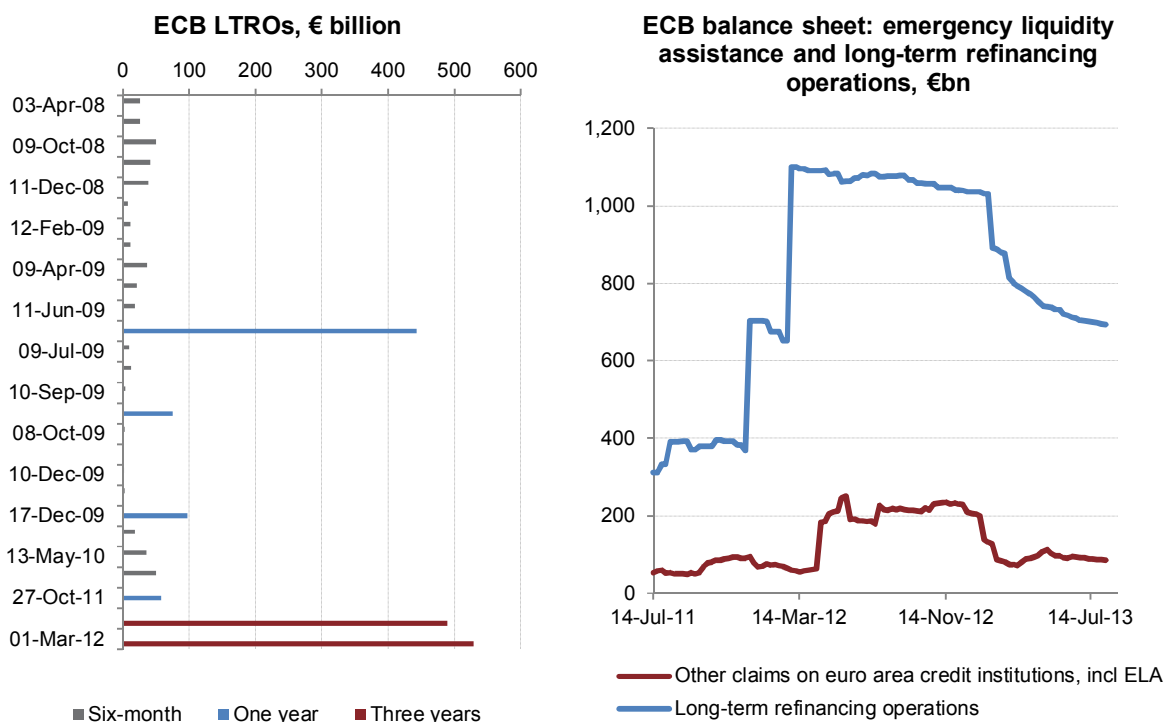


## Further to EA MFI balance sheets

- **The LTROs were the ECB's real bazooka**
- **Large-scale early repayments confirm that EA banks are now in better shape**
- **But continued regulatory pressures to deleverage could threaten still fragile recovery**

One of the most powerful weapons that the ECB deployed (as opposed to the OMT, which has so far not been used) to respond to the Great Recession and the related euro area crises was its longer-term refinancing operations (LTROs). These began with a €25 billion six-month, variable-rate refinancing operation in April 2008. That was followed by two other six-month LTROs, one in July 2008, also for €25 billion and another, for €50 billion, in October 2008. But already by then it was clear that the amounts were insufficient, with demand vastly outstripping supply. The next step was therefore to shift to fixed-rate full allotment mode. Beginning in June 2009, the ECB added the first of four one-year full allotment repos (three in 2009, one in mid-2011). Finally, in late 2011 as the euro area seemed to be at risk of breaking up under the impact of sovereign debt crises and the interbank market was again freezing up, two three-year LTROs were announced, again with full allotment, one in December 2011, the other in March 2012.



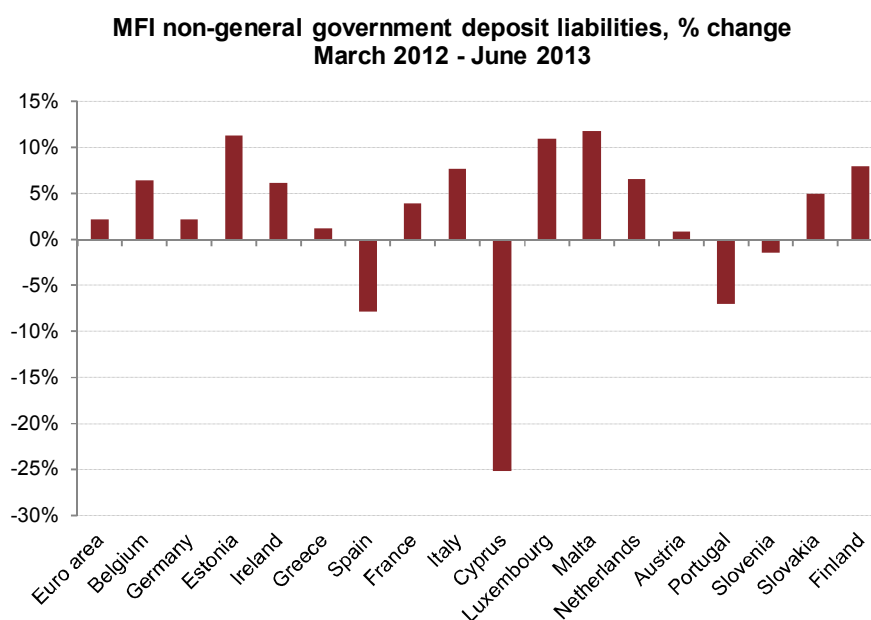
The numbers clearly show a pattern: introduce a new measure in an attempt to 'shock and awe' markets into functioning; then attempt to taper future moves until it turns out that markets seized up again.

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However, following the two unlimited three-year LTROs, markets seem to have calmed down and banks no longer have the same liquidity problems. This is not least shown by the fact that EA banks have repaid substantial amounts of the LTROs ahead of time. The amount outstanding in LTROs peaked in the first half of March 2012 at €1.1 trillion. By early August 2013, it was down to €696 billion, a fall of €404 billion. Some of this is the repayment in October 2012 of the last one-year LTRO, which amounted to €56.9 billion. Some of it is due to smaller amounts allotted in the regular (ie, one-month and three-month) LTROs. In 2012, the allotment in one-month LTROs averaged €17.8 billion and in three-month LTROs €14.4 billion. In the first seven months of 2013, the average was €5.7 billion in one-month and €6 billion in three-month operations. But these sums are dwarfed by the early repayments from the three-year LTROs. According to the rules, early repayment could begin a year after the operation. By mid-August 2013, a total of €218.9 billion or just short of 45% of the December 2011 LTRO had been repaid; as had €105.6 billion or just short of 20% of the March 2012 LTRO. At the same time, periphery country banks have become less dependent on emergency liquidity assistance (ELA) from their national central banks, a further sign of EA banks returning to health.

Given the cheap cost of these funds, banks would presumably only repay them in advance if they found even cheaper sources of funding. That is also clearly the case. One such source is retail deposits. From March 2012 to June 2013 non-general government deposits in EA MFIs rose by €311 billion – very slightly less than the €324 billion in early LTRO repayments. This obviously varies very much from country to country; whereas, eg., Belgian, Irish, Dutch and Finnish deposits rose by between 6% and 8% over the period March 2012 to June 2013, deposits in Spanish, Cypriot, Portuguese and Slovenian banks fell over the same period.

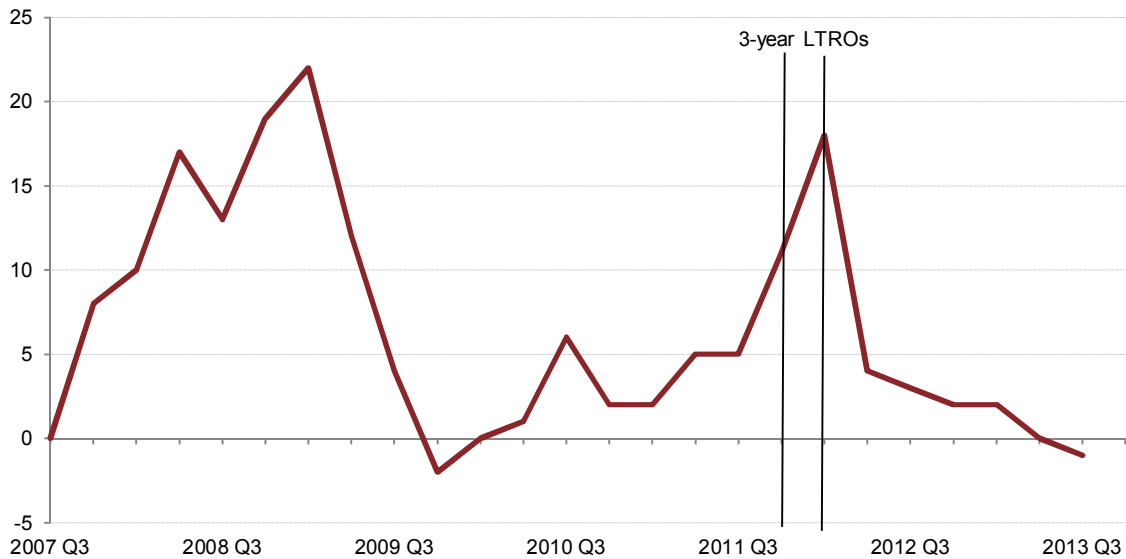


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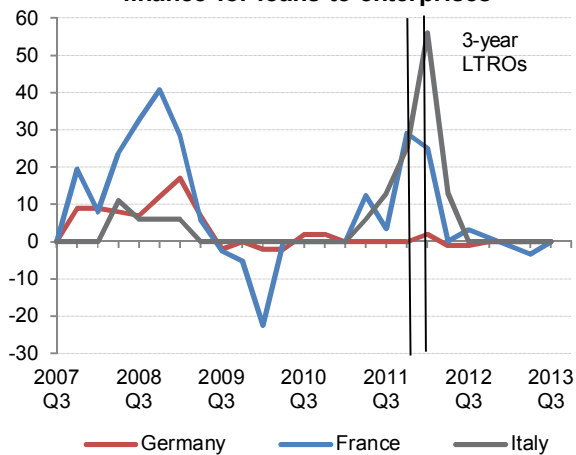
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Better access to funding is also clear from the various EA bank lending surveys. The ECB's survey for the entire euro area shows that funding constraints have eased substantially since the three-year LTROs were implemented and are now back at or even better than 'normal' levels (in so far as this can be judged from a survey that only goes back to 2003).

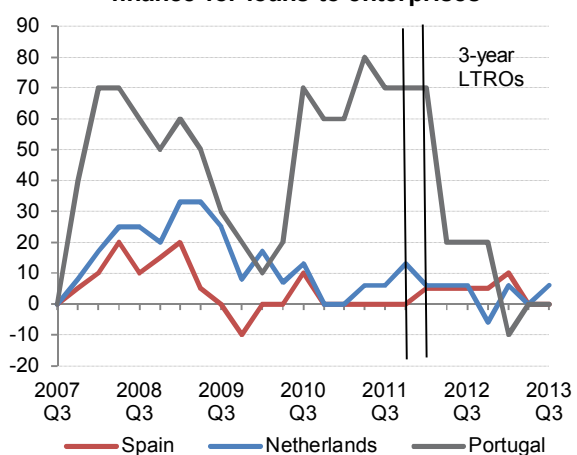
**ECB bank lending survey, access to finance for loans to enterprises, diffusion index**



**ECB bank lending survey, access to finance for loans to enterprises**



**ECB bank lending survey, access to finance for loans to enterprises**



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This is also true for at least the larger EA members. Some caution may need to be applied when comparing the individual country surveys. The French survey is from the Banque de France, not from the ECB; and banks are in general not keen on reporting – even anonymously – that they have problems raising capital or accessing market funding.

Nevertheless, it is clear, both from the survey data and from the ‘hard data’ – ie, the early repayment of LTRO money – that banks’ access to funding has improved across the EA. That is of course excellent news. But it is not the whole story. Euro area bank balance sheets are still contracting; and are likely to continue to do so under the pressure to achieve regulatory criteria imposed in the aftermath of the financial crisis. On 12th August, the *Financial Times* again contained an article about ‘European’ banks needing to cut €3.2tn worth of assets from their balance sheets to comply with the Basel III rules on capital and leverage. It is not clear from the article whether this refers to euro area banks, EU banks or banks in all of Europe. Nevertheless, a large chunk of such a reduction would clearly fall on euro area banks. Since their consolidated balance sheets amount to €26tn, this effectively would further stymie broad money and credit growth – both of which are crucial to the EA economy.

The EA is currently seeing the faint beginnings of a recovery. GDP growth in Q2 was stronger than expected (partly due to once-off factors). Survey data is improving as is some hard data, both from Germany and from other countries. EA equities have done well recently, although mainly on the back of US stock markets. Absent any further fiscal or political crises, they should do even better over the coming twelve months. What is now needed is for this recovery to take root and strengthen. What is not needed is to implement further regulatory measures – ie, insist on banks deleveraging and raising their capital/asset ratios further – which postpone the recovery. At the very least, this issue should be debated more openly. To put it simply – does the euro area in general and southern Europe in particular currently need growth (nominal and real) or is it better to forgo that in exchange for nailing down a regulatory regime on the banks which – bearing in mind that the likelihood of a financial crisis caused by reckless or excessive lending, in what is still a very early recovery, is extremely low, not to say non-existent – could be postponed until the economy has recovered further?

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