How not to be a lender of last resort

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Since December of last year, the European Central Bank (ECB) has injected massive amounts of liquidity into the eurozone banking system. There can be little doubt that these injections were necessary to save Europe’s banking system. In addition, these lender-of-last-resort operations were instrumental in stabilising the government bond markets in the eurozone. Yet it can now be said that they were ill-designed, making it likely that the ECB will have to discontinue these operations.

What went wrong in the way the ECB designed its lender-of-last-resort operations? It is important to keep in mind that the present crisis in the banking system is almost exclusively caused by the sovereign debt crisis that emerged in early 2010. After the insolvency of the Greek sovereign was exposed, investors were caught by panic and started to sell the sovereign bonds of other 'peripheral' countries. These countries were solvent, but they were caught in a liquidity crisis by the massive bond sales which led to a collapse of bond prices and sky-high interest rates. Since most of the sovereign bonds were held by eurozone banks, the sovereign debt(224,587),(852,619)
debt crisis turned into a banking crisis.

The ECB chose not to intervene at the source of the problem – the sovereign bond markets – and thereby allowed the crisis to become a banking crisis. And when the latter emerged, it delegated the power to buy government bonds to the banks, trusting they would buy these bonds. But the banks themselves were and still are in a state of fear.

The decision of the ECB to delegate the decision to buy government bonds to panicked bankers has three unfortunate consequences that will become clear now that the central bank has completed its second liquidity injection. The first consequence is that the banks channeled only a fraction of the liquidity they obtained from the ECB into the government bond markets. As a result, the ECB had to pour much more liquidity into the system than if it had decided to intervene itself in the government bond markets. If the banks used only half of the liquidity to buy government bonds, the ECB had to create two euros to make sure that one euro would find its way into the sovereign bond market.

Second, new waves of panic may grip the bankers again, leading them to massively sell off government bonds. The risk that this may happen undermines the credibility of the whole operation, and can quickly lead to a new crisis in the government bond markets. Will the ECB then again increase its lending to these banks in the hope that frightened bankers will resume their purchases of government bonds?
Third, and most importantly, the massive liquidity injections in the banking system create moral hazard problems that are more dangerous than those resulting from direct intervention in the sovereign bond markets. Banks are now given unlimited sources of funding to make easy profits. This reduces their incentives to restructure their balance sheets that will make them more resilient in the future. True when the ECB intervenes directly in the government bond markets, moral hazard risk is created because governments may have less incentive to reduce budget deficits. This risk, however, has been reduced significantly in the new institutional environment that gives considerable power to the European Commission to impose austerity programmes – a power the European Commission has happily embraced to impose excessive austerity in the eurozone and to drive it into recession.

The ECB’s LTRO (longer-term refinancing operation, announced in December 2011) has relieved the pressure in the sovereign debt markets of the eurozone. But this is only temporary. The peripheral eurozone countries are now pushed into a deep recession that will exacerbate their fiscal problems and will create renewed distrust in financial markets. As a result, the sovereign debt crisis will explode again, forcing the ECB to make hard choices. Either it will stick to its indirect LTRO approach giving cheap money to trembling banks with all the problems this entails. Or the ECB will become pragmatic and intervene directly with a steady hand in the government bond markets.

It is often said that Germany will never accept such direct interventions. Today this German opposition is difficult to overcome, and explains why the ECB reverted to the indirect LTRO-programme. But what is politically impossible today may in the end be accepted when it becomes obvious that direct intervention is the only way to save the eurozone. It would help if the German opponents liberate themselves from the dogma that it is a sin to create liquidity to buy government bonds when these bonds appear on the ECB’s balance sheet, while the same operation is viewed as virtuous when these bonds appear on the balance sheets of banks.