Prompt corrective action

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Europe’s central bank dishes out some €350 billion

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THE European Central Bank (ECB) is keen these days to spew cash into troubled markets. On Tuesday December 18th it accepted bids from 390 banks for close to €350 billion in short-term money, at below-market rates (between 4.21% and 4.45%). Is this is a $500 billion Christmas present, or a justifiable measure to avert an unseasonal crisis?

Certainly, it was a response to a sudden jump in two-week rates to over 4.9% the day before—a sign that banks were hoarding more liquidity than usual at this time of year, to tide them over the Christmas period.

And there had also been early indications that a joint operation by central banks, announced on December 12th, to ease turbulence in the interbank money market, was going to be inadequate. Despite easier lending conditions promised by America's Federal Reserve and the Bank of England, and despite the provision of American dollars via the ECB and the Swiss National Bank, banks were still holding onto their cash.

The underlying problem is that banks have still not taken the full impact on their balance sheets of the American subprime mortgage crisis. Many banks either own assets affected by mortgage losses, or they are funding lines of credit to structured investment vehicles (SIVs) which do, and whose valuations are shaky or impaired. Either way there is plenty of uncertainty—enough for money-market funds to prefer to reduce rather than increase their exposure to banks.

Of the three big central banks, the ECB has been the most willing to dish out cash. On August 9th, when market turbulence first hit, it called a quick tender and put €94.8 billion into the market. Banks can deposit all kinds of collateral with euro-area central banks in return for cash without paying a penalty rate, while, until the latest joint operation, the Fed still demanded a penalty rate as did the Bank of England, which also accepted only high-quality collateral. The ECB, a more flexible friend, has generously been providing liquidity to American and British banks too, if they have branches or subsidiaries in the euro area.

The joint operation, which also involves the Bank of Canada, was a sign that the ECB philosophy, to be generous in times of liquidity shortage, is gaining traction. Mervyn King, the Bank of England's governor, who has taken flak previously for being too hard-line, seems to have learned something. At a parliamentary committee hearing on December 18th he sang the praises of the anonymous auction which avoids the stigma that banks risk incurring if they come publicly to a central bank discount window—the “key lesson that central banks around the world have taken from the recent turmoil,” Mr King said.

But it remains to be seen whether liberal amounts of central-bank liquidity will encourage banks to do more than hoard cash. If, after the Christmas break, the interbank market still stutters, central banks will continue to have a problem transmitting their monetary-policy message to the market.

The hope is that it is just a question of time (and some pain) before banks consolidate their subprime exposure onto their balance sheets. But the fear is that trust in the banking system has been badly damaged for months to come. When Citigroup, Merrill Lynch and UBS, which have invested millions of dollars in risk management, can give the market nasty surprises, who can be above suspicion?