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Assessing the European Central Bank's Euro Crisis Policies

Ernst Baltensperger*

The European Central Bank (ECB) has a well-defined, clear mandate: to maintain price stability within the Eurozone and, as long as this prior objective is met, to support the general economic policies in the Community. It is well understood – as it is for any other modern central bank – that its monetary stability objective includes ensuring smooth operation of the Eurozone payment system and money market. This mandate, as well as the way the ECB chose to set its policy under it, met widespread approval during the first ten years of its existence. This has been of paramount importance to establishing the Euro as a successful, stable currency over this period. Indeed, this mandate and the high degree of institutional independence granted to the ECB in pursuing it probably are the strongest features of the architecture of the newly created Monetary Union, providing it with a much needed counterbalance to a number of other, structural weaknesses resulting from the Union's large degree of heterogeneity and the corresponding economic and political tensions and risks.

Views on all this have changed dramatically since the onset of the Euro crisis of recent years. In response to this crisis, the ECB has extended its range of actions in ways which have led to both internal controversy in the ECB Council and to external challenge arguing that the ECB is overstepping its mandate. A heated and often emotional debate has started, not only about the appropriate interpretation of the ECB's given mandate and the procedures and policies allowed under it, but also about this mandate itself and whether it is too narrow and should be broadened.

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The global financial crisis has led central banks around the world to extend the range of policies considered. "Unconventional" monetary policy measures have become common, including "quantitative easing" and "credit easing" in various forms (meaning direct interventions of the central bank in segments of the credit and capital markets where, with good reason, they have traditionally refrained from being active). The success of such interventionist policies remains to be seen in the future. While the ECB has been more reluctant than others in the use of such measures, it has started its own controversial program of acquiring sovereign debt of financially troubled members, beginning with large purchases of Greek government debt in May 2010. While this is defended by the ECB as a measure ensuring the operational stability and efficiency of money markets in these countries, it clearly has the effect of supporting them financially by keeping their refinancing conditions more comfortable than they would otherwise be. In this sense, it represents a violation of the Treaty on the Monetary Union and its no-bailout provision, at least in spirit if not in law.

Today, many urge the ECB to go even further in this direction, ultimately in form of an unreserved commitment to unlimited purchases guaranteeing these countries access to capital markets at "reasonable" financial conditions (whatever that may mean). Bringing out the ECB's "big bazooka" is dramatically advertised by many as the only remaining solution for ensuring the coherence of the Eurozone and survival of the Euro (and possibly the EU itself). A variant sometimes suggested is extending a banking license to the European Financial Stability Facility, giving it unlimited access to ECB credit which it could transform into help for the financially suffering member countries. The ECB has also been sharply criticized, especially in Germany, for having allowed a large run-up of net creditor and debtor positions under its Target 2 system, with Germany being a net creditor to the tune of over 300 billion Euros.

The central concern in all this is that it will move (or already has moved) the Eurozone towards a dangerous course mixing up monetary and fiscal motives for public policy actions. A dependence of monetary

policy on the decisions of fiscal authorities is, historically speaking, the biggest risk to monetary and financial stability. In the context of the European debt crisis and the associated weakness of the European banking system, which might make a recapitalization of banks through the states necessary sooner or later, this is a potentially explosive risk.

Independence of monetary policy from fiscal decisions has been a basic premise of European Monetary Union architecture. I am strongly convinced that this is of central importance for the Union's long run survival and must be preserved at all cost. Of course, in a consolidated view of the public sector, monetary and fiscal decisions are linked to each other through the sector's budget constraint. Central bank profit (seigniorage) is part of public sector revenue. In this sense, monetary and fiscal actions must be coordinated in one way or another. But precisely for this reason it is of paramount importance to choose the appropriate pattern of coordination. The monetary authority must have priority in setting its instruments in pursuit of its mandate (which asks for monetary stability and not, not even indirectly, for fiscal objectives), and the fiscal authorities must adjust and passively accept whatever fiscal revenue results from this central bank action. This is the only type of coordination consistent with enduring monetary stability and success. In the case of the Eurozone, where the fiscality of not just one federal government is involved, but that of 17 independent members, this is all the more obvious.

Against the background of this premise, I will examine two issues already referred to above:

1. Should the ECB maintain and extend its purchase program for member country sovereign debt? In particular, should it make an unconditional commitment to buy such debt in order to ensure "acceptable" financing conditions for financially weak members?[1] Would such a policy be successful at all?

2. Should the ECB adjust its policy vis-à-vis Target 2 and the resulting imbalances in net credit positions between member countries?

[1] It has become common to refer to such a policy as "Lending of Last Resort" for countries. I refuse to use this terminology, as the traditional doctrine of Lending of Last Resort was never meant to apply to governments and states, but only to banks. It was always seen as a response to a problem of asymmetric information specific to private capital markets and banks. In my view, it does not apply to governments in any way.

The ECB and member country sovereign debt

We must differentiate central bank purchases of government debt according to motivation:

- *Government debt purchases as an instrument of "normal" monetary policy.* Many central banks have a tradition of buying outstanding debt of their governments on the secondary market as a matter of routine, typically short-term debt. This is the textbook example of an open market operation. There is nothing wrong with it, as long as the central bank is guided by monetary policy motivations, i.e. it is setting the conditions for these purchases in accordance with its monetary policy objectives and mandate.

- *Government debt purchases as an instrument of "unconventional" monetary policy.* Some central banks, notably the US Federal Reserve and the Bank of England, have engaged in large purchases of government debt, of different maturities, in order to directly influence the conditions in the corresponding market segments. The shift to this policy of "quantitative easing" is due to the fact that central banks' traditional policy rates, like the Federal Funds Rate in the US for example, were close to zero already and thus not useable as an active instrument anymore. Again, in principle, there is nothing wrong with such measures, as long as the central bank's underlying motivation is one of monetary policy. Of course, these policies and the huge increase in liquidity generated by them are risky. Only the future will tell whether central banks will be able and willing to rein in this liquidity in due time, once economic conditions normalize and the demand for liquidity returns to traditional levels.

- *Government debt purchases with a (possibly hidden) fiscal motivation*. In practical terms, it is difficult to keep monetary and fiscal motives apart, once the central bank starts intervening directly in the markets for long term government bonds and consciously works at keeping long-term rates low. Central banks such as the Federal Reserve or the Bank of England officially justify their policies of quantitative easing in monetary policy terms. Intellectually, this is defensible. Nevertheless, suspicion that fiscal motives may also play a role cannot be very far. Fiscal motives can enter in two ways. Firstly, keeping rates low means direct relief for current government

finances. Secondly, factoring in future inflation may lower the real burden of existing government debt (as long as inflation premiums adjust only with lags). In Europe, the ECB defends its sovereign debt purchases with the need to stabilize money markets and banking systems in the troubled periphery countries, and thus in the Eurozone overall. Again, this is an intellectually supportable argument. However, since the effects of these purchases are so obviously and directly fiscal, and since fiscal woes are at the very heart of today's Eurozone problems, it is difficult to accept it at face value.

Should the ECB make an unconditional commitment to buy member country sovereign debt without limits, in order to support the markets for this debt and force interest rate spreads back to "reasonable and acceptable" levels?

This is often proposed today as the only efficient, or even the only remaining, crisis solution mechanism for the Eurozone's troubles, by investors, politicians and academics alike, especially from Anglo-Saxon quarters. In my view, this a high risk proposal which is likely to have damaging, and possibly fatal, long-run effects for the ECB as an institution and Eurozone architecture overall. For this reason, moreover, it is not at all clear that it would work as expected even in the short run.

The most serious flaw and long-run risk of the proposal is that the ECB would assume an essentially fiscal role. True, markets can exaggerate, especially in crisis situations. It is possible that risk premiums for some countries are overstated by the market today. But can we be sure of this? Interest rate spreads before Monetary Union were even higher than today. And how does the ECB decide on what constitutes an appropriate country by country structure of rates? The ECB would come under heavy political pressure to set rates according to the (fiscal) desires of member countries. It is very hard to see how central bank independence could be preserved under these conditions. The ECB would become dependent on the fiscal wishes of 17 independent member governments. These governments would try to exert influence effectively loosening their own budget constraints. This could hardly be helpful for fiscal discipline and structural reform in the crisis countries. On the contrary, it is likely to slow up the reform process and prolong the crisis.

Some discussants see these dangers, but argue that they can be overcome by announcing an unconditional future return to the no-bail-out principle, while pledging for unlimited ECB purchases of government debt as a crisis solution mechanism now (e.g. Wyplosz 2011). However, it is extremely difficult to see how you can credibly commit to something for the future, when you do precisely the opposite now. This is particularly true if the suggested solution for the present rests on a violation of existing law: the no-bailout principle is part of existing law; it has been violated, and with the proposal it would be further violated.

Many defend the proposal by arguing that, if only the ECB was forceful enough, the mere announcement would be sufficient and no actual purchases necessary. However, this is likely to be wishful thinking. It might hold true if current Eurozone woes were entirely due to market exaggeration, with no "real" underlying problems. But nobody believes that. It is common knowledge that important Eurozone members require deep structural reform and adjustment; otherwise, the currency union will never be able to overcome its internal imbalances.

Mere reliance on an announcement effect would require full credibility. Full credibility in turn requires unanimous support among all relevant participants. The latter could never be expected, as the biggest and most important player, Germany, is very much opposed. At best, a temporary calming of markets could be hoped for. But not even this is certain. With incomplete credibility, the private holders of sovereign debt might see the ECB's offer as a chance to load off and sell, creating a vicious, rather than virtuous, circle – not least in view of their current experience with Greek debt. In the medium and long run, markets would undoubtedly realize the illusionary character of the plan and see it for what it really is, a big bluff: If the ECB actually had to buy up major parts of the debt of its member states, the Eurozone would soon be politically destabilized and near its end.

By suggesting that mere announcement is enough and no actual purchases needed, while at the same time relaxing incentives for vigorous reforms in the crisis countries, the plan creates the illusion that the Eurozone's problem is just one of liquidity and can be overcome by a mix of bold action and temporary relief. Indeed, countries like Italy or Spain are not insolvent (yet), but suffer from serious liquidity con-

straints. But the reason for this is that they are on a course which will lead them towards insolvency, if not corrected, and the markets realize this. What they need is decisive reform taking them off the road towards insolvency, especially fiscal and labor market reform, not relief from the need for reform. Of course, such reform must be taken with a medium and long term perspective and, as much as possible, avoid risks of cyclical decline and recession. By creating a credible long-term commitment for efficient and viable social and economic institutions, it must create confidence and encourage consumption and investment. Governments cannot delegate this difficult task to the ECB.

The ECB and Target 2 Balances

Imbalances in the Eurozone's system for automatic settlement of all Euro payments and transfers, Target 2, have become a much discussed topic, especially in Germany. This is understandable. As Hans-Werner Sinn keeps pointing out, over the last few years the Bundesbank has accumulated a huge net creditor position in this system, exposing Germany to significant credit risk beyond what is already implied by all other support programs for financially weak Eurozone members. Net balances of ECSB national central banks in the Target system reflect net capital movements between member countries "organized" through the Eurosystem. In this sense, they are similar (and often compared) to balance-of-payments imbalances under a fixed exchange rate regime (which, at the given exchange rate, had to be financed by equivalent "official" capital transactions). However, note that the Eurozone is not just an arrangement of fixed exchange rates, but a single currency area. In a single currency area, we do not normally pay much attention to "regional" payments imbalances.

How have the large Target 2 imbalances come about? They are the combined result of a (crisis-related) redirection of capital flows from North-South to South-North and the (also crisis-related) shift of the ECB to a policy allowing Eurozone banks unlimited access to central bank money at very low cost. Greek (and other periphery) banks have dramatically increased their central bank credit. This has allowed Greece to maintain private capital exports and imports of goods and services beyond what would otherwise have been possible.

Is this a problem, and why? Firstly, it is a problem for Germany (and potentially other countries in a similar position), as its risk exposure is increased. Given the size of the Bundesbank's claims and its large capital share in the Eurosystem, this is of obvious concern to German taxpayers. Secondly, it is a problem to the extent that Target 2 credits have the effect of slowing up much needed reform in the receiving countries. Then, these credits may help to prolong, rather than overcome, the actual crisis.

What should be done? One view is that the Target system is flawed and must be reformed, once the crisis is over. In particular, periodic (e.g. yearly) settlement of open positions through transfers of marketable assets is proposed. A similar rule of the US Federal Reserve is cited as an example (Sinn and Wollmershäuser 2011). However, I share the concern that such settlement restrictions could seriously lower the efficiency of the European payment system and rob the Monetary Union of one of its central features (Bindseil and König 2011). The cited US rule for yearly inter-district settlement, in essence, is just a rule for redistribution of profit among the 12 district central banks and does not imply capital flows between regions. Consequently, it would not really correct the situation, in particular not the second problem mentioned above. Nevertheless, some variant of it could be used to at least partially compensate Germany for its increased risk exposure.

My own view is, however, that the problem must be mainly addressed by appropriately defining conditions for central bank credit. Unlimited access to such credit creates adverse incentives and cannot be the rule. Consider how we would look at the same issue, if it would happen in a single currency area such as the USA or Switzerland. Imagine that a US member state, say Texas, is broke, and as a result the Texan banking system is broke, because it holds a lot of Texan state debt. What would (or should) happen is that Texan banks would not have access to central bank credit anymore. The Federal Reserve would not accept their Texan state bonds as collateral anymore. Their problem would have to be solved through other mechanisms and procedures under the responsibility of bank supervision authorities.

Basically, central bank credit should be limited to fundamentally solvent banks and constrained by the amount of high quality and marketable assets banks are able to put up as collateral. If this time-honored principle of central banking had been employed,

Target 2 balances as experienced today could never have come into existence. It was correct to refinance Greek banks, as long as they could reasonably be viewed as being illiquid, but solvent. However, since the advent of the solvency crisis of the Greek state, this has not been the case anymore. The proper way to deal with Greek sovereign debt and Greek banks would have been through adequate debt restructuring and insolvency procedures. Target 2 imbalances are a consequence of the nonexistence of such procedures and the inability of the EU to understand the importance and necessity of a workable crisis resolution mechanism for member states. This is what led the ECB to extend – and overstep – its traditional role. Whether this was really necessary and desirable under these conditions, and how to get out of the resulting mess, is beyond the scope of this note. In any case, the proper way for the future would be to correct this deficiency and reduce the ECB to its original monetary policy role again, which is challenging enough, after all.

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