

EUROPEAN ECONOMIC PERSPECTIVES



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European Economic Perspectives

End-Year Liquidity: A Christmas Present from the ECB

Since the start of the credit crisis in August, the European Central Bank (ECB) has tried to draw a clear distinction between monetary policy operations and liquidity management. So, while it has continued to indicate a bias to raise interest rates, it has provided the banking system with additional funds to help it through the liquidity crisis. The best example of this came on Tuesday when the ECB injected a massive €349 billion at its weekly refinancing operation. This led to fears that the holes in banks' balance sheets might be worse than anticipated. However, much of the drawdown of funds by euro-area banks is likely to have been for precautionary reasons.

The first thing to note about this week's injection is that it replaced a €19 billion maturing facility. The net injection was therefore €130 billion. In addition, the ECB provided funds for 16 days rather than the normal seven days. The facility matures on January 4, suggesting that the main aim is to help banks deal with year-end liquidity problems.

There is certainly evidence that the banks have no immediate need for the extra cash. In the three days since providing the liquidity injection, the ECB has been forced to withdraw a daily average of €142 billion in overnight funds from the money market. Effectively, the central bank is providing a liquidity cushion for the next two weeks and charging an interest rate of 4.21%. If the banks do not need the cash they are able to put it back on overnight deposit at the ECB and receive a rate of 4.0%. This means banks are paying more than they are receiving for funds they may not actually need. But this is clearly regarded as necessary to guard against any liquidity shortfalls between now and year-end.

In order to provide a further insight into the funding of the euro-area banking system, it is worth looking at the total liquidity provided by the ECB. This now

stands at €475 billion, slightly higher than the €455 billion average seen since August (which, itself, is a little higher than the €432 billion average in the first half of the year).

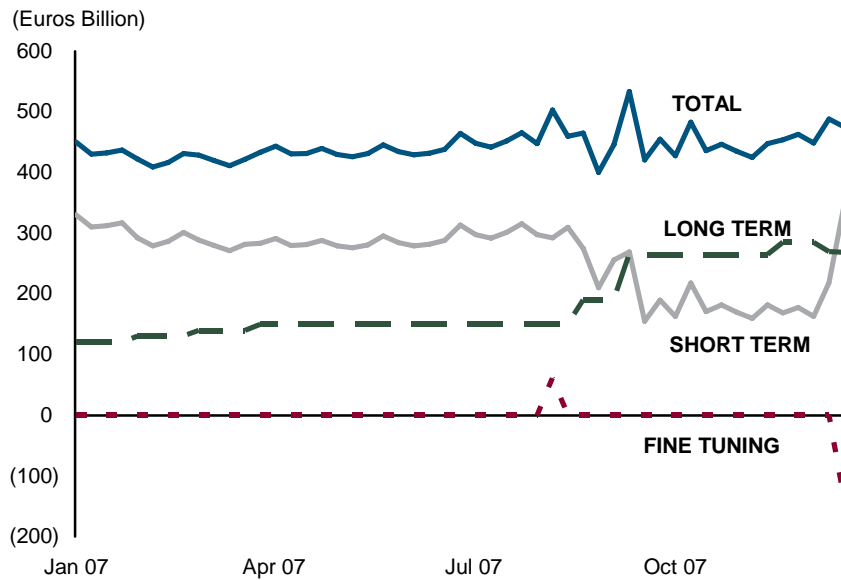
The most noteworthy aspect of the ECB's liquidity injections has been not in the total amount allocated but in the switch from short-term funding to longer-term funding. Since August, the ECB has raised its provision of three-month funds to an average €244 billion, up from €141 billion in the first half of the year (**Display 1**). However, it has offset most of this by lowering its provision of seven-day funds to an average €207 billion from €292 billion in the first half of the year. The aim has been to reduce the pressure on term rates, but this has met only limited success. While overnight money is currently trading below the 4.0% refinancing rate at 3.88%, three-month money is still trading at 4.79% (**Display 2**).

Another point to consider is the extent to which banks outside the euro area are tapping the ECB's generous allocation of end-year liquidity via their subsidiaries in the euro area. This information is not available, but there are attractions in borrowing from the ECB. Not only has it made more funds available at a lower rate than in the US or UK¹, but the ECB's collateral requirements are also relatively loose. This can be seen in **Display 3**, which lists collateral accepted by the ECB and Bank of England. Even though the Bank of England has temporarily relaxed its rules, the ECB still accepts a wider range of assets at a lower credit quality than its counterpart in the UK. In part, this reflects the need to ensure that sovereign debt issued in euro-area countries with weak credit ratings is eligible. Whatever the case, it does mean that a foreign bank that is struggling to raise funds in its own market might find the ECB an attractive proposition.

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¹ Although in a different currency and subject to exchange-rate risk

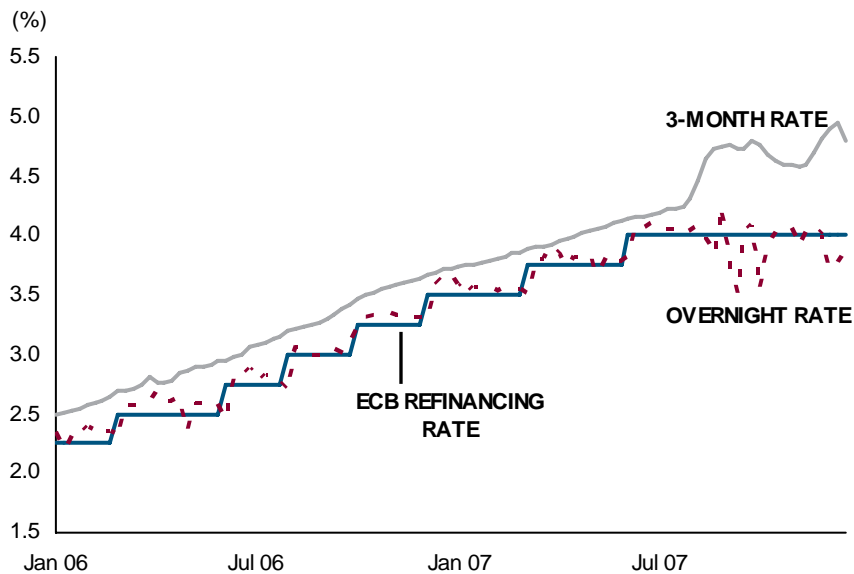
Display 1: The Maturity Structure of ECB Liquidity Injections ECB Lending to the Euro-Area Banking System



Note: Short term represents the liquidity provided at the ECB's main refinancing operation. This is normally for seven days but can vary in exceptional circumstances, such as with the recent injection of 16 day funds. Long term represents liquidity injected at the ECB's long-term refinancing operation. These funds normally have a maturity of three months.

Source: European Central Bank

Display 2: Term Money Market Rates Are Still Very High Key Euro-Area Interest Rates



Source: Bloomberg

Display 3: The ECB Accepts a Wide Range of Collateral Collateral Accepted Against Central Bank Lending to the Banking System

ECB Eligible Collateral	Bank of England Eligible Collateral
<i>Assets must meet "high credit standards", defined as a minimum credit rating of A- (S&P) or A3 (Moody's), and be denominated in euros</i>	<i>In normal market conditions, subject to a minimum credit rating of AA- (S&P) or Aa3 (Moody's):</i>
<i>Marketable assets:</i>	Gilts and Sterling Treasury bills
Sovereign and supranational debt instruments	Bank of England securities
Covered bank bonds	UK Government non-sterling marketable debt
Credit institution debt instruments	Sterling- and euro-denominated debt issued by European Economic Area central governments and central banks and supranational institutions
Corporate debt instruments	
Asset-backed securities	<i>Additional categories of collateral that the Bank will temporarily accept as a result of elevated pressures in short-term money markets:</i>
<i>Non-marketable assets:</i>	AAA-rated FHLMC, FNMC and FHLB securities
Credit claims on government, non-financial companies and international and supranational institutions	AAA-rated tranches of UK, US and European Economic Area asset-backed securities backed by credit cards
Retail mortgage-backed debt instruments	AAA-rated tranches of UK and European Economic Area residential mortgage-backed securities
	Covered bonds rated AAA
<i>Haircuts range from 0.5% to 18%</i>	<i>Haircuts vary by maturity</i>

Source: Bank of England and European Central Bank