The ECB’s QE2. What a Result

Mario Draghi has been a genius. And I am sure he realizes that all he has done is bought the politicians more time to sort out the fundamental issues surrounding the Eurozone crisis. In the first 3 year LTRO 489 billion EUR was allotted. In this, the second, 529 billion EUR has been allotted, apparently to a great many banks, some 800 of them.

I have written at length about the effects of the first LTRO. It recapitalizes the banks out of retained profits from their carry trades, it separates and realigns national debt by country thus reducing external debt, it encourages the banks to become the ECB’s proxies in monetizing sovereign debt thus it keeps rates low and allows sovereigns to refinance at reasonable rates. This we already know. The market reaction then was relief and thus a rally in risky assets, particularly the banks, the Euro, irrationally yet understandably, and just about anything you could shake a bid offer spread at.

What it doesn’t do is fix fundamentally inefficient economies. It just allows these economies to refinance themselves, essentially in the continuing issue of PIKs, in de facto voluntary exchanges. This can now go on until at some point when questions are asked of the fundamental soundness of the Eurozone’s member countries’ fiscal viability.

It is a risky strategy for the ECB. They are now accepting practically any collateral, subject to haircuts. One of the world’s largest and most important central banks has become a pawn shop; one charging a paltry 1% to its deadbeat debtors. If the politicians and bureaucrats do not keep up their end of the bargain in executing some fundamental reform, some of this collateral may default. Quite what the consequences are of such a default, I have not yet considered carefully. Presumably, the ECB will require further collateral to be posted. This would impair the balance sheets of the banks further and at a time when their assets, which are presumably similar to the collateral they have posted already with the ECB, are being further marked down, in what would effectively be an ECB enforced cram-down.

The first 3 year LTRO caught everyone by surprise and its implications for simply addressing money market liquidity and banking system stress was clear. Therefore risky assets rose.

This second 3 year discount window operation is less predictable. Why? People were expecting it and had sufficient time to confuse themselves. Markets have already recovered. If the first one worked a treat, why did 800 banks queue at the window hats in hand with their bric-a-brac? Was a big number good? Was a small number good? (The market was expecting 500 – 1000 billion EUR, they got 529 billlion.) What will these banks do with the money? This is the trillion EUR question. What could the banks possibly do with the money?

1. Well lets see. If they deposit it with the ECB this is a clear sign of problems in the banking system beyond the current expectations of man and regulator. This would be a negative carry position since they would pay 1% and collect 25 basis points. This is a clear danger sign.
2. They could lend it out to the private sector. Yeah right. Any economist expecting this should be given an umbrella, a colorful tie and made to predict the weather on national TV. They would have better luck. Basel 3 pretty much ensures that no self-serving, error-fearing, creatively challenged bank CFO or CEO would ever do that.
3. Lend it to your sovereign. That's what they did before and look where it got them. Yet this is capital efficient, most sovereigns, even downgraded ones still issue securities that attract no capital encumbrances under Basel 3. Which really is an indictment of Basel 3 and not the hapless banks. It's the carry trade all over again. And its doubling down. If the sovereign folds, its all over anyway. But there is an advantage as well. If the Euro breaks, at least assets and liabilities will be denominated in the same sea-shells and lollipops.
4. You could give it to the prop desk to try their luck at the tables, but wait, the Volcker Rule says this is a very very naughty thing to do and by the way the traders have all fled and joined or set up their own hedge funds.
5. Or, you could invest it in hedge funds and private equity. But Basel 3 says that that too is very very naughty and as a result you'd have to provide a lump of capital equal to 4 times the investmen
t in said hedge funds. You might make some money but there is that hefty

capital charge. But wait, there is one hedge fund you could invest with which bears a zero capital charge. And which one is that? Why the ECB of course, but that trade will earn you, let see, 0.25% – 1.00% = -0.75%. Its cheaper than paying XYZ Capital Partners 2 and 20 in fees, and it does guarantee you a return. A guaranteed loss of 0.75%.