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Why Frankfurt is the new frontline in the Eurozone crisis

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Summary

- Last week saw a further terse exchange between the European Central Bank and the German Bundesbank over the massive €1000bn expansion of the ECB's balance through its Long Term Refinancing Operations (LTROs).
- This has been facilitated through a relaxation of collateral standards and a long extension of loan maturities from a few weeks to up to three years. Most of this money has flowed into the weak banks of the Eurozone periphery states. This has proven a valuable short term fix for the Eurozone, but the long term risks are clear enough.
- The Bundesbank's concern at this is part conventional bankerly prudence and part politics, and important for both reasons. Its own exposure to ECB lending is obviously relevant. Moreover, because the lending in question is partly designed indirectly to fund sovereigns through Eurozone banks, the Bundesbank sees it as stretching the political mandates of both institutions to the limit.
- The tensions in Frankfurt are a symptom of the bigger political problems of the Eurozone. The ECB is storing up large amounts of debt to keep the Eurozone going, and implicitly raising the question of who is ultimately responsible for that debt. Frankfurt's real problem is that the Eurozone does not yet have a political answer to that question.

Last week saw another shot across the bows of the European Central Bank by the German Bundesbank, warning that the Eurozone monetary authority now needs to set out an exit strategy for its massive emergency liquidity operations in the Eurozone. Bundesbank President Jens Weidmann told his monthly press conference in Frankfurt that central bank liquidity operations were now pushing monetary institutions to the limits of their mandates.

Weidmann chose his wording carefully, implying both a looming crisis of "democratic accountability", but also a deepening clash with what he called the Bundesbank's "particular values". Behind these complaints is a dramatic transformation of the balance sheets of both the ECB and the Bundesbank that has changed the trajectory of the Eurozone crisis, but has provoked deep anxiety in Germany and elsewhere for both practical and political reasons.

The tension between the two big Frankfurt-based institutions is a symptom of the Eurozone's bigger political problem. Weidmann's balance sheet testifies to the fact that whatever Eurozone leaders might or might not have agreed in Brussels, the ECB is putting taxpayers' money on the line to keep the Eurozone afloat. In effect, it is bailing out the politicians who cannot openly address the question of Eurozone collective debt liability. This Global Counsel Insight note looks at the fraying nerves in Frankfurt and asks what they tell us about the bigger underlying political problems of the Eurozone.

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Frankfurt becomes the frontline

In three years the ECB has gone from being a relative backwater in European institutional terms to the epicentre of the Eurozone's response to the banking and sovereign debt crises. Starting with Jean-Claude Trichet's decision to purchase Eurozone sovereign debt on secondary markets after 2008 in an attempt to head off a liquidity crisis for Spain and Italy, the ECB has been putting its balance sheet in the way of the advancing Eurozone crisis.

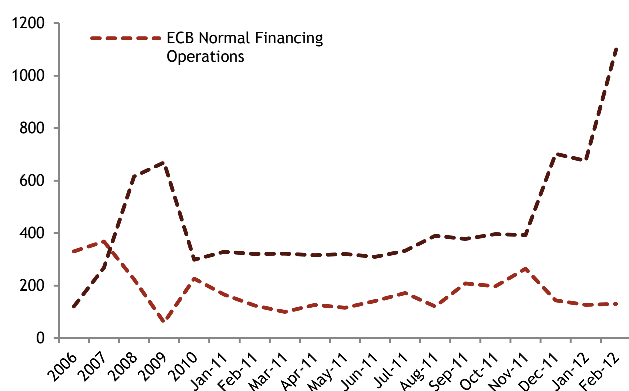

Chart 1: Expansion of ECB balance sheet through financing operations 2006-2012 (€bn)

Source: ECB 2012.

Trichet's successor, Mario Draghi, may have begun to unwind indirect liquidity support for Eurozone sovereigns on secondary markets, but in its place he has overseen an even larger expansion of the ECB balance sheet to provide direct liquidity support to European banks. Two large waves of Long Term Refinancing Operations (LTROs) have lent cheap capital to any European bank requesting it for up to three years, subject to collateral. However, these collateral requirements have also been loosened to facilitate access to the discount window. More than €700bn has been borrowed since last November (Chart 1).

The LTROs were motivated chiefly by the fear that the European banking system was freezing up, much as it did in 2008. Wholesale markets for both dollars and euros had begun to contract as participants began to worry about the underlying quality of the balance sheets of European banks, many of whom were carrying large amounts of European sovereign debt. With around €750bn in European bank debt needing to be rolled over in 2012 - €250bn in the first quarter alone - the ECBs response was to flood the market with cheap finance. By extending the maturity of loans from a few weeks to up to three years, the ECB has granted weaker parts of the European banking system a multi-year absence from the capital markets.

Around two thirds of the new funding has gone to banks in the periphery states: Santander, BFA, CASA and BBVA have all been big borrowers in Spain, taking more than €130bn between them. BCP, Intesa, Unicredit and Bank of Ireland have also tapped the window. But BNP Paribas, SocGen, Commerzbank and Deutsche Bank have all borrowed €15bn or more. What banks will do with this cash will depend on their funding situation. The fact that some €350bn of LTRO borrowing after February this year appears to have been immediately re-deposited with the ECB suggests many of them are still figuring out what to do with their borrowing.

Optimists argue that the LTROs have bought the Eurozone some time by removing the threat of a liquidity crisis in the banking system of the periphery states. The ECB calculates that a significant chunk of this money will end up reinvested in sovereign debt, or that banks will buy sovereign debt to use as collateral to get it. Sharply falling yields for Spanish and Italian debt suggest that both of these things have happened. Nevertheless, both Trichet and Draghi's strategies have been controversial even inside the ECB itself.

Critics of the LTROs fear that long term liquidity lines are as likely to be providing cheap capital for carry trades or simply shielding weak banks from a need to recognize losses and deleverage. By reducing bank dependence on capital markets it is also contracting the huge market for bank debt relied on by many institutional investors. By deepening the exposure of weaker Eurozone banks to their governments it has lashed the Eurozone's banks and their sovereigns even tighter together. Cheap capital of this kind is likely to be addictive,

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and the Bundesbank in particular is concerned by the question of how to wean banks off it.

Germany's growing pile of Eurozone IOUs

But the LTROs have also flagged up something else fundamental about the Eurozone. ECB support through national central banks has now replaced much of the stalling market for cross border interbank funding. Whereas before the banking crisis these cross-border flows were tucked away on private balance sheets, they are now showing up on the public ledger of the clearing house system that moves euros between Eurozone central banks – the 'TARGET2' balances of the Eurosystem. The resulting picture is a striking demonstration of the level of external imbalance between Germany and the periphery Eurozone states.

Why this happens is as follows. When central bank funds are moved between Eurozone countries they are recorded by the ECB as debits and credits against the sending and receiving central banks. The central banks of Spain, Italy, Portugal, Greece and Ireland have accumulated some €750bn in debits since 2008 as capital borrowed from their central banks has subsequently moved abroad within the Eurozone. The Bundesbank in contrast has stacked up around €500bn in credits, which appear on its balance sheet as 'claims' on the Eurosystem. These credits to the Eurosystem now account for more than half the Bundesbank's massively expanded balance sheet (Chart 2).

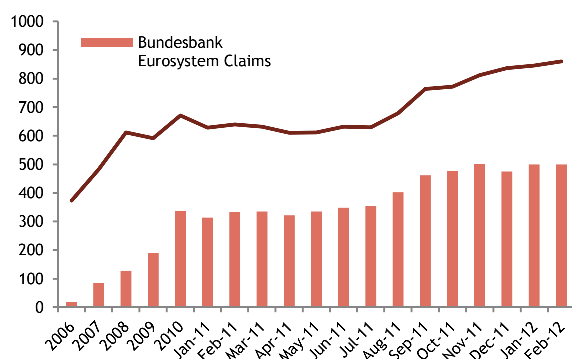

Chart 2: Bundesbank balance sheet and claims on the Eurosystem 2006-2012 (€bn)

Source: Bundesbank 2012.

Although this has been widely misunderstood, these are a necessary accounting fix rather than literal debts. Eurozone states are jointly liable for the losses of the ECB on LTROs, irrespective of their balances within the Eurosystem. Nevertheless the fact remains that the Bundesbank is potentially on the hook for Germany's 28% share of any ECB losses. The Bundesbank is nervous that the scale of its mounting pile of claims on the Eurosystem is a reflection of the abandon with which the ECB has been pumping funds into the periphery's banking sector on increasingly looser terms. The Bundesbank would not be excessively pessimistic to assume some of it will never be seen again. Indeed in the first week of March it raised its allowances for bearing losses for just this reason.

But if the Bundesbank is nervous about the LTROs largely out of old-fashioned bankerly concern about the quality of loans that are pouring out the ECB's discount window, it also has a more political anxiety. Funding the Eurozone banking system in order to fund European sovereigns with money for which the German taxpayer is ultimately liable is pretty much a fiscal transfer. It is a transfer for which the Bundesbank has no real political cover. Hence Weidmann's warning about democratic accountability.

Bailing out European politicians. For now.

Whatever the potential medium term problems implied by the LTRO, the massive expansion of ECB long term refinancing has provided a short term fix for the currency union by keeping its banking system working and funding sovereigns. Insofar as anyone has operated a big bazooka on the Eurozone crisis, it has been the ECB through these funding lines. The Bundesbank cannot stop the ECB exercising its prerogative in this way, but it will keep up the pressure for an exit strategy, not least because it knows that even within the ECB's Board there is plenty of anxiety around the direction of travel.

This points to a bigger problem for the Eurozone. Both the LTROs and the Bundesbank's rising stock

of credits against the Eurosystem are the result of political problems that have thus far proved too hard to solve. Eurozone states cannot agree how to guarantee collectively their individual access to debt on sustainable terms, so the ECB has done it for them, indirectly and at significant risk. Whatever else it might be doing, the ECB is bailing out European politicians – for now. There are few signs as yet of the politicians picking up the ball and addressing these problems more openly.

Germany will only stop piling up Eurosystem IOUs when investment returns to the Eurozone periphery and German consumers buy more of their goods. But that implies German acceptance of a measure of self-inflicted pain to balance out the competitive disparities in the monetary union, including open fiscal transfers through things like European structural policy and collective debt liability.

For as long as this remains politically off the table, the internal balances of the Eurosystem will be a reminder that cross border flows in the Eurozone are worryingly one way. Germany's Eurosystem claims on the rest of the Eurozone may be artificial debts, but they reflect a very real problem.

In building up exposure to potential losses to keep the Eurozone going the ECB simply raises again the basic question of who might – or must - end up guaranteeing or even bearing such losses. Frankfurt's real problem is that the Eurozone does not yet have a political answer to that question.

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