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Nicolas Doisy, Senior Economist and Strategist at CA Chevreux

“The ECB cannot resolve the fundamental problem, namely the quality of banks’ balance sheets”

(Translated by Crédit Agricole CIB)

Interview by Sophie Rolland

Unmoved by the euro zone Stabilisation Fund and budgetary austerity commitments, the euro zone’s markets still have their doubts. In one sign of this generalised distrust, the euro remained below the \$1.20 threshold yesterday. Against the Swiss franc, which has traditionally played the role of safe haven currency, the euro even fell to a new low of CHF 1.3746. German Treasuries, yet another safe haven, also reached new highs, as 10-year rates (which trend inversely to prices) reached a historical low of 2.50%. In this environment, European banks prefer to deposit their liquidity with the ECB than to lend amongst themselves. Since 27 May, €300 billion or more has been deposited with the central bank. On Monday evening, these deposits reached a new record level of €362 billion. For an explanation, we turn to Nicolas Doisy, a Senior Economist and Strategist with CA Chevreux.

Banks are depositing increasingly large sums with the ECB. In what way is this trend cause for concern?

At present, banks with surplus liquidity are refusing to lend to those in need of cash because they have doubts as regards the health of the counterparty banks’ balance sheets. This situation is potentially dangerous because the interbank market is in fact the wholesale money market and, ultimately, the credit market. When it becomes clogged, all of the economy’s financial circuits can break down. That is not yet the case. The European Central Bank has taken the necessary measures by intervening at the centre and ensuring that banks can always find a counterparty, thereby preventing the situation from deteriorating.

Is this situation very different from the one that existed following the Lehman Brothers bankruptcy?

Yes, since even though there is extreme mistrust directed towards European financial institutions, the ECB knows what steps are needed to prevent banks from experiencing a liquidity shortfall and it has the necessary tools at its disposal. In late 2008, the markets had serious doubts about the US economy and, in particular, its financial system. In 2010, the first signs of a recovery are present. Now, aside from the budgetary austerity and structural reform programmes, the main questions have to do with the health of the European banks and the capacity of the governments in the euro zone to provide incentives for them to restructure.

European banks are under pressure on the stock markets. Are they as fragile as the markets seem to think?

Clearly if the central bank had not intervened, some banks would probably have experienced major difficulties or even faced bankruptcy in recent weeks. The problem is that after everyone thought that the worst had been avoided in late 2008 and during the course of 2009, just about everyone in the euro zone relaxed and assumed that the situation would stabilise spontaneously. The Irish were the only ones who moved quickly to restructure their banking sector. In Spain, however, these efforts were marked by extensive flip-flopping, and the result is apparent today. According to the ECB, European banks may need to set aside €95 billion in reserves by end-2011, and no one knows exactly where the problems are located.

What can the ECB do to resolve the situation?

Lowering rates further would not serve any purpose, since we are dealing first and foremost with a crisis of confidence. Such a move could even prove to be counterproductive, if it were perceived as an improvised measure. The ECB cannot resolve the fundamental problem, namely the quality of banks' balance sheets. However, it will undoubtedly concentrate on so-called unconventional measures. In March, it already agreed to extend the liquidity facilities to one week and one month, contrary to its initial announcement. In May, along with the announcement of public-sector debt purchases, it reactivated its 3- and 6-month lending facilities.

Banks are also having trouble obtaining medium- and long-term refinancing in the markets. Is there a risk of a credit crunch in the euro zone?

A credit crunch – a situation in which credit to the economy, and the private sector in particular, contracts as a result of rationing by lenders – is indeed a possibility in the light of recent events. Banks may become even more reluctant to lend than they have been in recent months.