

# SIMPLES?

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The last day of November witnessed a remarkable surge in stock markets worldwide. The trigger? The announcement of co-ordinated intervention by the US Federal Reserve and the European Central Bank to alleviate a chronic shortage of Dollars in the European banking system. The response was dramatic. Equity markets enjoyed their biggest one day gain since 2009, instantly turning the month of November from a near disaster into a mere disappointment; the US market even managed to deliver a 2% gain for Sterling investors. Restoring confidence in the banking system may seem easy. But can fixing the Eurozone really be as simple?

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The key element of the latest co-ordinated show of intervention by the world's central banks lowers the price of the European Central Bank's Dollar swap facility from the Federal Reserve from 1% to 0.5% above the market rate. The underlying intention is simple: to reduce the short-term cost of borrowing badly needed Dollars for Europe's fragile banking sector. Prior to the intervention, the cost of turning Euros into Dollars had reached the highest level since October 2008, when Lehman Brothers collapsed. Reducing the cost of drawing on this facility makes it easier for European banks to fund their day-to-day operations. And, as the market's ebullient reaction showed, this facility does much to ease the short-term pressures on the banking system. A liquidity crisis has, thank goodness, been averted. Sadly, however, a bigger problem remains...

The real problem facing European banks is how to find longer-term sources of funding; they are understandably reluctant to write new loans unless they can find funding to match. Jittery bond markets and more stringent rules on capital adequacy mean that any new lending must be backed by increased reserves. At the moment, however, the general air of mistrust and worries about solvency mean that banks can't raise reserves in the either the credit or the equity market. Meanwhile, European banks' traditional lenders of last resort – US money market funds – are keeping their Dollars at home.

That means banks are refusing loans to companies and consumers. The resulting credit crunch is having a "contractionary" effect on European economies (it now seems likely that the Eurozone is on the verge of recession). In turn, slowing growth makes it hard for European governments to reduce their budget deficits regardless of how much austerity they implement. That puts their sovereign debt at risk of downgrade. And, as long as sovereign borrowers are at risk of defaulting on their debts, then the banks that hold that debt also look vulnerable. And so the downward spiral continues...

Looked at in this light, it can be seen that the illiquidity problem that the Fed and the ECB have addressed is merely a symptom of the broader crisis of confidence rather than its root cause. Is it, then, time to despair? Perhaps not.

There are reasons to hope that the ECB's intervention may herald a new willingness on its part to act aggressively to halt this downward spiral. The hope is that by swooping in to buy bonds of peripheral countries in sufficiently massive scale, the ECB will reassure a nervous bond market and provide the missing ingredient that the Eurozone so badly lacks: confidence. That could buy politicians time to confront their electorates (and the holders of their sovereign debt) with some unpalatable truths and set about putting the Eurozone on a sustainable footing.

So there may be reasons to hope that the Eurozone can be fixed – but it will take time. While fixing the short-term pressures in the banking market seemed easy, repairing the Eurozone may not be quite so simple.

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**The views expressed in this article are the writer's own and do not necessarily reflect those of the 7IM Investment Team.**

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