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Europe's Problems Just Got Twice as Bad

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DURHAM, N.C. ([TheStreet](#)) -- A massive 530 billion euro (\$707 billion) liquidity injection took place today in Europe in the form of Long Term Refinancing Operations, or LTRO.

This "helicopter drop" does not solve the eurozone's problems; it merely delays them. The European Central Bank is treating the symptoms, not the disease.

LTRO was launched in December by the ECB, which offers unlimited loans to European banks for a three-year term at an interest rate of only 1%. The loans are unconditional; banks can do what they want with the funding.

That's a remarkably low rate, given that most of the banks are insolvent. They would have no hope of getting terms like that in the open market. In December, 523 European banks wanted a piece of the action.

LTRO1 amounted to 489 billion euros of bargain loans. Importantly, about 300 billion euros was rollover. That is, banks had loans that were due and they rolled them into new loans at the 1% interest rate. The amount of "new" liquidity was less than 200 billion euros.

How massive is massive?

Today, 530 billion euros was taken up by 800 banks. The size of LTRO2 was larger than expected and the number of banks participating was far bigger than expected.

Before LTRO2, the ECB's balance sheet stood at 2.7 trillion euros, far exceeding the size of the Fed's balance sheet in the depths of the financial crisis.

Unclear is how much of the LTRO2 is new liquidity. LTRO1 had about 190 billion euros of new liquidity. My estimate is that LTRO2 has about 400 billion euros of new liquidity. Note this is all in one shot too. It is not a gradual program like the Fed's so-called quantitative easing (QE).

So the ECB's balance sheet has exploded to approximately 3.1 trillion euros. Currently, the Fed's balance sheet is only (!) 2.2 trillion euros. In the November 2008 (QE1), the Fed balance sheet was 1.5 trillion euros. So the ECB's injection is massive.

What is the difference between QE and LTRO?

In November 2008, the Federal Reserve embarked on a quantitative easing program. The idea was to purchase mortgage-backed securities as well as U.S. Treasuries. That action bid up prices of the bonds and reduced interest rates. The increased prices helped bank balance sheets. The lower rates helped banks reduce the cost of lending. The lower rates trickled down to the average borrower, whether a small business or an individual.

LTRO is different. LTRO is specifically directed at European banks. The loans are made to the banks, but there are no strings attached. That is, the banks can do whatever they want with the money.

Here are the possibilities:

1. Banks could borrow money from the ECB at 1% and invest in sovereign debt which might yield 7% (the so-called carry trade);
2. Banks could borrow money from ECB at 1% and provide loans to consumers and corporations;
3. Banks could borrow at 1%, issue bonds and then use the LTRO to buy them, i.e. buy your own bonds and hopefully reduce the cost of borrowing in the future; and
4. Park the money at the ECB and collect 25bp (the so-called reverse carry Trade).

Option 1 is what the ECB wants. The ECB is prevented from outright buying of distressed sovereigns. (It is, however, allowed to buy on the secondary market.) The ECB can achieve the same objective indirectly. It gives money to the banks (well, 1% is almost giving), and the banks do the dirty work for them.

For example, **Intesa Sanpaolo** said today it would take 24 billion euros in LTRO and invest in Italian Treasuries with maturities of three years or less. That carry trade is profitable for the banks, as long as the system is intact (i.e., there is no meltdown of the euro area). It is hoped that the increased profit will make banks healthier.

As I have pointed out in previous entries, European banks need the help. Most are insolvent.

An alternative strategy would be to massively consolidate European banks -- shuttering the ones that are the most insolvent and allocating quality assets to the relatively strong ones.

However, that is not the strategy that is being followed. Taking a page from the U.S. playbook, no one is allowed to fail. LTRO is available to any bank that can post eligible collateral.

So, in the end, this is printing money. The ECB balance sheet has exploded. It is far greater than the size of the Fed's balance sheet at the worst time during the financial crisis. Importantly, the quality of the ECB's balance sheet is far lower.

Remember in QE, the Fed was buying high-quality mortgages and Treasuries. In QE2, the Fed was buying Treasuries. The ECB has a pile of peripheral debt after having lent to zombie European banks.

Let's take a step back and consider the following question. Given that we know that European banks are already too highly levered, does it make sense for them to borrow more money and then invest the borrowed money in risky sovereign debt?

From an economic point of view, the answer is no. However, from the banks' point of view, the answer is an obvious yes. There is no downside for them. They will be bailed out if the situation in Europe deteriorates.

Where does the money go?

It is well understood that the most effective remedy to Europe's malaise is economic growth. However, little of the LTRO is going in that direction. Data released on Monday by the ECB details positive loan growth, but you need to look beyond the top-line numbers. There was negative consumer loan growth. There was negative non-financial corporation loan growth. The growth was being driven by financial companies.

Dependence on the ECB

LTRO is a sweet poison. Why should a bank go to the open market and borrow money when you can go to the trough and borrow at 1%? The LTRO creates a dependency on the ECB. The European banks have been effectively knocked out of non-European markets for funding because foreigners realize that these banks are largely insolvent. However, how long can the ECB provide backup? How long can the ECB ignore that many of the banks are zombie? Might the next page in the playbook be the Bank of Japan's strategy of the 1990s?

Avoiding tough decisions

I continue to believe that Europe is not dealing with its problem head on. The bailout of Greece is a fool's errand. The 130 billion euros and the "selectively defaulted" Greek debt does not solve the problem. Indeed, it is unbelievably naive to think that the Greek debt-to-GDP ratio will be 120.5% in 2012. It is a classic case of throwing good money at bad.

What Greece needs is a massive devaluation, and that is impossible given that the country is shackled to the euro. Even a 100% repudiation of its sovereign debt would not solve the problem. It is still running massive fiscal and trade deficits, and the debt would just be racked up again.

The same is true for the banks. I vote for consolidation -- elimination of the weak banks and the strengthening the strong.

How risky is the ECB?

There are a number of risks. However, it is key to understand that the main lever the ECB has is the printing press. Unlike a regular corporation, if the ECB gets into trouble (capital depleted by sovereign defaults), it could always print its way out.

First, we have already mentioned that the ECB's holdings are far lower quality than the Fed's (for example, it's holding Greek sovereigns at par when others took a haircut). That presents a risk.

Second, another risk is the system holding together. If a number of countries exit the euro (strong or weak countries), that would create risk.

Third, and by far the most important, is the risk of monetization. Yes, the ECB could print its way out of a problem. However, that could manifest itself in significant inflation in the future. It is true that we don't see it today because monetary velocity has plunged. However, at some point, velocity will recover and Euroland will be hit with a huge inflation tax. People don't put weight on this now because inflation is so low.

But it is naive to think that cranking the press like the ECB is doing has no repercussions. Inflation can be avoided only if the money is taken back. And we all know that taking money back is painful and hugely unpopular in the face of high unemployment.

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