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UMASS

The debt crisis and the European Central Bank's role of lender of last resort

by Carlo Panico and Francesco Purificato

1. The debate on the role of the central bank in the European debt crisis reveals the increasing difficulty of the authorities to apply sensible solutions. De Grauwe and Ji express this opinion by noticing that unfounded fears 'have been widely advertised in Germany and have contributed to creating a view in that country that the German taxpayer is likely to become the victim of a money machine that rewards the profligacy of Southern European countries' (De Grauwe and Ji, 2012, p. 1). These fears 'have become powerful political forces that make it difficult for the governments to find rational solutions to the euro crisis' (De Grauwe and Ji, 2012, p. 13).

In order to appraise this opinion we discuss how the European Central Bank (ECB) and the Eurosystem have been intervening in favour of the Government sector. We start by noticing that central banks can play the role of lenders of last resort in favour of the banking and of the Government sector and that "moral hazard" problems emerge in both cases. Yet, they have only been mentioned to curtail the interventions in favour of the Government sector, in spite of the fact that, during the last two decades, moral hazard regarding the behaviour of the Government sector has proved easier to solve than that regarding the behaviour of the managers of financial firms. The rules on multilateral surveillance, introduced to coordinate the monetary and fiscal policies in Europe, have worked more effectively than those on financial regulation. The former have induced some discipline in the behaviour of national Governments (see Fatás and Mihov, 2003 and 2010; Ioannou and Stracca, 2011, Panico and Purificato, 2012), while the latter have failed to induce prudent behaviour among the managers of financial firms.

2. When the debt crisis began in April-May 2010, the total value of the Greek sovereign debt was around 300 billion euros and it was sufficient to buy a portion of it to persuade the markets that the European monetary authorities, like those operating in USA, UK and Japan, were determined to stabilise the interest rates and normalise the transmission mechanism of monetary policy. To avoid the negative consequences of the speculative attacks, it was necessary at that time to spend a small sum compared with

- the approximately 1,000 billion euros extraordinary three-year loans that the ECB granted to the euro area's credit institutions on December 8, 2011 and on February 29, 2012,
- the funds activated by the assistance programmes,
- the loss in GDP, employment and growth caused by the restrictive policies imposed to the countries under attack.

The sum to be spend in April 2010 to counter-act the speculative attacks appears even more negligible if we consider that the imposition of policies undesired by the majority of the population is seriously interfering with the working of democracy and with the respect in international relations that has characterised the history of regional integration in Europe since the 2nd world war. Moreover, it is increasing inequality, triggering social tensions, magnifying conflicts among member States, undermining the confidence in the European values and institutions and disrupting political life.

3. On May 10, 2010 the ECB announced the start of the Securities Market Programme (SMP), envisaging the purchase of Government securities to restore the working of the transmission mechanism of monetary policy. The decision represented a drastic change in the philosophy of the Eurosystem, which had always denied the possibility of funding national Governments through the monetary base. It stated that the Eurosystem could buy securities in the secondary markets because these interventions do not contradict the Treaty on the functioning of the European Union (EU) and the Statute of the ECB.

Why did the ECB wait until May 10 to announce the SMP? In spite of its independence, the ECB, like the other European authorities, waited the end of the regional elections of May 9 in Renania-Westfalia (Germany) to respond to the speculative attacks to the Greek sovereign debt. The attacks started at the end of March, gambling on the view, which proved correct, that the European authorities would not react until the election had ended.

The SMP foresees that the securities are bought from the Monetary Financial Institutions and the payments are settled in their current accounts with the Eurosystem. To avoid changes in the monetary policy stance and the risk of inflation the Programme establishes that the liquidity injected must be sterilised through fine-tuning operations in the form of collection of fixed-term deposits. Moreover, as a protection against the risk of losses on the value of the assets, the securities are bought on a held-to-maturity basis.

4. In spite of these precautions, there was opposition to the SMP within the Governing Council of the ECB and some of its components criticised it in their national newspapers. Weber, then President of the Bundesbank, criticised its adoption in a German newspaper, the *Börsen-Zeitung*, the day after its official announcement. An article by Stark, the German component of the Executive Council of the ECB, published in the *Financial Times Deutschland* on October 25, 2010, further corroborated the view that conflicting national interests within the European Monetary Union (EMU) were a relevant issue in German politics. Stark himself resigned from his position in September 2011, after the Programme resumed the purchase of securities that had been suspended in January 2011 (see Table 1 below).

Table 1 - Securities Markets Programme: purchased and sterilised securities
(billions of euro)

	2010											
	Jan	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
Purchased	0.0	0.0	0.0	0.0	35.5	55.3	60.2	60.8	63.3	63.3	67.2	74.0
Sterilised	0.0	0.0	0.0	0.0	26.5	51.0	60.5	60.5	61.5	63.5	66.0	60.8
	2011											
	Jan	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
Purchased	76.5	77.5	77.0	76.1	74.9	74.2	74.0	115.6	160.7	173.5	203.3	211.9
Sterilised	76.5	77.0	76.5	71.4	75.0	74.0	74.0	110.5	156.5	169.5	194.5	211.0
	2012											
	Jan	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
Purchased	219.1	219.3	214.2	214.2	212.1	211.3	211.3	208.8	209.5	209.3	208.5	208.5
Sterilised	219.0	219.5	213.5	214.0	212.0	210.5	211.5	209.0	209.0	209.5	208.5	208.5

Source: ECB

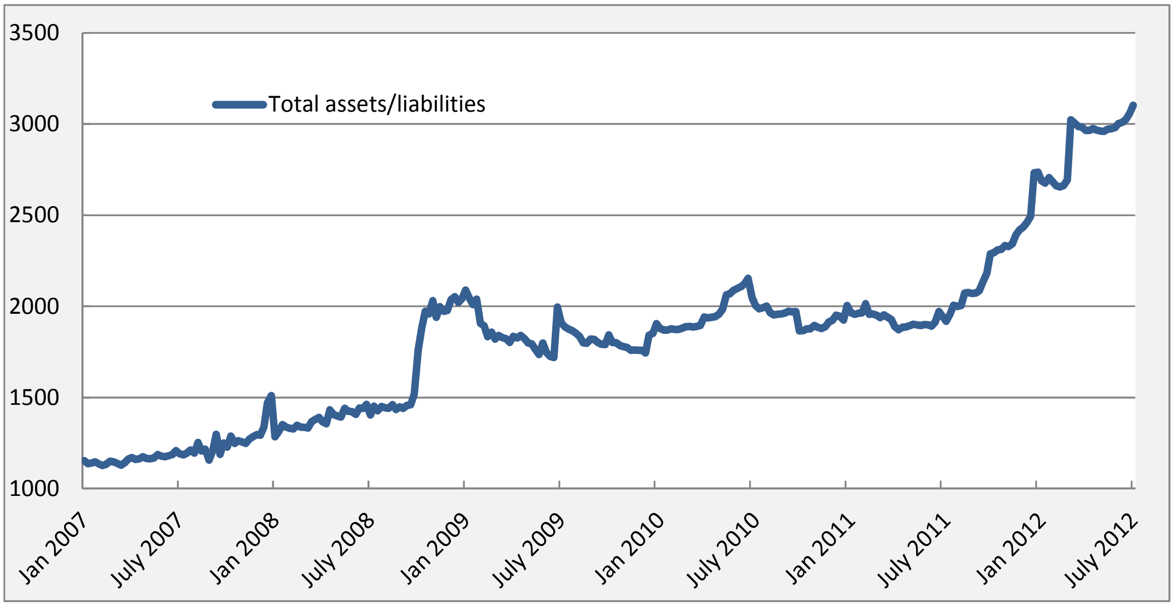
These events, interpreted as a sign of the existence of national conflicts within the ECB, held back the central bank’s interventions against speculation, as it happened to the Federal Reserve during the crisis of 1929, and favoured further increases in the interest rates on the sovereign debt of the countries under attack. According to the principles inspiring the organisation of the Eurosystem and affirmed by the Treaty on the functioning of the EU and by the Statute of the ECB, these conflicts should not affect the components of its governing bodies, whose decisions must reflect the interests of the whole area, rather than the national ones.

5. The resumption of the purchases of securities by the SMP in August 2011 followed the deepening of the debt crisis caused by the declarations of several political leaders in favour of an agreement between the Greek Government and the private sector on a partial reduction of the face value of sovereign bonds. These declarations signalled to the electorate the will of those leaders to impose on the banking sector part of the cost of the management of the Greek sovereign debt. On July 21, 2011, the European Council, i.e. the Council of the Heads of State or Government of the European Union, brought in the content of those declarations in its Decision to resort to “Private Sector Involvement” for Greece. This Decision made market operators realise that the private creditors of the Government sectors had to bear losses on their loans. The size of the loss was specified in February 2012, when the Greek Government and the private sector agreed on a 53.5% nominal “haircut” on the face value of debt.

The ECB had opposed this solution fearing the negative effects of a debt restructuring on the management of sovereign debts and on the working of the interbank markets. The concerns of the central bank were justified. By the end of July, speculative attacks further raised the interest rates and involved in the crisis the Spanish and the Italian sovereign securities. The confidence in the public finances and the banking systems of these two countries declined and the interbank loans to their financial institutions shrank (see ECB, 2012, p. 59). As a consequence, liquidity provision and the stock of assets and liabilities of the Eurosystem rose as sharply as after the failure of the Lehman Brothers (see Figure 1 below). To replace the interbank markets, the Eurosystem had to set in through its payment system, called TARGET, which is an acronym standing for *Trans-European Automated Real-Time Gross Settlement Express Transfer*. TARGET is the infrastructure through which liquidity circulates in the euro area. It allows central bank money to be transferred between the National Central Banks of the area and to settle, through them, cross-border payments between private banks.

Figure 1 - Consolidated financial statement of the Eurosystem, total assets/liabilities (Jan. 2007- July 2012)

(Billions of Euro, end of period weekly)



Source: Elaborations on ECB database

6. The deepening of the crisis in Summer 2011 led the central bank to compensate the damage of the Private Sector Involvement by introducing new measures in favour of the banking sector. On December 8 the ECB implemented the first of two additional "non-standard" measures in the form of extraordinary long-term refinancing operations at fixed rate tender and full allotment (i.e. unlimited amount) for the banks of the euro area. The maturity of the loans was three years and the interest rate 1%. This first operation provided over 489 billion euros for credit institutions. The second provided them with about 530 billion euros and took place on February 29, 2012.

On the same day Weidmann, President of the Bundesbank, published in the *Frankfurter Allgemeine Zeitung* a letter to Draghi, President of the ECB. The letter thinks back on some criticisms against the increase in the provision of liquidity through the TARGET payment system (see Sinn and Wollmershäuser, 2011; 2012). These criticisms, which name "debtor countries" those under attack and "creditor countries" the others, argue that the Eurosystem has been surreptitiously helping debtor countries to avoid the salutary discipline of the markets, imposing additional risks on the taxpayers of creditor countries.

For Sinn and Wollmershäuser (2011; 2012), the debt crisis has been caused by the decision of the political authorities of debtor countries to let their citizens live beyond the material possibilities of the economy. This choice has generated unsustainable current account deficits, loss of confidence in the public finances and in the banking systems of these countries, and a sharp contraction of the loans of the inter-bank markets to them. The consequent interventions of the Eurosystem have raised TARGET balances, which are claims on and liabilities to the ECB in the balance sheets of the National Central Banks. Within the TARGET system the ECB acts as a clearing-house. Whenever central bank money moves within TARGET from one country to another, the transferring central bank records in its balance sheet a liability to the ECB identically equal to the reduction of another liability, e.g. the deposit held by the commercial bank making the payment. The recipient central bank instead records in its balance sheet a claim on the ECB identically equal to the increase in a liability, e.g. the deposit held by the commercial bank receiving the payment. When the interbank markets cease to function, the provision of liquidity by the Eurosystem and the TARGET claims and liabilities increase, as shown by Figure 1. For Sinn and Wollmershäuser, the rise in these balances is a source of additional risks for the taxpayers of creditor countries.

7. De Grauwe and Ji (2012) oppose these positions. Their econometric analysis shows that the increases in liquidity and in the TARGET balances during the debt crisis are related to speculative capital movements, rather than to the current account deficits of debtor countries (for a similar view see Cecioni and Ferrero, 2012). The capital movements are triggered by the spread of unfounded fears about the working of the EMU and by the existence of conflicting national interests within the governing bodies of the ECB, that makes its interventions against speculation insufficient and uncertain.

De Grauwe and Ji also reject the use of TARGET claims as a measure of the additional risks incurred by the taxpayer of creditor countries. When the interbank markets cease to function TARGET balances replace those held by private financial institutions. Yet, there are no additional risks for the taxpayers of creditor countries because those previously assumed by their private banks for loans given to private banks of debtor countries are now taken by the National Central Banks for claims on the ECB and the probability that the Governments of creditor countries must intervene to rescue the ECB cannot be considered higher than the probability that they have to intervene to rescue private banks.

De Grauwe and Ji (2012, pp. 11-12) finally reject the statement that the rise in TARGET claims increases the risks incurred by the holders of base money. This statement, they argue, signals an erroneous understanding of the working of a fiat money system. The acquisition of TARGET claims implies the issue of central bank money (legal tender), whose value, in a fiat money system, does not depend upon the value of the assets held by the central bank. Under these conditions, the risk borne by the owners of base money is related to the loss of its value in terms of goods and services and, as long as price stability is maintained, no loss is made for holding it.

8. On September 6, 2012, the Governing Council of the ECB decided to replace a new Programme, named Outright Monetary Transactions (OMTs) in secondary sovereign bond markets, for the SMP. The new Programme foresees that the Governing Council has full discretion in deciding its activation, continuation and suspension for the countries involved and that the liquidity created through the purchase of securities be sterilised. Moreover, the Programme sets that the securities are bought on a held-to-maturity basis, have maturity between one and three years, and are issued by Governments that respect the conditionality imposed by the European authorities.

In an interview to the *Neue Zürcher Zeitung*, published on September 26, Weidmann, President of the Bundesbank and the only member of the ECB to vote against the new Programme, explains the reasons of his opposition. The interview explicitly confirms that conflicting national interests influence how the ECB intervenes against the speculative attacks. Weidmann states that these conflicts have affected the content of the Programme, which is the result of a compromise between two positions. The first, in favour of the Programme, wants to counter-act the speculative attacks by endowing the ECB with the power to buy unlimited amounts of securities. The second rejects this solution believing that the purchase of securities cannot solve the crisis, which is due to structural problems such as lack of competitiveness and misuse of public finance. Weidmann supports the second view, saying that the Programme helps the Governments of debtor countries to avoid the discipline of the markets and ‘spreads liability risk among euro-area taxpayers’ (http://www.bundesbank.de/Redaktion/EN/Interviews/2012_09_26_weidmann_nzz.html). He says that other colleagues in the Governing Council were convinced that his concerns are justified, but thought that they can be addressed by appropriately designing the content of the Programme.

Weidmann does not clarify to which risks for the taxpayers he refers. They cannot be related to inflation and loss of value of the securities, because the SMP sterilises the liquidity injected and operates on a held-to-maturity basis. One is thus led to think that he refers to the risks mentioned by Sinn and Wollmershäuser. In the previous sections we have seen that outstanding economists turn down the criticisms raised by these authors. In spite of that, the President of the Bundesbank seems to suggest that the TARGET balances introduce additional risks for the taxpayers of creditor countries. By doing so, he contributes to propagating fears that favour the speculative capital movements and make it difficult for the authorities to apply rational solutions to the euro crisis.

9. The analysis of the interventions of the Eurosystem in favour of the Government sector suggests that the existence of national conflicts within its governing bodies has favoured speculation. The debt crisis could be avoided if, in April 2010, the ECB had timely intervened in favour of the Government sector, as it did for the banking sector on August 9, 2007, when the financial crisis began, and after the failure of the Lehman Brothers (see Panico and Purificato, 2010). On the contrary, like other European authorities, the ECB waited the end of the regional elections in Renania-Westfalia to counter-act the speculative attack against the Greek sovereign debt. After then, the existence of conflicts within its governing bodies has kept its interventions insufficient and uncertain.

De Grauwe and Ji point out that the media and some professional blogs are spreading false interpretations of the crisis and unfounded fears on the working of the monetary union, making it difficult for the authorities to apply sensible solutions. They consider the misuse of public finances by the national political authorities the main cause of the crisis:

the national authorities have let the citizens live beyond the material possibilities of their economy. This interpretation has led to the proposal of austerity policies, which are proving as disastrous as those implemented in Latin America since the 1980s (see Capraro and Perrotini, 2012).

Part of the scientific literature considers that the European debt crisis has the same origin as those affecting Latin American countries since 1982. Recalling the works of Calvo (1988), Calvo et al. (2003) and Eichengreen et al. (2005), De Grauwe (2009; 2011a; 2011b; 2011c) and Valiante (2011) argue that, if the central bank does not act as lender of last resort for the Government sector, this is forced to issue debt in a currency that it does not control and, under these conditions, sovereign borrowers with sound fundamentals can be driven into a default on their obligations. On the contrary, Haufler et al. (2011), a document presented in a professional blog, opposes liquidity assistance to the countries under attack claiming that Governments unable to persuade the markets must be considered insolvent. Always recalling the works of Calvo and Eichengreen, Kopf (2011: 10) argues that this conclusion 'ignores key findings of the theoretical literature on sovereign debt crises'. As shown above, a similar conclusion can be drawn on the criticisms raised by Sinn and Wollmershäuser, to which the President of the Bundesbank seems to refer approvingly.

The relevance of the moral hazard problem related to the central bank's interventions in favour of the Government sector cannot be underplayed. This problem is related to the working of the process of coordination between monetary and fiscal policies. A debate on this issue developed in the literature since the start of the EMU and reached important conclusions well before the crisis of 2007. In spite of the diversity in the theoretical positions presented, the debate shows consensus on the following points:

- to formulate transparent (i.e. unambiguous) rules of coordination,
- to increase flexibility (i.e. the ability of the rules to differentiate among cyclical conditions and the problems of each economy),
- to pay attention to financial sustainability, to the avoidance of pro-cyclicality, to the introduction of structural reforms and innovation and to the formation of physical and human capital,

- to strengthen the enforcement to enhance cooperative attitudes among the actors of the coordination process and to favour the search for the most convenient policy for the whole area.

According to some authors, these conditions can be met by setting a European fiscal agency, which can favour the use of fiscal policy to enhance growth and can avoid the adoption of measures that cause recession and intensify structural disequilibria (see Panico and Purificato, 2012).

The literature on the crises and on the institutional organization of policy coordination contains rich material for the sensible solutions of current problems. Yet, the media and some professional blogs keep proposing false interpretations, which spread unfounded fears, and punitive solutions in terms of austerity policies. These solutions negatively affect the economic conditions of the large majority of the population in debtor and creditor countries and do not reflect the interests of the whole area.

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