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PROPPING UP EUROPE?

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Highlights

- The Bank of England, the Federal Reserve (Fed) and the European Central Bank (ECB) responded to the crisis with exceptional initiatives resulting in a major increase in thei balance sheets. After the ECB's end-2011 launch of three-year bank refinancing (LTR there has been speculation that all three have de facto embarked on 'quantitative easing'.
- However, major differences remain: the Bank of England and Fed have mostly relied on large-scale purchases of government bonds, while the ECB has relied on lending financial institutions with repurchase agreements of collateral (repos).
- The LTRO has successfully mitigated funding needs and reduced interbank stress, a has had a significant impact on sovereign bond yields in southern euro-area countries and increased southern banks' government debt holdings, while northern banks hav reduced sovereign exposure.
- The LTRO has had only weak effects on funding for households and non-financi corporations; credit dynamics remain weak particularly in the southern euro area.
- Underlying structural problems relating to banks, the macroeconomic adjustment and the euro area's governance need to be addressed before financial stability and economic growth can return. Monetary policy cannot fundamentally address these problems and is made less effective by macro/institutional heterogeneity.

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THE SIZE AND THE NATURE of the two recent Euro-and thereby to stimulate the economy despite the rigidity of the policy rate (Bernanke, 2009; King, 2009).

Jean-Claude Trichet, however, until the end of his tenure as ECB president, repeatedly indicated that the aim of the ECB•s unconventional policy was not to substitute interest-rate cuts at the zero bound, but rather to ensure the proper transmission of interest-rate changes to the non-financial sector. According to the so-called separation principle adopted by the ECB, the goal of its non-stan-

decomposition. We distinguish five categories:

1 Lending to financial institutions, mainly within the framework of repurchase agreements (repos);
2 Government securities held by the central banks within the framework of asset purchase programmes;
3 Non-government securities held within the framework of asset purchase programmes;
4 Foreign exchange swaps with other central banks (for the Fed)/foreign currency lending to domestic institutions (for the Bank of England and the ECB).
5 Other assets not elsewhere classified.

The first three categories correspond to the three main instruments used by central banks during the current crisis, and they correspond to the three sets of tools distinguished by Fed chairman Ben Bernanke in his presentation of the Federal Reserve•s crisis response (Bernanke, 2009). The same instruments have to varying degrees also been used by the other two central banks.

The fourth category is intended to capture the effect of foreign exchange swaps entered into by the Fed and its partner central banks with the purpose of providing US dollar liquidity to European financial institutions.

The fifth category is a residual. For the Fed only, we include an additional category called •Other operations• that includes significant programmes conducted during the financial crisis that are not easily classifiable as repos or securities purchases but that we want to differentiate from

1. This type of comparison was advocated by ECB president Mario Draghi in the introductory statement to a press conference on 8 March, in which he said that •The Eurosystem has a very large volume of assets that have nothing to do with monetary policy, eg gold, foreign exchange reserves, among other things. If you compare the ECB•s balance sheet with that of the Federal Reserve System or the Bank of England, the latter are very lean, they do not have the same volume of assets. You have to make the comparison in terms of the additional risks caused by the two LTROs. You have to compare the ratio of monetary policy instruments to GDP in the three different areas of the worldŽ.

2. The Eurosystem is the monetary authority of the euro area, comprising the European Central Bank and the central banks of countries using the euro.

Figure 4: Assets held by the Federal Reserve, 2007-12 (% 2007 GDP)

Figure 5: Assets held by the Bank of England, 2007-12 (% 2007 GDP)

Figure 6: Assets held by the Eurosystem, 2007-12 (% 2007 GDP)

Source for Figure 4, 5 and 6: Bruegel based on Fed Cleveland and FRB Factors (reserves balances); Bank of England; ECB.

€ In both the US and the UK, the surge of repo lending to financial institutions was short-lived. It took place in response to the disruption of the interbank market following the Lehman shock and was unwound during 2009. By the beginning of 2010 it had either disappeared entirely (Fed) or been reduced to traditional proportions (Bank of England), and did not resume afterward. In the case of the ECB, however, there were repeated spikes of repo lending, with a resumption on a massive scale in December 2011;

€ In the US and the UK, government bonds purchased within the framework of credit easing or quantitative easing programmes largely substituted repo operations from 2009 onwards. At the end of February 2012, these assets accounted for 103 percent of the increase in the overall size of the Fed balance sheet since February 2007, and 116 percent in the UK. In the euro area, however, the bulk of the increase took the form of repos operations. These accounted for 64 percent of the increase in the size of the balance sheet between February 2007 and February 2012, against 20 percent for government bonds.

€ Other categories of assets represent a relatively minor part of all three balance sheets. Swaps and dollar liquidity provision represented a temporarily significant part only in 2008-09. Non-government securities were significant only for the Fed and only for a very short period.

€ On the whole, what this comparison indicates is that by early 2012 all three central banks had increased the size of their balance sheets by roughly comparable amounts, but that the balance sheet compositions were entirely different. Purchases of government bonds accounted overwhelmingly for the increase in the US and the UK. Liquidity provision to the banking system accounted for the largest part of the increase in the euro area.

By itself this difference is however not necessarily indicative of a difference in the monetary stance. One interpretation of it is that at end-2011, the ECB faced severe dysfunction in the banking system and had no choice but to again

4.2 Impact on banks

The LTRO has at least temporarily solved the acute funding needs of euro-area banks by providing abundant liquidity at low rates with lower collateral standards. It has not, however, fundamentally altered the underlying problems of weak banks. One way of assessing this is to look at the stock market value of the banks. If the LTRO has increased the solvency of banks, their stock prices should have increased too. In principle, the low-cost three-year loans offered by the ECB should be seen by market operators as helpful for restoring the soundness of the banking system and thereby boosting bank stocks.

Angeloni and Wolff (2012) look at the normalised average bank stock-market index (consisting of the banks located in a given country) since January 2011. The sample consists of those banks stress-tested in the European Banking Authority's (EBA) recent stress tests. A clear pattern of the effects of the ECB•s LTRO cannot be discerned. Shares have continued to move sideways since October and seem unaffected by the ECB•s operations. This result suggests that the ECB helped ensure the funding of banks but did not address bank solvency concerns. ECB action has contributed to the financial system•s stability, but has not helped bank shareholders.

Figure 10: Banks' stock market price indexes

Source: Datastream. Note: Stock market index normalised to 100 for January 2011.

4.3 Pass-through to the real economy

The LTRO has clearly helped to improve the funding conditions of banks. At the same time, the huge increase in the deposit facility suggests that banks still hoard a lot of liquidity at the ECB, even though this means incurring losses for the banking system as a whole (liquidity received through the LTRO costs 1 percent while the deposit facility only offers 0.25 percent). Confidence has therefore not yet returned to the euro-area banking market. Is there any evidence that the LTRO has led to an expansion of credit growth to the euro-area corporate and household sectors?

Growth of credit to non-financial corporations and to households continues to be very weak and is falling in the euro area as a whole (Figure 11). Figure 11 does not suggest that there is yet a change in the downward credit trend, with annual credit growth in February 2012 at 0.4 percent for the non-financial corporate sector and 1.2 percent for households. At the same time, the money growth in the countries that had a huge credit boom before the crisis. It is also very clearly visible that credit growth rebalanced during 2007-08, with countries such as Germany, which for a long time exhibited subdued credit growth, experiencing a significant pick-up in credit.

Figure 12: Bank loans to non-financial corporations, annual growth rate[2] (%)

Source: Bruegel based on EC2fJ /F1 1986 Tm 11 0 0 11 51.0232 416.6agdit growth, exba14.2(: Bru)13.9(h)8-8.8(y)0(c)14cre (f8(, e)t
0
0
0

Figure 15: Financial integration of corporate credit loans

Source for Figures 13, 14 and 15: Bruegel based on ECB, MFI interest rates. Note to Figure 13: Loans to non-financial corporations up to 1 million at floating rate and up to 1 year initial fixed rate; loans to households for house purchase at floating rate up to 1 year initial fixed rate. Note to Figure 14: 2-year backward-moving correlation coefficient of interest rates for house purchase at floating rate and up to 1 year initial rate fixed (series code 1.2.1.5.) to the euro-area rate. Note to Figure 15: 2-year backward-looking moving correlation coefficient. Loans up to 1 million at floating rate and up to 1 year initial rate fixed (series code 1.2.2.8.) to the euro-area rate.

At the same time, however, interest rate levels therefore indicates that the LTRO has had a particularly strong effect on the government-bond yields of countries with lower credit ratings. Some of the liquidity in the banking system thus appears to have been used to buy more of the gov-

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ANNEX

The ECB, the Fed and the Bank of England conduct monetary policy in different ways and pu different policies to deal with the crisis. To compare them, we reclassified the items presented i balance sheet into six macro-categories:

- € Repos: including lending to financial institutions
- € Purchase of government securities
- € Purchase of non-government securities
- € Foreign exchange swaps/foreign currency lending to banks
- € Other assets
- € Other operations, including those new schemes adopted that cannot be easily classified in another category

Source: Bank of England	BANK OF ENGLAND	
ITEM IN BALANCE SHEET	DESCRIPTION	CLAAN

CLN Kaopern€ A3137 .91373 scn /GS2 gs 282.136 516.016 1

Source: ECB	EUROPEAN CENTRAL BANK (ECB)
ITEM IN BALANCE SHEET	DESCRIPTION