



Renewed Eurozone Concern as Liquidity Injections Don't Solve Solvency Woes

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Executive Summary

Standish Global Macro Strategist Tom Higgins worries that Europe's debt problems could again rile markets, as investors recognize that the European Central Bank's (ECB) long-term refinancing operation (LTRO), a much welcomed source of financing for European banks, is doing nothing to address the region's underlying solvency problems. Resolving those problems through monetary policy is complicated by the large disparities in economic growth and inflation across the eurozone's economies, rendering both loosening and tightening inappropriate for certain parts of the region. As a result, Standish remains cautious about the European economic outlook and fears that renewed uncertainty over Europe's fiscal stability could lead to another bout of global financial market volatility.

"What counts in making a happy marriage is not so much how compatible you are, but how you deal with incompatibility."

— Leo Tolstoy

Is the LTRO Honeymoon Ending?

The eurozone appeared to be on firmer footing at the beginning of 2012 as investors expressed relief that systemic risk in banking system had been reduced by the ECB's LTRO program. After a long hiatus in the second half of last year, European banks were able to issue roughly €100 billion in unsecured debt during the first three months of 2012.¹ Moreover, sovereign spreads in Spain, Italy and Portugal tightened versus German bunds even as Greece was forced to restructure its debt.²

However, the LTRO honeymoon may be ending as investors realize that the flood of liquidity does nothing to address the underlying solvency problems facing the sovereigns or the banking system. Most of the recent pressure has been on Spain where 10-year bond yields are trading back above the levels they were at when the ECB first announced the LTRO back in December.³ In some ways, the LTRO may be aggravating Europe's problems by encouraging peripheral European banks to buy more sovereign debt and postpone the necessary deleveraging of their balance sheets.



¹ Bloomberg, March 31, 2012.

² *Ibid.*

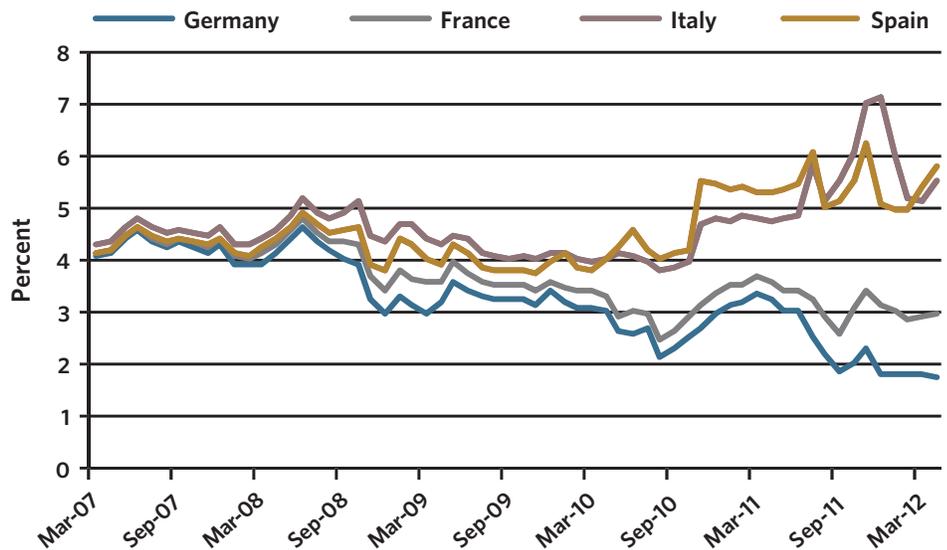
³ *Ibid.*

It is easy to imagine a scenario in which sovereign spreads in Spain and Italy continue to widen, placing bank balance sheets in a precarious position, given significant cross holdings of government debt across the eurozone.

Some have argued that the ECB would quickly step in with a third round of the LTRO before the situation deteriorated to that point. Yet large disparities in economic growth and inflation expectations between eurozone economies may complicate the ECB's ability to act, should bank funding pressures reemerge. Monetary policy is too loose for Germany and too tight for just about every other country in Europe. Therefore, we remain cautious on the European economic outlook and we worry that this could spill over into another bout of global financial market volatility.

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Spain and Italy Under Pressure Again (European Sovereign 10-Year Bond Yields)



Source: Bloomberg, as of March 30, 2012.

European Central Bank in a Bind

The impact of the ECB's LTRO was initially underestimated when it was launched in December 2011. Investors shrugged it off as another half measure from European policy makers. Yet within a few weeks, the power of this new tool became apparent. The LTRO provided a much-needed source of funding to European banks at a time when other sources of liquidity, including the capital markets and bank deposits, were drying up.

Between the first and second rounds of the LTRO, European banks tapped the ECB for roughly €1 trillion in three-year loans against a wide array of collateral. The Bank of International Settlements estimates that banks satisfied around 80% of their 2012-2014 funding needs.⁴ Investors became more bullish on Europe believing that the LTRO lowered the risk of bank failures while indirectly funding peripheral European governments as they worked to get their fiscal houses in order. There was even some speculation that European banks might use their new found liquidity to begin lending again to businesses and households.

⁴ Nick Vaase, Goetz von Peter, Mathias Drehmann, and Vladyslav Sushko. "European Bank Funding and Deleveraging." *BIS Quarterly Review*, March 2012, p. 3.

Given this backdrop, we worry that Europe will continue to be a source of global financial market volatility in the coming months.

However, these hopes were quickly dashed. Instead of lending, banks in Spain and Italy have been either using the lower cost of funding at the LTRO to retire higher cost existing debt or for purchases of their own sovereign debt as part of a carry trade. The latter option may explain why Spanish and Italian yields dropped following the first two rounds of LTRO before reversing more recently. Investor confidence began to wane after the Spanish government unilaterally announced that it would not meet its deficit targets in 2012. Spain and other debt-laden economies in peripheral Europe appear to us to be trapped in a negative feedback loop in which domestic recessions push down government tax revenues, leading to demands for more fiscal austerity, and thus further economic weakness.

In order to break this vicious cycle, we believe the peripheral economies need to find a way to stimulate economic activity. But with the fiscal tap shut off, monetary policy is the only option. Unfortunately, the ECB is in a bind, given the wide disparities in economic growth and inflation expectations across the eurozone. At the extremes, Spain has a record high unemployment rate of 23.6% as of February 2012 compared to record low unemployment of 5.7% in Germany.⁵ Rather than looking for ways to stimulate activity in the peripheral economies, the German representative on the ECB's Governing Council, Jens Weidmann, is already discussing ECB exit strategies. Indeed, during a Bundesbank press conference in mid-March, Weidmann asserted, "All council members are aware that non-standard measures create risks and have to be unwound."⁶

Risk of Further Financial Market Volatility

Given this backdrop, we worry that Europe will continue to be a source of global financial market volatility in the coming months. Although we believe the ECB will step in with a third round of the LTRO if strains resurface in bank funding markets, the bank's track record suggests it will be reactive rather than proactive due to the opposing viewpoints on the Governing Council. This implies that sovereign spreads in Spain and Italy might have to approach the previous highs before the ECB feels compelled to act. We expect this to be accompanied by a deterioration in European credit and a weaker euro.

Even with another round of the LTRO, it is becoming clear that European leaders need to lay out a plan for addressing the structural flaws in the common currency and the need for a true pan-European euro bond issuance program. This would entail lifting restrictions on the free flow of capital and labor across borders, harmonizing tax and entitlement programs, and developing a true pan-European budget that allows for transfer payments from stronger to weaker regions in the currency area. It would take years to implement such measures, but investors would likely take comfort that Europe was working toward a common goal. Perhaps most importantly of all, for the euro to be successful, citizens and government leaders across Europe will have to stop putting their national interests before the needs of the eurozone as a whole.

⁵ Eurostat as of March 2012.

⁶ Jana Radow and Simone Meier, "Weidmann Says He's Not 'Discouraged or Isolated' on ECB Council," *Businessweek*, March 13, 2012.

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