



EUROPEAN CENTRAL BANK
EUROSYSTEM

DG MARKET OPERATIONS

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Money Market Contact Group

Teleconference held on Friday, 7 May 2010 at 10:30

In the ad-hoc teleconference, which was launched in order to receive banks' feedback on recent market developments, market participants were generally very concerned about the recent deterioration of liquidity conditions in bond and money markets. Many of them mentioned that the situation was reminiscent of the one following the Lehman bankruptcy in September 2008.

The origin for the difficult situation was generally seen in the dislocations that had emerged in the euro sovereign debt markets. These dislocations were viewed as having a major impact on the market perception of the credit risk of European banks, as the latter were known to hold large amounts of such government bonds. In this respect, it seemed to be not only the concern that there might eventually be a restructuring of the government debt of one/some euro area countries, but that there was also a lot of uncertainty as regards the effect of the recent price moves on banks that have to mark-to-market their positions.

Members mentioned that these concerns seem to have caused US institutional investors to tighten their USD liquidity supply to European banks, which has caused severe dislocations in the FX swap market (which is used by European banks to generate USD liquidity). This is apparently not limited to the EUR/USD FX swap, but is also affecting other currencies' swap rates like the GBP. Additionally, banks reported that the renewed concerns have led to increasing difficulties to raise unsecured EUR cash, especially in longer maturities, as institutional money market investors were shortening the maturities at which they are still willing to offer funds.

Of note is that all participants stressed that the situation has developed extremely quickly and in fact quicker than after the Lehman bankruptcy. This was explained by banks (and institutional investors more generally) apparently having simply switched back to their earlier crisis modes, which they still have in fresh memory. Moreover, institutional investors liquidating (or being forced to liquidate) their positions were seen as being the driving force behind the recent developments - speculative behaviour (e.g. in CDS markets) may also have contributed somewhat, but was not viewed as being the main driver right now.

Against this background banks urged the ECB to come-up in the very near-term with a convincing crisis package that should include (i) an intervention in the government bond markets (ideally backed by a political mandate to do so); (ii) the re-introduction of USD providing operations; and (iii) the re-introduction of (ideally unlimited) longer-term EUR operations.

Several banks actually characterised the situation as being worse than after the Lehman default, as (i) the situation deteriorates much faster; (ii) a government backstop for the banking industry is no longer credible in some countries; and (iii) even with a quick and complete implementation of the package outlined above the situation might not calm down, if the perceived political uncertainties persist.