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TRENDMACRO LIVE!

On the Second 3-year LTRO

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Lorcan Roche Kelly

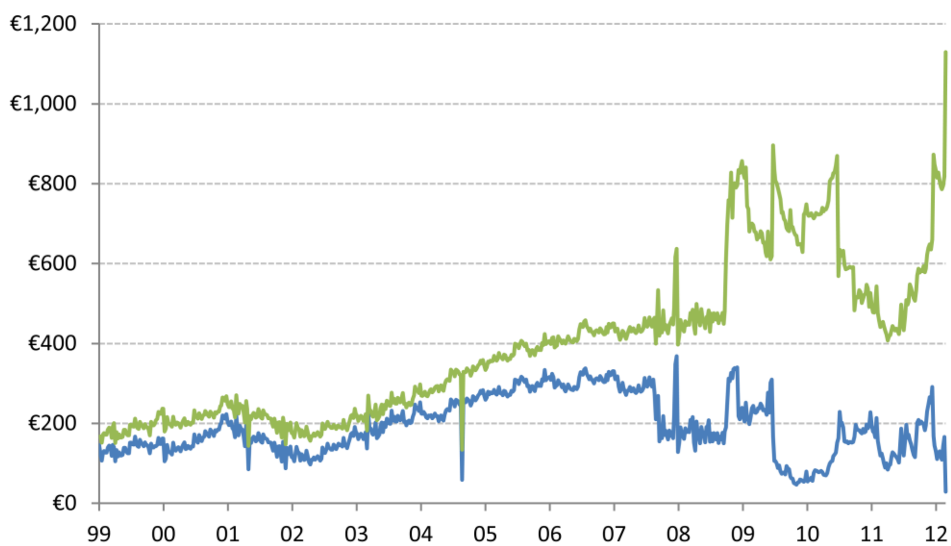
It's official: euro area banks won't be Lehman. Now can they be more than zombies?

Banks drew €529.5 billion from the ECB's second three year Longer Term Refinancing Operation (LTRO). This is closer to our guesstimate of €560 billion (see "LTROphoria" February 27, 2012) than the Bloomberg consensus estimate of €470 billion. This moves the total liquidity provided by the ECB sharply into new all-time high ground (please see chart below).

- The initial market reaction to the number has been limited, with a slight weakening of the euro and a tightening of Italian and Spanish yields -- all to the good. This reaction is not a surprise as the size of the LTRO itself is, basically, not much of a surprise.

But the headline number of €529.5 billion isn't what really matters. What counts, first, is the *net* new liquidity added by this operation -- the difference between the LTRO allotment today and the roll-off of existing financing. Today's net is €311 billion, approximately half-again the amount added by the first 3-year LTRO in December. Second, what counts is

Total ECB refinancing operations **Short-term component** EUR billions



Source: ECB

Update to strategic view

ECB, EUROPE FINANCIAL STOCKS, EUROPE MACRO, EUROPE BONDS: The second 3-year LTRO beat market expectations, but is generally in-line. The operation pushes ECB liquidity provision to the banks to record highs, but this should not feed through to inflationary pressures nor destabilize the ECB itself. This definitely resolves the banks' funding risks, and takes off the table the possibility of a Lehman-type global systemic credit hard-stop. By ruling out asset fire-sales and financing carry trades, this should sustain the improvement in sovereign spreads.

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which banks accessed the LTRO. We won't know the distribution across countries for some time yet (in December, much of it went to Spain and Italy). But we do know that 800 banks participated, far exceeding the 523 in December.

Now that this highly anticipated event has finally occurred, the big questions are: what will banks do with the liquidity, and what are the economic and market impacts?

- **Covering funding needs.** We took the maverick view in December that the 3-year LTRO would take Lehman-type systemic risk off the table (see "Europe's Wall of Liquidity" December 21, 2011). With today's operation, this view has officially been adopted by the conventional wisdom, with even Goldman Sachs coming out with research saying euro area banks are insulated from funding shocks until 2014. We continue to believe that this, not any specific macro data, has been the key driver to the slow-motion melt-up in stocks worldwide (see "Risk Reappraisal" January 20, 2012).
- **The carry trade.** Liquidity from the LTRO's enables banks to finance their existing sovereign debt positions -- which is to say, to not have to dump them at fire-sale prices to raise liquidity -- and even take on new ones to earn rich spreads. As a result, the positive moves in peripheral sovereign debt since the first 3-year LTRO in December have been very significant, and there is no reason to think that this move will not continue.
- **Regulatory compliance.** Senior banking sources inform us that some of the institutions that used today's operation are doing it purely to stabilize their regulatory compliance risk. Basel III rules introduce a supervision standard called the liquidity coverage ratio (LCR), which measures the stock of high quality liquid assets versus the net outflows from a bank in a 30-day period under a stress scenario. So the more high quality liquid assets a bank has -- cash, very short debt instruments -- the better its LCR will be.
- **Lending.** It's a sad comment that lending -- the core business of banks -- is the last thing we think about nowadays, crowded out by matters of sheer survival. All else equal, today's LTRO may lead to increased customer lending, but this seems far from the top of their list of priorities. Surely with an above-expectations uptake, we avoided the risk that euro area banks would signal an intention to simply hunker down into survival mode, accepting with resignation their status as zombies (see "On the ECB and BOE February Rate Decisions" February 9, 2012).

We regard the two 3-year LTRO operations as tantamount to quantitative easing, although the ECB would never publicly admit to that (see "Cash for Gold!" January 11, 2012). As such, it is a positive for the euro area, which took considerable damage from the ECB's reckless tightening campaign last year (see "EUicide" April 7, 2011).

- The latest data, released this morning, shows inflation in the euro area at 2.6% year over year -- a slight downward revision of the earlier flash estimate. While above the ECB's explicit target, it is

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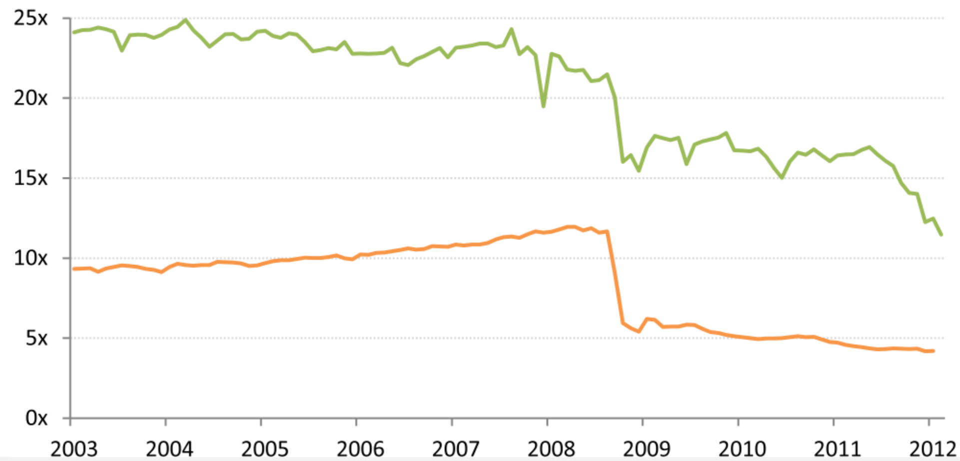
falling. So far, QE in the United States and the United Kingdom has not produced serious inflation problems, and we have no reason to think that the ECB's stealth version of QE will do so.

- Some clients have asked us if the two LTRO's have resulted in the ECB acquiring a dangerously large balance sheet, risking its own institutional stability. We don't see it that way. In fact, we think this begins to redress a long-standing problem that the ECB's balance sheet has been too small in relation to Europe's very large banking system. Today's LTRO puts the leverage of the euro area banking system to the ECB (that is, the ratio of banking system assets to central bank assets) at the same level as the United States just before Lehman failed -- which then resulted in a major deleveraging achieved by the Fed's rapid expansion of its assets (please see the chart below). Thus, by the standards of the Fed, at least, the ECB remains too small.

Leverage of banking system assets to central bank assets
Euro area **United States**



Source: ECB, Federal Reserve, TrendMacro calculations

Bottom line

The second 3-year LTRO beat market expectations, but is generally in-line. The operation pushes ECB liquidity provision to the banks to record highs, but this should not feed through to inflationary pressures nor destabilize the ECB itself. This definitely resolves the banks' funding risks, and takes off the table the possibility of a Lehman-type global systemic credit hard-stop. By ruling out asset fire-sales and financing carry trades, this should sustain the improvement in sovereign spreads.