

What is the nature of the liquidity problem facing banks in the euro zone?

Trends in interbank spreads and the fact that it is virtually impossible for banks to obtain loans beyond the very near term show that there is a problem of banking liquidity in the euro zone.

However, if we suppose there is only one bank in the euro zone, movements in deposits and loans as well as reserve accounts held by central banks (by the ESCB) show that this single bank is ultra-liquid (very "cash rich"), as is to be expected in an environment of robust growth in global liquidity and a switch by savers into risk-free assets. The problem, accordingly, is not an overall problem of banking liquidity but a problem resulting from the drying-up of liquidity loans between banks.

To solve this problem, the following developments would be needed:

- a rise in asset prices that would lead to growth in the shareholders' equity of banks; but their current difficulties lead them to sell assets, and this, on the contrary, drives prices further downwards. This is where a public buyer of assets could play a role;*
- a massive recapitalisation of banks that would wipe out their default risk, but the cost of capital is too high for this to happen;*
- otherwise, purely bilateral financing between the ECB and banks; it would be more efficient if the spread between the repo rate and the "marginal lending facility" rate were to be noticeably reduced, as in the United States.*

Strains on the interbank rate

Movements in the 3-month interbank spread (**Chart 1**) reflect the magnitude of strains currently weighing on interbank market. Banks are struggling to find liquidity beyond extremely short horizons, despite the ECB's injections of liquidity. This situation seems hard to understand from a macroeconomic point of view as global liquidity is growing at a very rapid pace and the monetary base (liquidity created by the ECB) of the euro zone is increasingly quite rapidly (**Chart 2**).

Chart 1
Euro zone: 3-month interbank/swaps yield spread

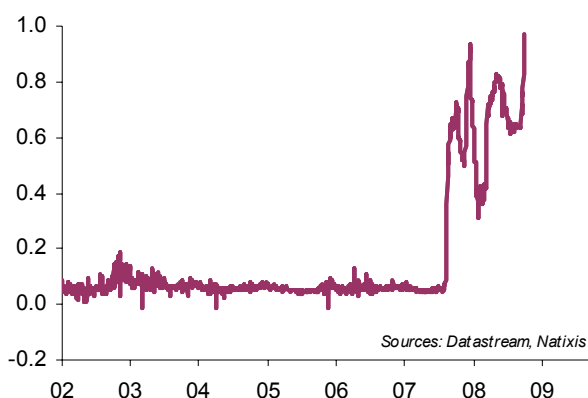
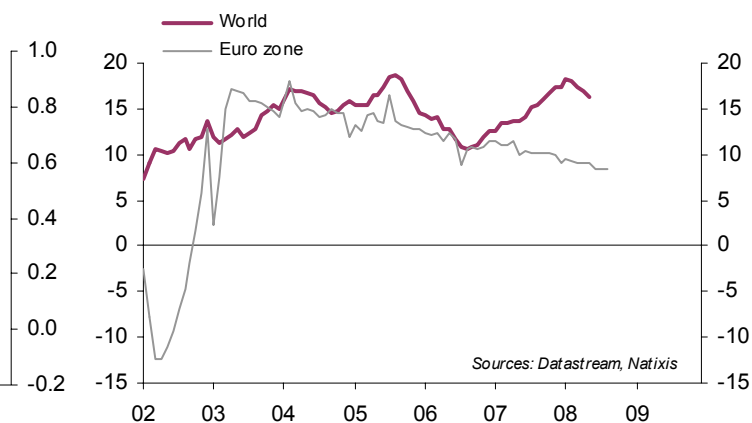


Chart 2
Monetary base (in local currency, Y/Y as %)



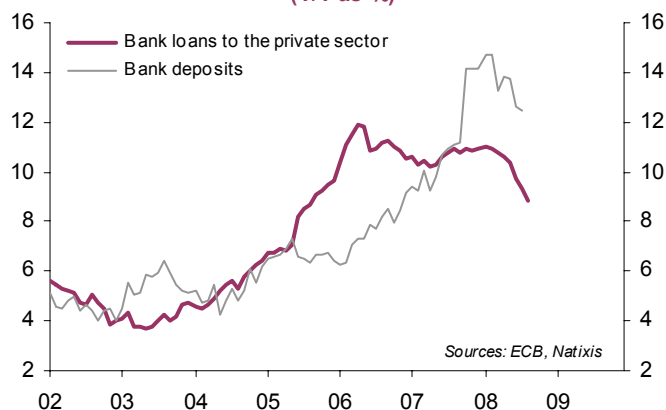
In fact, a distinction needs to be drawn between the situation of certain banks and the situation of banks as a whole.

Let us suppose there is only one bank in the euro zone

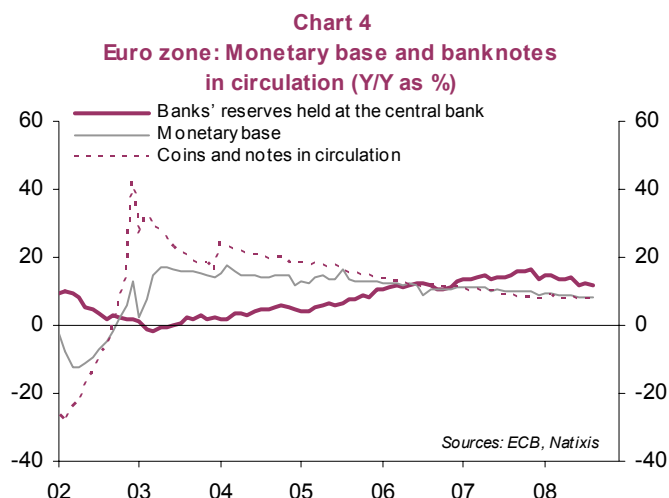
This bank supposed to be the only one in the euro zone would be characterised by:

- because of the rise in risk aversion that leads to savers switching into liquid and risk-free assets, and due to the slowdown in credit, **a faster increase in deposits than in loans since mid-2007 (Chart 3).**

Chart 3
Euro zone: Bank loans and deposits (Y/Y as %)



- and this would lead to an improvement in the situation with respect to liquidity of this supposedly single bank, as would be reflected by the rapid growth in its reserve accounts held at the central bank (**Chart 4**).



- until the financial crisis broke out, the situation was different: from 2005 to the summer of 2007, loans had outpaced deposits (**Chart 3**). **Chart 5** shows that since mid-2007, the ratio between deposits and total balance sheet has risen.

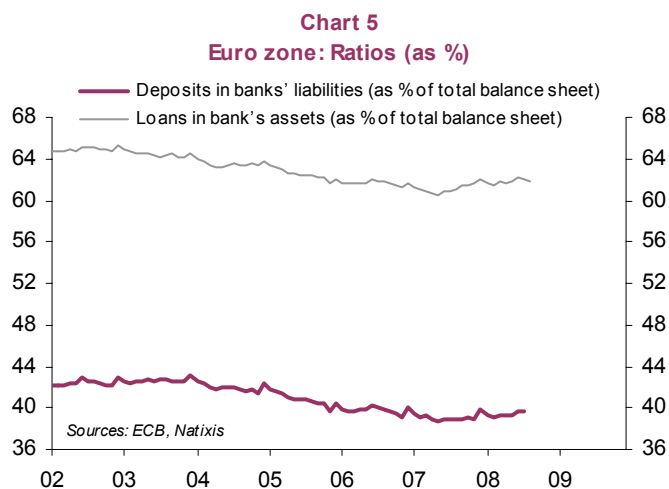


Chart 6 shows that the previous growth in loans had been financed by bond issuances (defined in a broad sense: senior debt, ABS, covered bonds).

However the cost of monetary funding (cf. **Chart 1** above) and the issuance cost of senior debt (**Chart 7**) have climbed to a very high level. However, the single bank of the euro zone could continue to fund itself with deposits.

Chart 6
Euro zone: Net bond issuance, issuance of money-market instruments and equities by banks (as % of GDP)

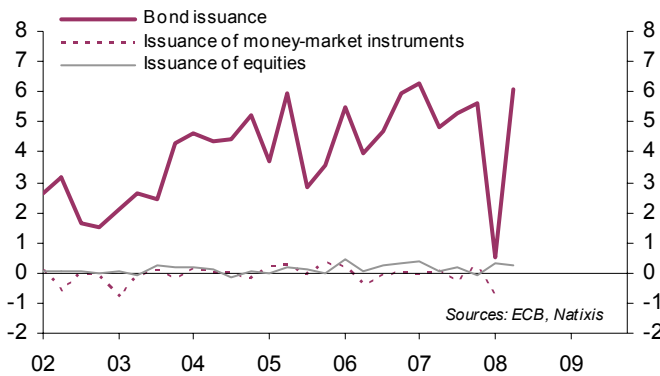
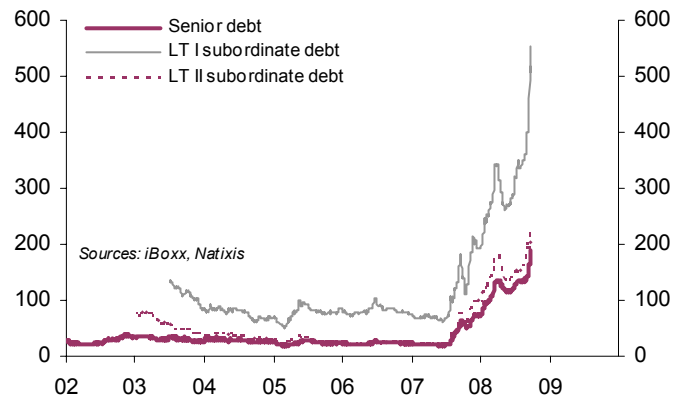


Chart 7
Euro zone: Spreads on banks'



In view of the foregoing, how can the liquidity problem be solved?

The problem of banking liquidity in the euro zone therefore is not an aggregate problem of liquidity affecting the entire banking sector, since if there were just one bank it would be over-liquid, but a problem arising from a lack of liquidity loans between banks, flowing from banks with excessive liquidity to those where liquidity is insufficient.

By consequence, three solutions seem realistic:

1. a rise in asset prices, which are now abnormally low in comparison with fundamentals (e.g. equities given growth in earnings of listed companies, **Charts 8A and B**; in comparison with the actual corporate default risk **Chart 8C**; MBS in comparison with the default risk of borrowers having taken out mortgages, **Chart 9**), which would enable banks to rebuild their equity.

Chart 8A
Euro zone: Eurostoxx index (Q1 2002 = 100)

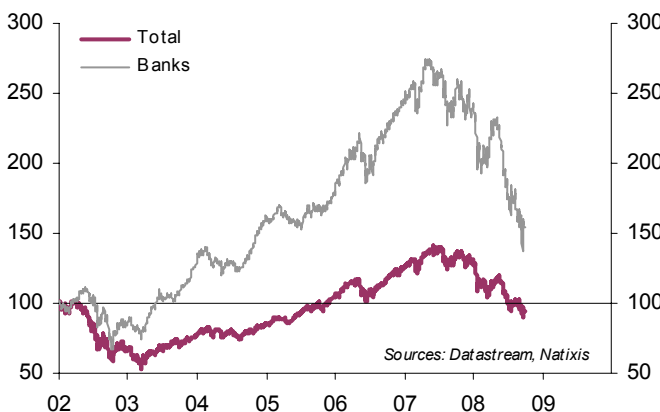
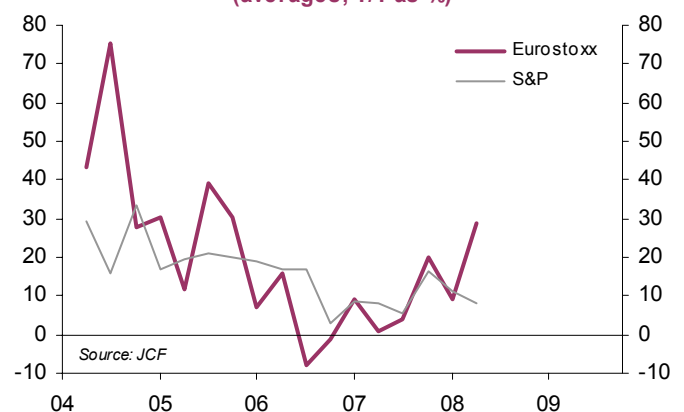
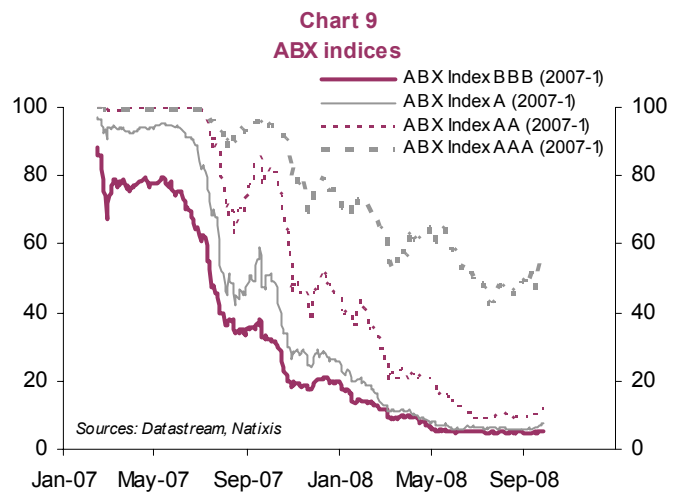
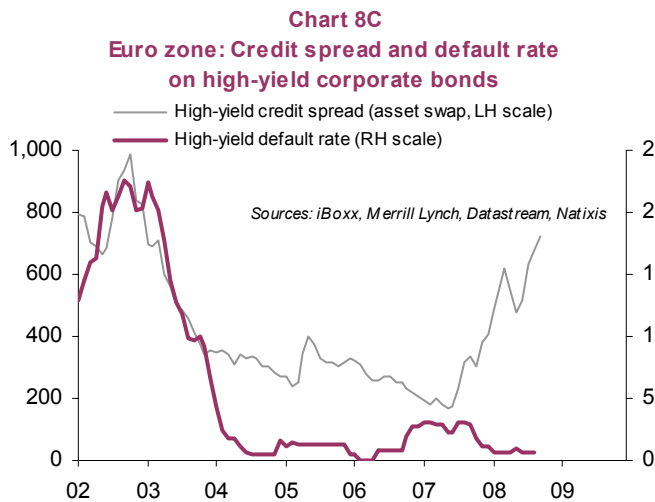


Chart 8B
EPS growth ex financial companies (averages, Y/Y as %)





However, **a spontaneous rally in asset prices is unlikely**: the liquidity problem facing banks, the high level of risk aversion, forced sales for some funds, etc., lead to a lack of demand for risky assets and a further decline in their prices.

This is where government can intervene: purchases of assets by governments or by public investors can trigger an upward spiral in prices.

2. **banks could significantly increase their capital to reduce their credit risk noticeably**, and this would kick-start the interbank market. Since the start of the crisis, **banks have increased their capital by a lower amount than their asset write-downs**, leading to a rise in their credit risk (Table 1).

Table 1
Asset write-downs and capital increases carried out by banks

In USD bn	Total		Q3-08 (at 25/08/08)		Q2-08		Q1-08		Q4-07	
	Write-downs	Increases	Write-downs	Increases	Write-downs	Increases	Write-downs	Increases	Write-downs	Increases
America	263.3	194.5	18.2	52.7	70.3	71	69.3	59.9	75.5	29.8
Europe	234.6	162.4	0.7	27.4	41.5	84.5	89.7	23.8	87.2	17.2

Q3-07		Before Q3-07	
Write-downs	Increases	Write-downs	Increases
28	0.8	0.7	0
15.9	10.6	2.8	5

Sources: Bloomberg and companies

However, this solution hardly seems realistic, given the very high cost of capital raised in shares (Chart 8A) or in subordinated debt (Chart 7).

3. the ECB could make loans to banks on a bilateral basis: the interbank market would then be replaced by direct funding of banks by the ECB. To ensure the cost is reasonable, it would then be efficient if the ECB, just like the Federal Reserve did, were to cut the marginal lending facility rate (currently 100 basis points above the repo rate); if it were only 25 basis points above the repo, interbank spreads would be squeezed by the same proportion. Why penalise the discount window if it is becoming the normal financing tool of banks?

Conclusion: The usual practices of central banks have become inefficient

If there were just one bank in the euro zone, it would be "cash rich", and there would not be any banking liquidity crisis. By consequence, it results from the drying-up of liquidity loans between banks.

Since banks in the euro zone no longer trust one another, the only solutions are:

- either that **governments (or public investors) help improve banks' creditworthiness**, for instance by driving upwards the prices of assets held by banks (the very core of the " Paulson plan ");
- or the ECB **should change its stance to granting systematically bilateral loans to banks** (systematically using the "marginal lending facility", i.e. the discount window), and this would require **reducing the cost of the discount window** (it is currently 100 basis points higher than the repo rate).