Central banks can solve credit crunches by pumping more money into the economy, but only if they focus on banks that have a genuine liquidity shortage. That is one of the implications of research by Philippe Andrade, Christophe Cahn, Henri Fraisse and Jean-Stéphane Mésonnier, to be presented at the annual congress of the European Economic Association in Mannheim in August 2015.

The two three-year longer-term refinancing operations (LTROs) implemented by the Eurosystem in December 2011 and February 2012 represented a very large positive funding liquidity shock to the euro area’s banking system. More than one trillion euros was injected into banks, increasing the size of their balance sheets by more than a fifth and giving them a very cheap loan for three years.

This study looks at the experience of French banks and finds that banks that were willing to pay more for these loans ended up lending out more of the money to non-financial companies. Each one million euros of central bank money lent to these banks led to a 95 million euros increase in the credit made available to the average firm. This shows that banks with serious credit problems ended up being the best targets for pumping money into the economy.

Meanwhile, the banks that wanted liquidity later in 2012 were more interested in exploiting a source of cheap funds. The authors comment: ‘Quantitative easing is more likely to succeed if the central bank provides liquidity at long horizons. We find that liquidity injections were more efficient for less capitalised banks and helped larger corporate borrowers. Our evidence also suggests that quantitative easing did not encourage banks to ever-green bad loans to ailing firms.’

More...

Can the central bank stimulate bank credit to the real economy during a financial crisis by pumping massive liquidity into commercial banks? Or is this like ‘pushing on a string’, as the popular wisdom since Keynes’ first description of the liquidity trap would suggest?

Looking at the impact of a recent quantitative easing policy run by the Eurosystem, the 2011-12 longer-term refinancing operations (LTROs), and using a very detailed credit dataset for France, this study finds that the answer is positive, but also that some conditions are decisive for success.

The two three-year longer-term refinancing operations implemented by the Eurosystem in December 2011 and February 2012 against the backdrop of an escalation of the euro area sovereign debt crisis, represented a very large positive funding liquidity shock to the area’s banking system.

In gross terms, the total liquidity injection amounted to more than one trillion euros and it increased the size of the Eurosystem’s balance sheet by more than a fifth. Furthermore, this liquidity was lent for three years at a very low interest rate compared with the funding terms banks faced in financial markets at the time.
This study exploits this policy measure and a rich and representative dataset of bilateral bank-firm credit exposures in France to assess to what extent a central bank can sustain the provision of bank credit to the real economy by such massive liquidity injections into the banking system.

The authors restrict their sample to firms that had credit relationships with at least two banks before the announcement of the policy measure and compare the change in the credit supplied to the same firm by two different banks that borrowed different amounts of liquidity in the Eurosystem’s LTROs. They therefore control effectively for French firms’ declining demand for bank credit over 2012.

In addition, they also control for all bank-specific factors that are likely both to impinge on their own credit supply to firms and to affect their desired bid for central bank liquidity. This makes it possible to evaluate properly the causal impact of LTROs on the supply of bank credit.

The study finds that banks that bid more in the LTROs did use this cheap and potentially unlimited funding source to offer more loans to non-financial corporations. According to the baseline estimates, each one billion euros of central bank money lent to the average bank holding company led to a 95 million euros increase in the credit made available to the average firm over the 12-month period from September 2011 to September 2012.

The richness of the dataset also makes it possible to derive further policy relevant conclusions. First, the effect is almost exclusively associated with the first, December 2011 round of the LTROs, as bidding banks were on average more financially constrained. As in February 2012 the ECB explicitly dismissed fears of any stigma that could be associated with a bank’s bidding at these operations, more banks bid at the second LTRO in late February 2012. But these institutions were less liquidity constrained and more eager to exploit an attractive funding opportunity.

Taking advantage of a unique feature of these operations, namely the three-year maturity at which the central bank liquidity was lent, the researchers also find that such a quantitative policy is more likely to succeed if the central bank provides liquidity at long horizons.

In addition, they use detailed information on banks and firms to show that liquidity injections were more efficient for less capitalised banks and benefited more large corporate borrowers.

Last, the evidence suggests that the LTROs did not encourage banks to ever-green bad loans to ailing firms.

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Contact:
Jean-Stéphane Mésonnier, Banque de France:
jean-stephane.mesonnier@banque-france.fr