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European Central Bank Takes Steps to Prevent a Second Credit Crunch

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The European Central Bank's focus at this week's Council meeting was less on the level of interest rates and more on providing liquidity to euro-area banks. At a time when the euro area may be in the formative stages of a credit crunch, the ECB is probably right to focus on the supply of credit rather than its price.

Jean-Claude Trichet's final press conference as European Central Bank (ECB) President did not deliver the rate cut craved by so many investors. But the ECB was extremely generous in other areas. Not only did it guarantee full allotment at all liquidity-providing operations until (at least) July 2012, it also announced two special longer-term refinancing operations with maturities of roughly one year, and a second covered-bond purchase program. Together, these measures should help alleviate funding strains in the euro-area banking system.

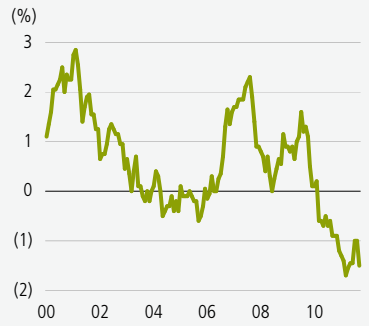
There are two main reasons for the ECB's focus on unconventional or nonstandard measures. First, for most Council members, the economic data are probably not yet soft enough to justify a rate cut—especially after last week's news that inflation has risen to 3.0%. Second, the level of its key refinancing rate—still close to record lows in nominal terms and heavily negative in real terms **(Display 1)**—is not the ECB's biggest problem at present. Indeed, the central bank is currently more concerned about the transmission of its monetary policy to all 17 euro-area member states and in ensuring the financial stability of the euro area as a whole. This is why President Trichet described the nonstandard measures as being of "extreme importance" and implied that they had taken precedence—temporarily at least—over the interest-rate debate.

In our view, the ECB is right at this stage to be more concerned about the monetary transmission mechanism and financial stability of the euro area than the level of its key refinancing rate. Signs of financial stress are now abundant in the euro area, especially in the sovereign debt and bank funding markets. Moreover, two pieces of data released over the last week suggest that these tensions may be spilling over into the real economy.

Tighter Lending Standards

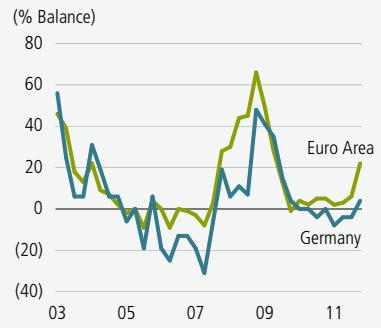
The first is the ECB's quarterly bank lending survey, which showed a significant increase in the number of banks planning

Display 1
Real Rates Still Heavily Negative



As of September 30, 2011
Source: Haver Analytics

Display 2
Banks Start to Tighten Credit Standards



As of October 6, 2011
Source: Haver Analytics

to tighten credit conditions during the fourth quarter. This is particularly clear for lending to nonfinancial companies, with the net percentage of banks planning to tighten lending standards rising to +22 in the fourth quarter from +6 in the third quarter **(Display 2, previous page)**. This is well below the peak seen at the end of 2008, but still represents a big increase. Moreover, the relatively modest increase in the German component of this survey (Germany is the only country that has so far published separate data) suggests that the increase in some other countries may have been more dramatic.

It is interesting to consider what is driving the tightening of lending standards. It is clear from responses to the survey that a deterioration in the general economic outlook is causing banks to become more cautious. However, the net percentage of euro-area banks quoting market access (i.e., their ability to raise external finance) as a constraint on lending rose to +20 from +9, a significant increase **(Display 3)**. Moreover, a comparison with Germany, where the market access reading was unchanged in the fourth quarter, points to much larger rises in some other countries.

Higher Effective Lending Rates

The second piece of evidence comes from the ECB's survey of effective lending rates in the euro area. This provides compelling evidence that interest rates actually paid by households and firms are increasing more rapidly in the periphery than in the core euro-area countries. Over the last year, the average interest rate on all outstanding loans to nonfinancial companies has risen by just 21 basis points in Germany and 26 basis points in France. Comparable figures for Spain, Italy and Ireland are far higher, at 62, 69 and 71 basis points respectively **(Display 4)**.

Overall, the data suggest that the euro area may be in the formative stages of a credit crunch, comparable to late 2007 and early 2008, rather than the post-Lehman period. But unlike 2007 and 2008, the evidence suggests that the deterioration in credit conditions may be disproportionately concentrated in a small number of countries. For the ECB, the most important thing in these circumstances is to try to improve the supply of credit to those countries, rather than cut interest rates—in the current environment, the benefit of cheaper money might not even be passed on in those countries.

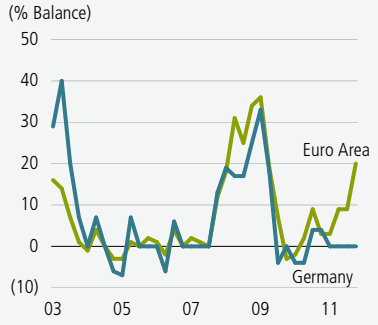
ECB Likely to Cut Rates Soon

But this does not mean interest rates don't matter or that the ECB won't cut rates in the near future. Indeed, while there was no attempt to signal a November rate cut at this week's press conference, the ECB is clearly moving in a more dovish direction. The Governing Council no longer describes the monetary-policy stance as "accommodative" and President Trichet admitted that the case for lower rates was considered in some depth at this week's meeting—with a minority of Council members favoring an immediate move.

With the euro area now almost certain to move into a mild recession, the question is not so much will the ECB cut rates as when. With no clear signal at this week's press conference, it is tempting to think that a decision has been deferred until December. But the situation is rapidly evolving and the ECB has, in the past, tended to provide less guidance on the timing of rate cuts than rate hikes. So if the data are sufficiently weak, we would not rule out a rate cut in November. ■

Display 3
Market Access Tightens . . . for Some Banks

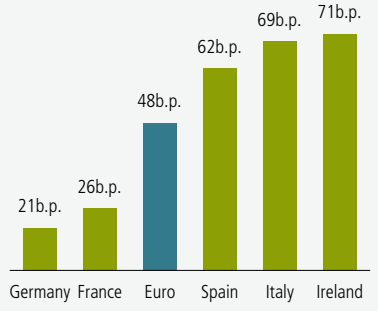
Net Percentage of Banks Quoting Market Access as a Constraint on Lending



As of October 6, 2011
Source: Haver Analytics

Display 4
Higher Effective Rates in the Periphery

Annual Change in Effective Interest Rate on Outstanding Loans to Nonfinancial Companies



As of August 31, 2011
Source: Haver Analytics