Euro In Crisis Yet Again: Spain in Trouble. Italy is Potentially Worse. But Worry Not.

If anyone believed that the proceeds of the LTRO were meant to be spent buying bonds in the secondary market, they have misunderstood the raison d'etre of the LTRO. The ECB has made available this 1 trillion EUR so that banks may purchase new issues of their respective sovereign debt. They will not be making SME loans, or buying sovereign debt in the secondary market, or other sovereign's debt within the Eurozone. The ECB is not refinancing the banks; it is refinancing the sovereigns. Once this is understood the high cash balances of the banks with the ECB generating negative cash flow is explained.

The risk of sovereign default is therefore low, at least in the next 12 months. If the risk should rise, the ECB will find some way of helping these countries refinance themselves, either through direct bond purchases at auction or further LTROs. The foregoing is therefore academic but it may be amusing to look at the refinancing risk in the next 12 months anyway.

All eyes are on Spain and Italy. Spain's 5 year CDS spread is now 510bps, an all time high, rising from 350 bps in early February. Italy's 5 year CDS is 470bps, from 350 bps in mid March. This year, Spain will need to refinance 46 billion EUR of debt, and plans to issue 87 billion EUR of new debt. Italy on the other hand has 193 billion EUR to retire in 2012 and a planned issuance of 245 billion EUR. Which country would you worry about more?

Well don't worry. The ECB has been and will be the lender of last resort, directly or indirectly, to the European sovereigns. In many ways, this takes central banking to its roots. The world's second oldest central bank, the Bank of England was established to fund William III's military expenditure in rebuilding the Royal Navy.