

Eurozone: Is The European Central Bank Able And Willing To Leverage Up?

With Eurozone sovereign debt crisis worsening and politicians hesitant to take bold actions just as options are dwindling down fast, European Central Bank (ECB) could be the one key factor that could stem the deterioration, just like what the US Federal Reserve did after the Lehman failure in 2008. In the US, there is only one central bank and one Treasury, but in Eurozone, there are 17 different governments and Treasuries, with their often conflicting and inconsistent objectives, and ECB is caught in between.

Since the US Fed greatly expanded its balance sheet in its Quantitative Easing (QE) programs to revive economic activities and backstop the financial sector, the focus is now on ECB whether it has the capacity to carry out what other central banks had done to rescue the financial system, and whether it is willing to follow the footsteps of US Fed, Bank of England, and Bank of Japan. While the ECB is considered to be underleveraged and has more capacity to maneuver, so far it seems unwilling to go along the line of large scale asset purchase operations.

Does ECB Have the Capacity to Leverage Up?

As shown in the table below, the US Fed's two QE programs saw its total assets rose from USD900bn just before the Lehman collapse in 2008 to USD2,855bn today, with capital of USD52bn, as it purchased mortgage-backed assets, US agency debt from Fannie and Freddie. This translates to a leverage of 55x. Other central banks which engaged in similar QE programs, such as Bank of England and Bank of Japan, also saw leverage of similar size.

In contrast, ECB is only leveraged up by 6x with its capital of EUR24.7bn. Its bond buying program ("SMP") is limited and can only purchase bonds from secondary market, and is said to have a weekly maximum EUR20bn. Even this maximum has not been reached, as average weekly purchases are only about EUR5.bn in the October-November period. With Italy (and Spain) facing more challenges in bond markets, ECB will be under increased pressure to provide a backstop.

| ECB...A Question Of Willingness, Not Ability | | | |
|--|------------|--------------|----------|
| | Capital | Total Assets | Leverage |
| US Federal Reserve | USD52bn | USD2,855bn | 55x |
| Bank of Japan | JPY2,730bn | JPY142,363bn | 52x |
| Bank of England | GBP4.4bn | GBP229.6bn | 52x |
| European Central Bank | EUR24.7bn | EUR163.5bn | 6x |
| Monetary Authority of Singapore | SGD25bn | SGD299bn | 12x |
| Hong Kong Monetary Authority | HKD599bn | HKD2,400bn | 4x |
| Bank Negara Malaysia | MYR19.7bn | MYR390bn | 20x |
| Bank Indonesia | IDR68.8tn | IDR1,180tn | 18x |

Source: Latest financial accounts of Fed, BoJ, BoE, ECB, MAS, HKMA, BNM and BI; UOB Economic-Treasury Research

ECB's capacity is certainly large: even if it were to raise its leverage to just half of US Fed's, i.e. to 28x, that would create an additional capacity of more than EUR520bn. At leverage up to 55x, ECB could have additional capacity of EUR1.2tn.

As a reference, MAS is leveraged 12x, and ECB's 6x looks to be very conservative in its conduct of monetary policy. Note that 96% of MAS's total assets of SGD299bn are classified as Foreign Financial Assets, which include bank balances, SDR, Treasury bills, bonds, and notes.

Next year (2012), Italy (and Eurozone) would be facing a severe test as it needs to tap the bond market for more than EUR320bn and interest payment due is EUR55bn. This is sharply higher compared to this year's rollover of "just" EUR31.3bn and interest payment of EUR1.7bn.

In terms of capacity, ECB can certainly take on the role as "fireman" with a big "liquidity" hose to douse the fire that has spread from smaller countries (Greece, Portugal, Ireland), to larger ones (Italy, Spain), and may have spread to core Eurozone (Germany, France) as shown in last week's "failed" bund auction. The question is: is ECB willing to leverage up and backstop the financial system?

Is ECB Willing to Leverage Up?

So far indications are that ECB is unwilling to backstop the financial system, as Germany (largest capital contributor to ECB) is fiercely opposed to such a move. Last Thursday, ECB exco member José Manuel González-Páramo reiterated the position that it "is not the fiscal lender of last resort to sovereigns." Various ECB members also noted that large scale government bond purchases would violate the bank's mandate and not solve the crisis. In addition, the banking systems within Eurozone are the responsibility of individual member countries, and ECB cannot rescue institutions that it has no control over.

ECB: Able But Unwilling, So Far ...

Based on the above estimates, ECB is certainly able to do more in the current situation. The only question is its willingness, and indications so far are in the negative. **With all the legal, bureaucratic, and philosophical differences, it seems that ECB would be standing back while the fire burns, and would probably step in only at the very last moment or perhaps until after market capitulation has occurred.**

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