THE LIQUIDITY OF BANKING AND BUSINESS SYSTEM

After dealing with an aspect of the liquidity of companies through the prism of their Working Capital, it comes to evoke the liquidity of banks, and its links with the growth of the economy and companies.

Liquidity is generally regarded as “the ability to meet its obligations of cash depending on their maturity” and is defined in three ways:’

Banking literature first retained a narrow definition called "funding liquidity.” This concept covers the liquidity (i.e. cash or assets that can be quickly converted to cash and held therefore) necessary to meet the demands of withdrawals of funds in the short-term from counterparties or to cover their operations. This dimension of liquidity is likely to be predominant in the context of processing as it is traditionally practiced by the banks.

The second definition of bank liquidity considers that banks are also heavily involved in the negotiation of assets. This second dimension, closer to the “market liquidity” (and sometimes also called thus), relates to the ability of banks to liquidate a non-monetary asset, for example a title originally acquired investment to be held to maturity, in an action last spring to raise funds in Central Bank money.

The third definition concerns the liquidity made available to the economy by the Central Bank, both directly by refinancing banks, that by controlling the supply of credit through the rates of interest, statutory reserves and where appropriate of so-called “unconventional” operations. These three components of the liquidity concept have a strong impact on the growth of the economy.

Bank liquidity and macroeconomics

It is useful to focus on the dynamic correlations between liquidity and growth of real GDP. It turns out that the phases of expansion of bank liquidity are closely correlated to the GDP growth: positive flows above the cycle of one to two quarters of pro-cyclical manner.

Secondly, the phases of contraction of liquidity are positively correlated with the cycle that they precede - generally and empirically - two to three quarters. This would suggest that banks manage liquidity of relatively pro-cyclical manner. However, the reallocation of surplus balance is slightly counter-cyclical and follows the cycle with a lag of one to two quarters. The appetite for liquidity therefore increased when economic activity is accelerating, the refinancing needs arising in particular an offer of loans more sustained increasing also in all phases. In addition, it can be worth 'frontloading' acquisition of liquidity during the early stages of an economic recovery in anticipation of an increase in lending activity, therefore anticipate positive flow over

the cycle. Banks may also hold the liquidity for reasons of transactions. These balances are determined by the yields expected and will be adjusted down during economic upswings, to enjoy more profitable investment opportunities in other market segments. This point raises the question of the sustainable macro-economic quality of liquidity. On the other hand, the phases of decline in activity are accompanied by phenomena of "report to safe values" or "*flight to quality"* - mainly Government bonds - resulting in lower liquidity contractions but more limited interest to finance, industrial and commercial enterprises.

The predominance of one of these effects at the level of each institution depends, ultimately, on different factors specific to banks or to the sectors concerned. Liquidity managers are likely to "favour their liquidity ratios on capital gains" which can lead to a reduction in the stock of lending in the "real" economy (i.e non financial institutions), more lucrative but riskier than those granted to the sovereign issuers. So the banking system may tend to "caution against the macroeconomic context" of liquidity management. This preference is consistent with the regulatory constraints imposed on banks concerning their liquidity management, which tends to indicate that the current framework is to encourage behaviour conducive to the stability of the part of the banks but to nervousness with respect to their customers. Finally, the reallocation of 'surplus' of liquidity on the balance sheet is slightly counter-cyclical and follows the cycle with a lag of one to two quarters. This temporal unfolding is perhaps linked in part to the endogenous nature of transactions relating to the liquidity compared to the behaviour of the banking sector and market activity. Recall that the reallocation of 'excess' liquidity reflects the importance of the redistribution of liquidity which actually takes place in addition to the observable compensation of inputs and outputs. His character moderately counter-cyclical means that banks do more transactions for liquidity (and with a lag) during periods of downturn than during economic upswings. Given the connection between the liquidity of the market and the banks, the guarantee of an efficient functioning of markets and their liquidity, when banks intensify their transactions on (liquid) assets has been remaining an objective of financial stability since the 2008 crisis.

The pattern of responses to shocks on the price of assets and on the interest rate is consistent with the idea that cash flows are the result of a trade-off between the motives of "financing" and the search for "earnings". An impact on asset prices slows entries of liquidity of 0.5 percentage point, while it stimulates output of liquidity of 0.17% approximately. It comes to the effect of "portfolio management". Finally, changes in interest rates have a short-term impact on cash flows. An increase of 25 basis points of the interest rate causes an immediate increase in positive flow of liquidity on the balance sheet of 0.06% and a decrease of the negative flow of liquidity of 0.2%.

While this last effect is paradoxical from a macroeconomic point of view, the dynamic response of cash flows remains consistent with the classical theory that liquidity responds negatively to increases in interest rates. The paradoxical impact of shocks on the interest rate may be related to the trade-off between the expected yields and interest rate risk. The liabilities of the banks being

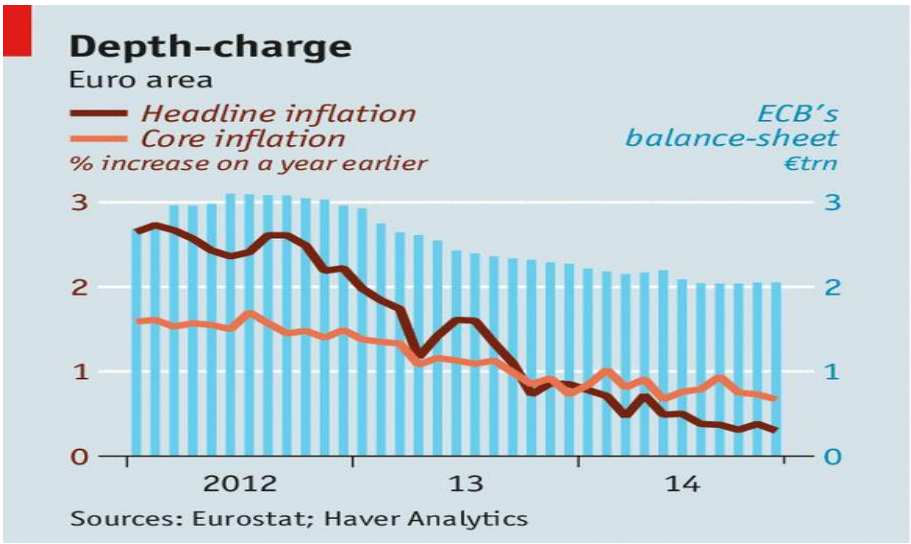
generally less stable than the assets and its sensitivity to higher interest rates, interest charges normally vary more than short-term interest income. An increase of the interest rate thus potentially reduces profits and vice versa.

Thus we perceive some elements of explanation of the policy of the central banks both on interest rates and the amount of liquidity available to the banking sector to support a failed growth rate and participate in the recapitalization banks by integration with the reserves of the generated profits of refinancing but observation of the current situation in the major currency areas led to infer that other measures may be necessary, as they are implemented with some success in the United States and the United Kingdom, and some disappointments in the Japan and around hazards, among others, to the creation of "asset bubbles" and a non-optimal allocation of financial resources . This is the main debate between the ECB and the German Bundesbank, for example, the French and German Governments on the other.

The situation and the economic indicators in the Euro area are not uniformly encouraging

The market conditions in the Euro area have improved considerably since 2008-2010 in the financial markets in general, interbank, shares and bonds in particular. This improvement was a necessary condition for economic recovery although to varying intensities according to the currency areas (cf. supra). It was, however, not enough to find a level of satisfactory activity in Europe and in Japan. Therefore, the ECB has decided to implement programs of purchasing Government bonds on the secondary market to refinance banks but also to bring down interest rates and reduce financial costs of States, banks and businesses. But the level of the rate of inflation in Europe can lead to a deflationary episode and a –potentially hazardous- search of high-yielding assets to satisfy the expectations of institutional investors with the systemic risks that can arise.

The inflation rate of the European economy has been 0.2% and 0,1% respectively in the third and fourth quarter of 2014 and -0,6% in January, -0,3% in February and -0,1% in March. The forecast is, – 0.7 percentage point for 2015 and 0.3 percentage points for 2016 related to a strong decline in energy prices and a sluggish recovery but an active ECB monetary policy: . Mario Draghi, President of the ECB has implemented a proactive programme to 1600 billion Euros of the balance sheet of the ECB increase and therefore liquidity made available to financial institutions in the euro zone... which unfortunately does not, mean that they irrigate the economic fabric.. At the same time after a growth of 0.7% in 2014, revised ECB estimates give figures of + 1.1% and + 1.4% respectively in 2015 and 2016 values incompatible with a reduction of unemployment in Europe, and so weak and uncertain that a near-recession cannot be excluded.



That is why the ECB has proposed to refinance banks that grant loans to non-bank businesses: the program *Targeted Long Term Refinancing Operations* (TLTRO). The ECB allotted EUR 129.84 billion 306 financial institutions under this refinancing operation to four years at a very low rate (0.15%).

This amount, consistent with that expected on average by economists and analysts interviewed by Reuters, brings the total of the cash loaned by the institution in the context of its first two TLTRO, to 212.4 billion Euros while she had planned a maximum envelope of 400 billion and this success calls for new measures to include the purchase of sovereign debt.

These exceptional refinancing operations were initially regarded as one of the major new weapons used by the ECB to try to revive the economy of the euro area and prevent deflation.

The lack of interest shown by banks for the TLTRO complicates the task of the ECB, which has set itself the objective of reducing the size of its balance sheet to its level of early 2012, which implies an increase of about 1,000 billion Euros.

Their very success calls for additional initiatives, especially as the deflationary risk is always present, as shown in the announcement Thursday of a drop of 0.2% of the consumer prices in France last month, and the passage of the indicator of core inflation rates into negative territory, of not seen since the beginning of follow-up in 1990.

However, by including both TLTRO and purchases of covered bonds and collateralized assets (ABS) begun in recent months, including the amounts have so far been modest, it is unlikely that the increase in the balance sheet exceeds 300 billion by the end of the year, a finding that feeds expectations of additional measures in 2015 to reach the target of 1000 billion Euros set by the ECB.

On 9 March 2015 the Euro system started the purchase of bonds issued by euro area central governments and certain agencies and international or supranational institutions located in the

euro area under the **Public Sector Purchase Programme** (**PSPP**). Combined, the ABSPP, the CBPP3 and the PSPP constitute the **Expanded Asset Purchase Programme** (**APP**). Monthly purchases under the APP will amount to €60 billion. They are intended to be carried out until at least September 2016 and in any case until the Governing Council sees a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term.

So much that there are few observers who believe that the massive injection of liquidity into the banking system will result in a restart of the credit because the businesses, in the indecision of their future business conditions, still seem reluctant to borrow, some before auto-censurant even to file a request for credit file.

The key question of the coming months opens the door on the possibility that the ECB is involved in debt business and above all sovereign debt purchases, an option questioned by several Member countries, Germany at the top.

Governments and businesses are taken in hand because you can all expect the central banks.

The crisis, as often, has been raised by a banking event and not due to unstable macroeconomic policies. It was therefore imperative to fill the dramatic fall which could be fatal to undertakings, the interbank liquidity. All measures taken at the time and which have led to public and bank debt rarely recorded in peacetime.

It's now too easy to consider that maintaining a high liquidity and a reduction of public deficits is the solution as this has been precisely and extensively documented in 2010 by the Chief Economist of the Fund International Monetary Olivier Blanchard.

The macro-economic objective of a stable and sustained growth and moderate inflation has not changed. But this crisis and observed economic creativity showed political and economic leaders that new tools are at their disposal.

Central banks have used them in different ways with contrasting results. The subject, well documented is the type of policy mix to be implemented.

The increase in liquidity by the ECB is a necessary condition for the resumption of growth this consumption and business investment. Necessary but not sufficient. Implementation of pragmatic and non-ideological public sanitation and adjustment to the sustainable pace of European economies is the key to recovery.

Out of the doldrums in which operates our business depends on the informed will of officials of a Central Bank's liquidity management, but it is the responsibility of policy makers...and voters.
It is also the responsibility of companies that will develop in the coming months "disintermediated" (i.e. linking direct borrowers and institutional and individual investors)

funding programs - that will follow complementary distribution channels of the banking system in an evolving regulatory framework.

Dominique Chesneau *has acquired experience in the financial services as a corporate treasurer, as head of a trading room and as an audit partner with PWC and Deloitte.*

He has been the managing partner of TresoriskConseil since 2005.

Within financial institutions and corporates, his areas of expertise are the financial risk management, treasury and cash management and the associated regulatory and accounting aspects of the French industry and a professor at HEC Business School.