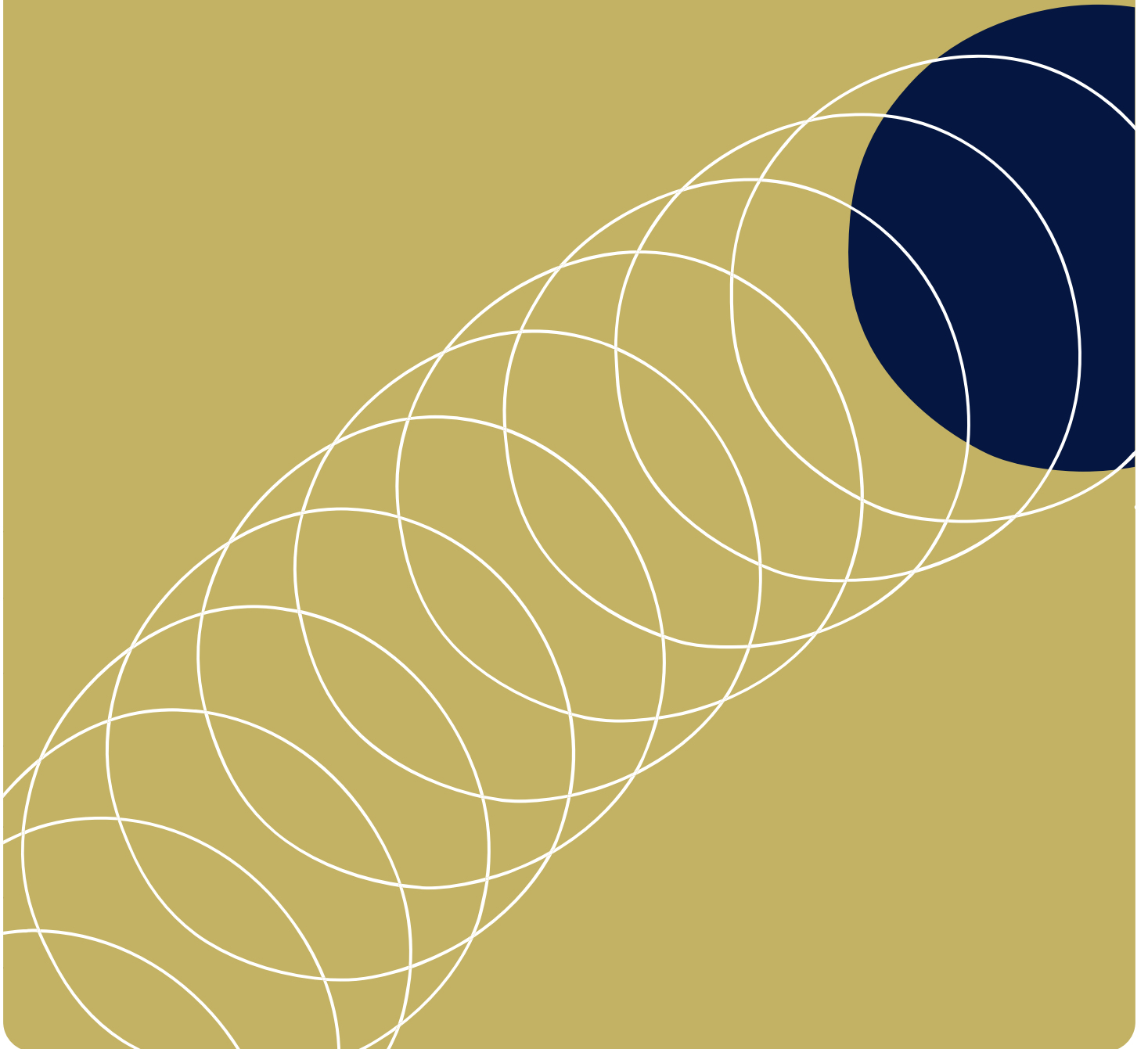


Initial 3-year ECB tender should cause no inflation

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Initial 3-year ECB tender should cause no inflation

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For the first time ever, the ECB has conducted a 3-year tender. The response from banks was overwhelming: the central bank allocated a total of EUR 489 billion. The ECB's very expansive monetary policy and government bond purchases are fanning inflation fears from many quarters – also among analysts. However, in an environment marked by a crisis of confidence and sharply decelerating global economic activity, inflation threats are indeed limited and clearly outweighed by the risks of deflation. The pace of inflation is likely to wane in the coming months.

What are the consequences of «easy money»?

For the first time, the ECB has loaned banks 3-year money and thus made its debut in the capital market realm. Over the entire term of these credits, no annual interest payments are due. The accounts will be settled upon maturity. The allocated sum of EUR 489 billion at the current base lending rate of 1% (conditions will be adjusted in the event of rate hikes) should further heighten the inflation fears of many investors. This is because, even without the 3-year tender, the ECB has provided a vast amount of liquidity to the system through its regular open market activities: since this past August, the central bank has granted close to EUR 4.5 trillion in bank credits.

The fear is that this move will cause an increase in bank lending to the public and therefore fuel inflation. But in fact the refinancings via the ECB are increasing, mainly due to the dwindling trust banks have in each other. They are no longer holding their liquidity at third-party institutions but instead parking it at the central bank. For that reason, the balance sheet of each and every commercial bank will not bulge, but most certainly that of the ECB. Economically viewed, however, this is equivalent to a «wash sale»: nothing has changed.

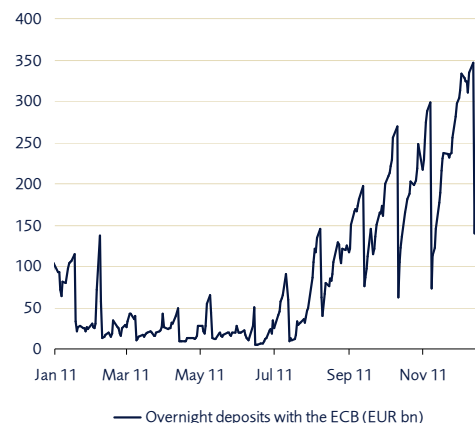
Moreover, in banks' lending practices, not only do the aforementioned aspects play an increasingly important role, but also the concept of term-congruent refinancing. Under the «golden rule of banking», borrowed short-term money may only be lent short term, while any long-term capital funding may only be lent long term. As a means of adding stability to the financial system, the new Basel III capital requirements also limit banks' ability to finance long-term credits via short-term deposits. Because generally the rates at the short end of the term structure are lower than those at the long end, this leads to higher costs and narrower margins.

So even if the ECB makes more liquidity available to commercial banks, no immediate increase in bank lending should result and hence no inflation risks. Decisive in this regard is rather the question as to how easily credit institutions can obtain longer-term capital in the financial markets through the issuance of bank bonds. At present, that can be accomplished only with difficulty: on one hand, the mutual mistrust amongst banks is a tremendous hindrance and, on the other, justifiable concerns about the solvency of many banks is leading to reticence on the part of investors to buy those bonds. The consequences are grave:

- Because there is hardly a possibility at present to arrange term-congruent refinancing, this significantly limits the opportunities to grant long-term credits.
- Many banks' lack of ability to tap the capital markets is causing them to trim their balance sheets, which also has a considerable impact on the potential for granting new loans – and all of this despite an expansive ECB policy.

Therefore, deflation threats exist. As was the case in 2008, the liquidity being supplied by the ECB is merely increasing the central bank money supply. The transmission mechanism which normally sluices that money into the real economy is out of kilter at present (one outcrop of this is a drastically reduced multiplier effect). The commercial banks are simply taking the liquidity provided by the ECB and immediately depositing it with the central bank. This can be deduced from the overnight deposits of European commercial banks with the ECB.

Overnight deposits of commercial banks with the ECB

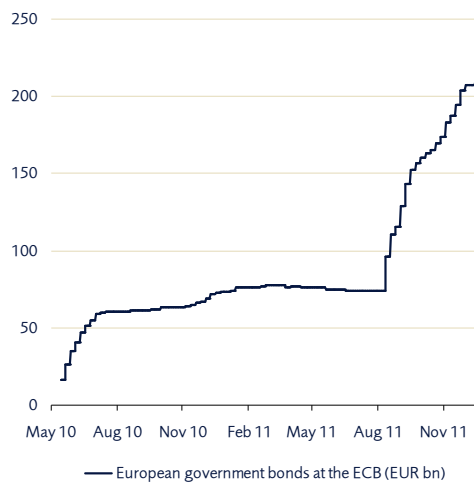


Source: VP Bank, Bloomberg

What are the consequences of the ECB's bond purchase programme?

In the meantime, the ECB's government bond purchase programme has reached a cumulative volume of EUR 211 billion, which is anyway sufficient to fan inflation fears. And precisely for that reason, the need of many investors for security is growing – as is evidenced by the persistently high price of gold. One the other side of the coin, the implied rates currently priced into inflation-protected bonds are at moderate levels.

ECB government bond purchase programme



Source: VP Bank, Bloomberg

The link between government bond purchases and growing price pressure is not readily deducible. Commercial banks maintain current accounts with the central banks. If for example the ECB buys government bonds from the banks, the proceeds initially land in those accounts and the central bank money supply in the hands of the commercial banks increases; thus credit institutions are carrying a higher surplus reserve with the ECB than before.

If the banks use the money to grant new loans to the real economy, there is an increase in the inflation-relevant M3 money supply. Only then does an inflation risk arise from the bond purchases.

But when the central bank purchases bonds directly from private investors (non-banks), it transfers the purchase price to the account of the seller at a commercial bank. This also immediately increases the M3 money supply.

Nonetheless, the deflation risks predominate. In the currently difficult economic environment, it is improbable that companies will demand new bank loans for capital spending purposes, or that private households use their newly gained liquidity for consumption purposes. To the contrary, that those

government bonds were even sold is rather a sign of pessimism, and that pessimism is more likely to increase the savings rate than lower it. Indeed: at 13.7% of available income, the savings rate in the euro zone testifies to a high degree of safety awareness.

Inflation should remain limited also for other reasons. Empirically, even if the money is used for new purchases, the correlation so deeply rooted in monetary theory – i.e. that an increasing money supply goes hand-in-glove with increasing inflation – is weakened significantly under the current circumstances: especially in times of free production capacity in an economy, the corporate sector most often opts to increase production volumes rather than to raise prices.

Inflation risks averted?

Regardless of whether it is attributable to the purchase of government bonds or to the unlimited liquidity that has been made available, if that newly created central bank money gets into circulation in the real economy due to a revival of banks' willingness to grant new loans, there is an increased risk of higher future inflation. The prerequisites for that are:

- A significant upturn in the economy: Only when production capacity is exhausted is there leeway for manufacturers to raise prices.
- Optimistic consumers: Consumers' confidence in the health of the economy must be high enough that personal spending or capital investments are financed with borrowed money.
- Trust in the banking system: If commercial banks' ability to arrange long-term refinancing via the capital market is sufficiently assured, then short-term funding provided by the central bank can act additionally as a stimulus for further lending to the public.

Because none of these three requirements is fulfilled at present, we take the view that the coming year will be accompanied by low inflation rates – in some countries such as Greece and Portugal, there could even be the threat of deflationary tendencies.

Investors who on the other hand anticipate significantly higher inflation in the months ahead should ask their Client Advisor for our recommendations on inflation protection.



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