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FOCUS NOTES

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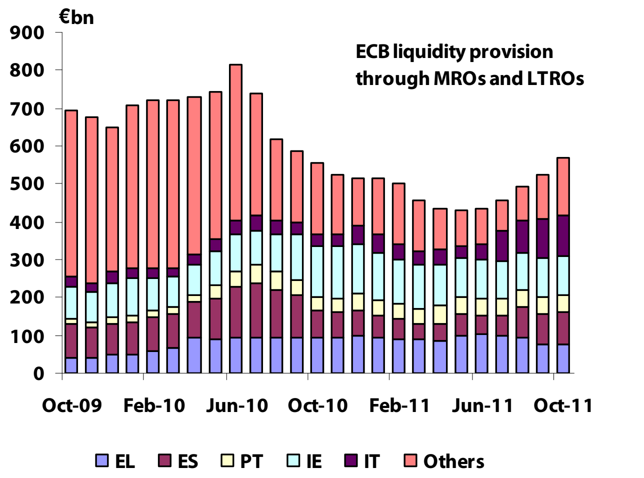
Euro Area: Bank strains pose downside risks to the euro area economic outlook.

- Bank funding pressures have intensified as downside risks concerning the debt crisis have materialized. The ECB has taken a bold course of action to assuage the liquidity risks in the banking sector.
- Increases in bank lending rates to firms have been more pronounced in the debt burdened countries, thus underscoring the negative feedback loop between the sovereign debt strains and the banking sector.
- The subprime crisis and the sovereign debt crisis have revealed the vulnerability of banks due to their exposure to the excesses of the economy and to government paper holdings. This seems to have led to a higher degree of divergence in lending rates among the euro area members than what was observed during the "Great Moderation" period, when banks enjoyed easy access to funding.
- Adequate lending to the real economy is essential, given that European firms rely heavily on bank lending. Although there are no signs of a substantial drop in lending volumes, risks are to the downside due to the lingering debt crisis.

Stress in the euro area banking sector has taken a turn for the worse since late summer, as downside risks regarding the debt crisis have materialized. Cumbersome policymakers' actions have failed to contain the sovereign debt crisis, which has now spread to more systemic member countries, most notably Italy. As a result, markets have become increasingly nervous about the financial sector in large part due to banks' exposure to periphery government debt. Banks' balance sheets also suffer from downbeat expectations about the economic outlook, most notably in countries with particular weaknesses, such as Spain and Italy due to the burst of the real estate bubble. Rising CDS spreads and the widening of the Euribor-OIS spread to the highest level since the financial crisis in 2009 illustrate the pricing of higher level of risk by inter-bank lending markets.

The scarcity of market funding has left the ECB as the lender of last resort for banks. Banks from the periphery have taken up most of the liquidity offered, whereas banks in core countries seem to be enjoying easier access to money markets as is implied by the reduction of their dependence on the ECB for liquidity (Figure 1). The ECB has recently adopted a series of bold measures to address the building of tensions in the financial markets, in contrast to its fierce unwillingness to acquire a more active role in the stabilization of the sovereign debt markets. These measures include i) full reversal of the monetary tightening cycle by cutting the refi rate down to 1%, ii) reactivation of the covered bond purchase program (worth to €40bn), iii) provision of cheaper USD liquidity in conjunction with other major central banks, iv) the introduction of two 3-year long operations with full allotment, v) softening of the collateral rules to support take up of liquidity in the 3-year operations and vi) reduction of the margin requirement for 2% to 1%. The aforementioned measures constitute a

Figure 1

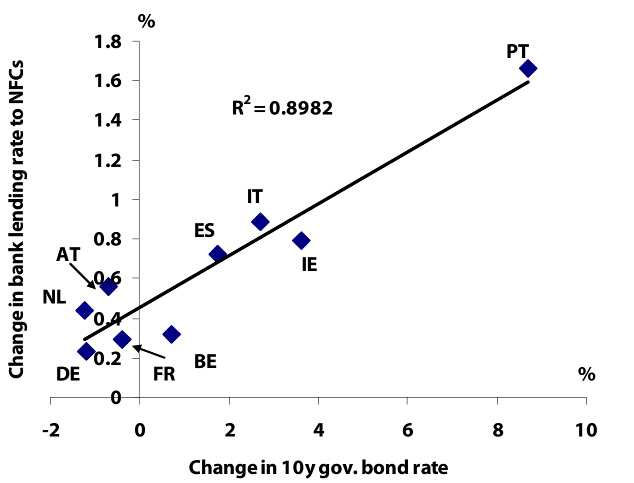


Source: Bloomberg

bold course of action to assuage the liquidity risks plaguing the financial sector, facilitating banks to meet their refinancing needs and to avoid aggressive deleveraging.

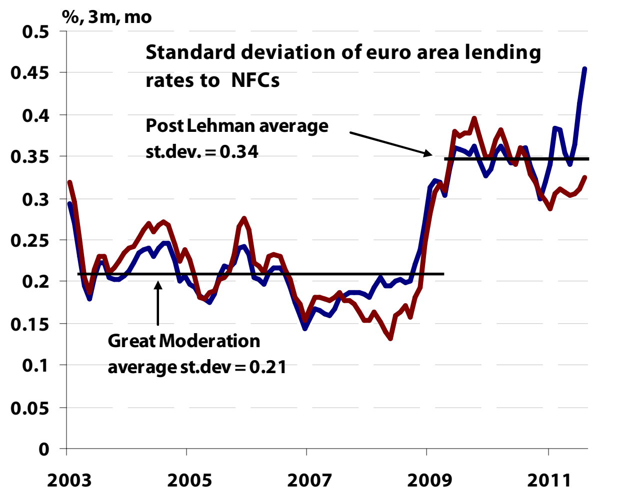
Rising funding costs for banks due to the lingering sovereign crisis lead to tighter credit conditions mainly in two ways: less credit to the real economy and higher borrowing costs for households and corporations. Figure 2 illustrates the impact of the sovereign crisis to the borrowing costs. The increase in lending rates to non-financial corporations since the onset of the sovereign crisis in mid-2010 has been more pronounced in the weakest countries of the periphery, whereas it is more modest in the core countries which enjoy sounder fiscal fundamentals. Restrained liquidity to the real economy hinders consumption and firms' investment plans, posing a downside risk to the euro area economic outlook. It therefore raises the risk of fiscal slippages, which then governments need to address with additional austerity measures. As a result, a negative feedback

Figure 2



Source: ECB, Bloomberg

Figure 3

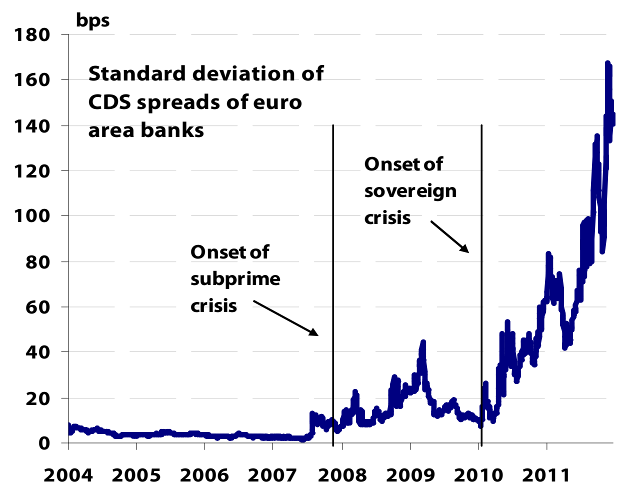


Note: The red line refers to Austria, Belgium, France, Netherlands, Germany and Finland. The blue line includes the above group plus Italy and Spain. The standard deviation averages refer to the red line.
Source: ECB

loop is created between the lingering sovereign crisis and the spillover effects in the banking sector.

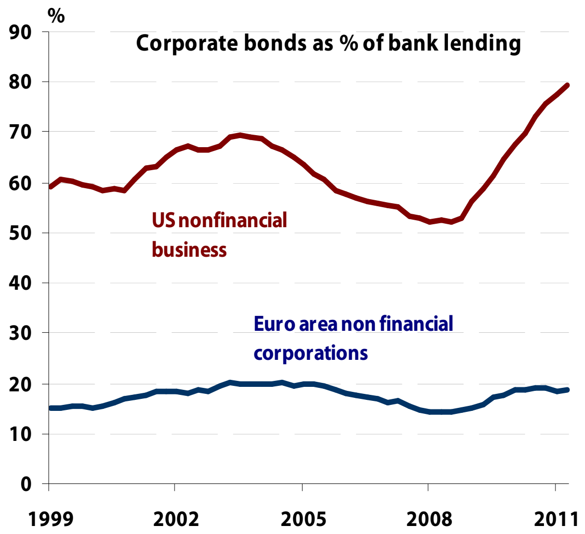
Lending rates to non financial corporations (new business loans) have started rising after they reached trough in mid-2010. However, in most countries they remain lower than those observed at the time of the Lehman Brothers collapse, with the exception of Greece and Portugal where the relevant borrowing costs have approached the post Lehman collapse peak. Among the core countries, the degree of divergence in the borrowing costs of firms has risen compared to what it has been during the

Figure 4



Note The list of banks consists of Banca Monte, UniCredit, Santander, Societe Gen, Commerzbank, BNP Paribas, Credit Agricole, *Deutsche Bank,, BBVA, ING and Rabobank.*
Source: Bloomberg

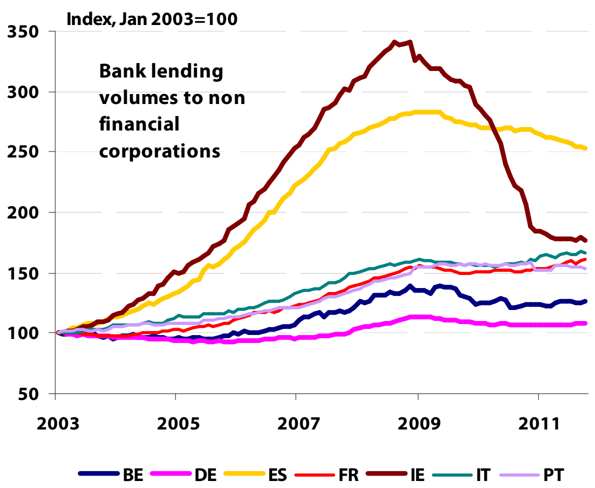
Figure 5



Source: ECB, Fed

"Great Moderation" era (Figure 3, red line). The group of countries includes Austria, Belgium, France, Netherlands, Germany and Finland. The benign economic environment prevailing before the onset of the subprime crisis and easy access to cheap funding seems to have resulted in homogeneous lending rates. However, the financial crisis revealed the divergent degree of vulnerability of the banking system in each euro area member. Divergent CDS spreads (Figure 4) suggest varying market pressures for banks which seem to play out as heterogeneous lending rates to non financial corporations. Not surprisingly, the divergence becomes even more pronounced if we add Italy and Spain to the aforementioned group of countries, as banks in these two countries are seriously afflicted by the sovereign crisis (Figure 3, blue line).

Figure 6



Source: ECB,

Adequate funding of the real economy by banks is essential for the well being of the euro area economy, given that European firms rely heavily on bank lending, much more than their US piers (Figure 5). Despite the woes of the banking sector, there has not been a dramatic decline in outstanding lending to non financial corporations in most euro are members (Figure 6). Credit volumes are inching higher in France and Italy, whereas they have stagnated in Germany and Belgium. A significant drop in credit volumes has materialized in Ireland and Spain, due to the burst of the real estate bubble. Interestingly though, in Ireland the outstanding loans have stabilized. With respect to changes in lending volumes, credit growth to NFCs is negative in Greece and Spain, while in Portugal it currently stands slightly above zero. Looking ahead, prospects for bank lending to firms remain grim due to further muddling through in the debt crisis front. Increasingly tightening credit standards underscore our negative outlook for lending growth. On the positive side though, corporate balance sheets look strong, thus mitigating the consequences of retrenchment in bank lending.

The decision of euro area policymakers to strengthen the capital adequacy of banks is, in our view, likely to restrain bank lending to the economy in the medium term. Banks need to build a capital buffer so as to raise their core Tier 1 ratio to 9% by the end of June 2012, aiming at backstopping potential losses from sovereign paper holdings. Banks have three main options to meet this target without resorting to state or EFSF aid: tap the markets to raise private funds, retain profits and deleverage. The last option would have the most adverse impact on growth relative to the others, as it would add to the tightness of lending conditions.

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