The ECB's liquidity: no-one will die of thirst

Ana Rubio

Diario Expansión (Spain)

Liquidity is to banks as water is to humans: essential for life. A liquidity crisis is usually symptomatic of more deep-seated problems, and in many cases leads eventually to bankruptcy.

The ECB's last liquidity auction under the targeted longer-term refinancing operations (TLTRO II) euro zone banks took €233 billion, more than twice as much as the markets had been expecting, and the number of banks participating, 474, was also surprisingly high. Does this mean Europe's banks are dying of thirst? Not at all, in a world in which excess liquidity is reaching new highs. In this case it was merely a matter of price, because this water is very cheap. If the banks grant more loans to consumers and businesses than in the past, in a period set by the central bank, the central banks could pay them up to 0.4% for the liquidity they request. Because in an environment as extraordinary as the present one, in which official interest rates are negative, it is possible for the banks to receive liquidity and be paid to do so.

Why did European banks ask for so much liquidity? In the first place, because there is no longer any stigma attached to doing so - the markets no longer assume that banks resorting to the ECB do so because they are in difficulty, as was the case during the crisis. Moreover, the markets have recently begun to think that the central bank will withdraw its monetary policies sooner than expected, which would increase the price of money. And this was the last of the four liquidity auctions announced by the ECB under its TLTRO II programme.

The big question is: what are the banks going to use this liquidity for? The money obtained in this auction make the sector's financing cheaper, whether by reducing the cost of its present liabilities, replacing dearer ones or supporting future balance sheet growth by means of new lending or the purchase of profitable assets. In any case, the fact that the amount requested was so high increases the probability that it will be used to grant new loans, demand for which is growing, since the more the banks lend, the cheaper this funding will be for them. And at a time when bank profitability is so squeezed in Europe, every little helps.

At present average European bank profitability barely exceeds 5% ROE (return on equity), way below pre-crisis levels and what the markets demand, which most banks put at between 8% and 10%. And this is a problem, because an unprofitable industry will have difficulty obtaining financing in the markets if it needs to do so, and this makes it less resilient. The ECB's policy of low interest rates has had the secondary effect of eroding banks' profits, by reducing the difference between income on assets and the cost of funding. The impact is greater in the case of the Spanish banks, a large part of whose assets is tied up in mortgage loans at variable interest rates, which are adjusted quickly to lower interest rates, and a large part of their liabilities in retail deposits, remuneration of which does not usually fall into negative territory. In this regard, the ECB's auctions may involve a significant injection for Spanish bank's results, thus removing potential problems of financial stability which worry the authorities.

However, the ECB's intention with these targeted auctions is to stimulate new lending, which is vital for the recovery of the euro zone economy and for the transmission of its monetary policy. Specifically it centred on lending to consumers and businesses, which it considered more important. Thus the large volume of liquidity taken up in this latest auction is good news for the central bank in that it makes it more likely that its objective will be achieved. Now it is up to the banks to make good use of this liquidity. There is plenty of water in the world, but that is no excuse for wasting it.