# European Central Bank averted global financial freefall

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European financial markets could have completely frozen up in December, setting off a global credit crunch, had it not been for a massive injection of liquidity by the European Central Bank (ECB).

Speaking at the World Economic Forum in Davos, ECB president Mario Draghi said the injection of €489 billion into the financial system had “avoided a major, major credit crunch, a major funding crisis.”

Official figures released on Friday show that the banking system was experiencing a significant contraction in December. Bank deposits were down by €25 billion for the month, while loans to households and companies fell by €47 billion.

*Financial Times* columnist Gavyn Davies described the results as “extremely worrying” because they showed “a financial system moving rapidly into a major episode of deleveraging with bank deposits and lending entering freefall.” Were these trends to continue “they would be truly ominous, not just for activity in the eurozone, but also for activity in many emerging countries, which are heavily dependent on credit from European-based banks.”

Since the injection of funds under the ECB’s Long Term Refinancing Operation (LTRO) there has been a significant increase in ECB lending to the banks and a similar increase in banks’ deposits at the ECB. Draghi discounted suggestions that the liquidity injection had no impact on the economy because banks had merely been taking money from the ECB and then depositing it. Different banks were involved, he said.

Draghi’s explanation only underscores the depth of the underlying crisis of the European financial system. The process he described means that problematic banks have been borrowing heavily from the ECB, while stronger banks have been making deposits. In normal circumstances, the banks would lend to each other. Such is the lack of confidence that inter-bank lending has virtually dried up. So the ECB has had to step in and mount a round-robin operation to prevent the system from freezing up.

While this operation has, at least for the present, averted the prospect of a 2008 Lehman-style collapse, it has done so by sowing the seeds for an even bigger crisis. As part of the LTRO, in which the ECB lends money to the banks over three years at very low rates, the bank broadened the category of assets it would accept as collateral.

Brown Brothers Harriman currency analyst, March Chandler, recently pointed out in a note to clients: “The ECB’s balance sheet has exploded, but not with high-quality assets. The quality of its balance sheet is a cause of concern in some quarters ... [and] is at the risk of becoming a ‘bad bank’.”

In other words, without a fundamental solution to the crisis—and there is nothing even resembling it on the horizon—emergency measures initiated at one point lead to the build up of new contradictions within the financial system that explode at another.

Meanwhile, the troubled banks become increasingly dependent on the ECB. The extent of their weakness can be seen from figures on the Italian banking system.

According to a recent Morgan Stanley report, Italian banks were the biggest users of the ECB emergency funds, receiving €50 billion, with UniCredit, the country’s top bank by assets, taking €12.5 billion. The report noted that in drawing on the ECB, the big Italian banks had covered more than 90 percent of their funding requirements for 2012. This is a two-way process—as the Italian banks become more dependent on the ECB, unable to receive finances from normal sources, so the ECB becomes locked into the fortunes of the Italian economy and financial system.

The ongoing European financial crisis has led to deepening conflicts among the major capitalist powers. The United States, together with Britain, is pushing for a greater provision of funds to finance the bank bailout mechanisms.

International Monetary Fund (IMF) managing director Christine Lagarde, who takes her cue from the US, has called for available funds to be doubled to at least $1 trillion. According to Lagarde, if the firewall is big enough it will not have to be used. But no one knows how much is enough. According to some estimates, as much as $4 trillion would be needed.

Speaking at the Davos forum, US Treasury Secretary Timothy Geithner insisted that the only way to maintain the European monetary union was “to build a stronger firewall. That’s going to require a bigger commitment of resources.”

At the same time, however, the US is opposed to the IMF raising additional funds to meet the crisis, demanding that the money come from European sources.

This is being strenuously opposed by the German government of Chancellor Angela Merkel, who insists that fiscal discipline can bring the crisis under control.

The conflicts over the size of the “firewall” do not derive from ideology—a greater concern for the health of the world economy on the part of the US and its allies on the one side, and a Teutonic desire for austerity and restrictions on the other—but from the respective interests of their banks and financial institutions.

While US banks and finance houses are not overly exposed to European debt directly, they would be badly affected by a default. This is because the credit default swaps (CDS) taken out by lenders as insurance would be activated and firms such as Goldman Sachs, heavily involved in CDS operations, would take a major hit. Washington’s US interest, therefore, lies in keeping the system going with ever greater amounts of bailout money.

The Merkel government, on the other hand, is concerned that the more money it is forced to inject into the euro financial system, the greater will be the stress on its own debt position and its banks. German banks were significantly impacted by the onset of the crisis in 2007-2008, not least because of the worthless assets sold to them by American finance houses.

These divisions express one of the central contradictions of the global capitalist economy: the more integrated economic and financial processes become, and consequently the greater the need for global policies, the more clearly the impossibility of such a “solution” is revealed as the major powers seek to defend their “own” interests against their rivals.