foreign currency assets thus acquired by the Fed were funded by the US Treasury through its Supplemental Financing Program (SFP).

- Under the SFP, the Treasury issued to the public cash management bills and deposited the proceeds with the Fed. As the Fed's dollar swaps suddenly exploded to a maximum of $583 billion near year-end 2008, that was entirely funded by the SFP (please see the chart below).

**Fed dollar swap lines — Supplementary Financing Program**
USD billions $50 billion in present ECB swaps not apparent yet in Fed's data.




Source: Federal Reserve

- As the swaps rolled off in 2009, the SFP stabilized at $200 billion, funding the Fed's assets acquired in rescue operations conducted on behalf of the Treasury -- Fannie Mae, Freddie Mac and AIG.
- In late 2009, the SFP briefly fell to near zero, as the Treasury got squeezed by Congress's tardiness in increasing the statutory debt ceiling. It was replenished to $200 billion once the debt ceiling was raised (see "Some Tightening!" February 24, 2010), and then fell off in 2011 as the Treasury, once again, started running up against issuance limits.
- In the voodoo accounting of the Fed's balance sheet, as the SFP fell off it was replaced by excess reserves.
- *Today* -- how will the Fed's foreign exchange swaps be funded? Surely the SFP cannot be revived in today's constrained Treasury issuance environment.
- No doubt excess reserves will be reported higher by however many dollars are required so that the liability side of the Fed's balance sheet equals the asset side. But we are unable to construct a narrative that fully


Source: http://www.bokbluster.com/

accounts for how those excess reserves would actually arise, under these circumstances. The Fed itself gives no explanation in its FAQ.

- This leaves us thinking that in order to meet the *ad hoc* needs of the Fed's open-ended liquidity commitment to foreign central banks, the Fed will simply print as many dollars as needed, and drop them from as many helicopters as required.
- We offered one explanation for why last week's announcement of the coordinated dollar liquidity facility set off such a fierce rally in stock markets worldwide. We speculated that it was because, after more than a month of malign neglect of Europe's spiraling debt crisis, here at last was a gesture to "do something" -- whether or not the facility was actually ever utilized (see "It Only Feels Like Blood in the Streets" December 1, 2011).
- Now that it *is* being utilized, maybe more is revealed about the market's enthusiastic reaction. Its utilization maneuvers the Fed into another round of quantitative easing -- quiet, even stealthy, but QE just the same.

Turning back to Europe, the European Banking Authority (EBA) released today details of the capital requirements for the major European banks. Total needs -- according to the EBA -- are €114.6 billion. Spanish banks having the largest requirement -- Santander needs €15.3 billion, far ahead of the next worst, Italy's Unicredit at €8 billion.

However, the EBA only tests the systemically important banks. It does not test the German *landesbanke*, the Spanish *cajas* or any of the other smaller-scale banks across the Euro area. In Ireland, in 2009, it was not a systemically important bank that brought about the heaviest losses -- it was Anglo Irish Bank, a smaller property lender.

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**Bottom line**

The European banking system is going from bad to worse, with indicators revealing new funding stresses. The ECB today moved to provide ample liquidity to the system to forestall a major credit hard-stop. However, it has once again ostensibly washed its hands of any responsibility for solving the sovereign debt crisis, putting world markets under pressure again. At the same time, though the ECB continues to eschew QE, a spillover effect of Europe's banking stresses is triggering *de facto* QE3 from the Fed.