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The ECB must step in to save the eurozone

The current turmoil in the eurozone bonds markets shows striking parallels to the situation in autumn 2008. Then, bank depositors had lost confidence in the stability of the institutions holding their assets, and the threat of a bank-run could only be avoided by comprehensive government guarantees for all banks. Today, we are observing a bond-run: a self-fulfilling crisis of confidence in the stability of most eurozone sovereign borrowers. This is driving long-term rates up, so that for more and more countries a temporary liquidity problem is becoming a permanent solvency problem. As regulators still treat government bonds as the safe core of the financial system, this vicious circle threatens the stability of financial institutions not only in the eurozone but also in the rest of the world. It intensifies the recessionary tendencies in the global economy so that in turn the financial situation of governments becomes worse. It's a perfect vicious circle.

It can be broken only by stopping the bond-run as soon as possible. One way out would be a joint liability for the debt of eurozone members. But as the reaction of Angela Merkel's government to a recent proposal of the German Council of Economic Experts has shown, the prospects for such a solution are not very good.

An alternative is the Soros plan as outlined in the Financial Times on October 24. The authorities could use the Emergency Financial Stability Facility to enable the European Central Bank to act as a lender of last resort without violating its statutes. The ECB would provide practically unlimited amounts of liquidity while the EFSF guaranteed the ECB against the solvency risks that it would incur. Acting together, they could resolve the liquidity problems facing the banks, and enable fiscally-responsible governments to issue treasury bills for less than one per cent.

Unfortunately the policymakers have not even started to consider this plan seriously. They originally envisioned the EFSF as a way of guaranteeing government bonds. They would have to reorient their thinking if the EFSF were to be used to guarantee the banking system. In July, when the EFSF was first proposed, it would have been large enough to take care of Greece, Portugal and Ireland. Since then, contagion has spread to Italy and Spain and the efforts to leverage the EFSF have run into legal and technical difficulties.

Since the Soros plan would take some time to prepare, in the interim the ECB is left to deal with a rapidly deteriorating situation on its own. On Monday the Bundesbank's president questioned the right of the ECB to act as a lender of last resort. On Tuesday contagion spread to the rest of the eurozone. The financial markets are testing the ECB and want to find out what it is allowed to do.

It is imperative that the ECB should not fail that test. The central bank must stop the bond run at all costs because it is endangering the stability of the single currency. The best way to do it in the near term is to impose a ceiling on the yield of sovereign bonds issued by governments that follow responsible fiscal policies and are not subject to adjustment programmes. The ceiling could be initially fixed, at say 5 per cent, and lowered gradually as conditions permit. By standing ready to buy unlimited amounts the ECB would effectively turn the interest rate ceiling into a floor from which bond prices would gradually rise without the ECB actually having to buy unlimited amounts. That is what the Swiss government did successfully when it tied the franc to the euro at 120.

Normally central banks fix only short-term interest rates but these are not normal times. Government bonds that were considered risk-free when financial institutions acquired them, and are still treated as such by the regulators, have turned into the riskiest of assets. Italian and Spanish bonds are viewed as too risky to buy with a yield of seven per cent because they are regarded as toxic, and the yield could just as easily rise to ten per cent. Yet the same bonds would be attractive long-term investments in the current deflationary environment, at say four per cent, as long as the excessive risk is removed by imposing a five per cent ceiling on interest rates.

The recent bond-runs have developed because the authorities hold sharply clashing views on the propriety of bond purchases by the ECB. The Bundesbank has been and remains vociferously opposed. But the deflationary threat is real and is beginning to be recognised even in Germany. The statutes of the ECB call for the maintenance of price stability and that requires equal diligence with regard to inflation and deflation. The asymmetry is not in the statutes of the ECB but in the minds of Germans who have been traumatised by hyperinflation. However, the board of the ECB is an independent authority whose independence has to be respected even by the Bundesbank.

The interest rate ceiling should be regarded as an emergency measure. In the medium term it could encourage politicians to abandon fiscal discipline. In Italy, for instance, Silvio Berlusconi will be waiting for Mario Monti to trip up. Therefore the breathing space gained by imposing it should be used to establish appropriate fiscal rules and to devise a growth strategy that would enable the eurozone to grow out of its excessive indebtedness.

This article was co-written with Peter Bofinger, who is professor of economics at Würzburg University. George Soros is chairman of Soros Fund Management and a philanthropist

Response by Raoul Ruparel

Greater intervention by the ECB raises more problems than it solves

George Soros and Peter Bofinger present a measured approach for the intervention of the European Central Bank in eurozone bond markets, essentially envisioning it as a temporary liquidity provider of last resort. However, the ECB is already playing this role to a large extent. It has along with the eurozone bail-outs bought European politicians 18 months in which to devise the fiscal rules and growth strategy the authors call for. Unfortunately, leaders have repeatedly failed to reach any semblance of consensus on a lasting solution to the crisis.

Therefore, the exit strategy envisioned here for the ECB is dubious. Without a clear mechanism for winding down the ECB bond purchases, it becomes impossible to imagine a situation where the ECB could end its bond buying programme without causing huge market distortions.

The authors approvingly cite the example of the unlimited liquidity provision given to banks. However, this could equally be used as an illustration of the risks mentioned above. Although the ECB's unlimited liquidity provision for the banking sector may have avoided a bank run, it simultaneously created a set of so-called 'zombie banks'. Precisely because of the absence of an exit strategy, these banks have now become reliant on ECB liquidity to survive, while stripping them of the incentive to reform the bad practices and mismanagement which got them into this situation in the first place. The cost of this is now becoming clearer, with some banks on the precipice of failure, forcing a widespread recapitalisation of the banking sector – of which some cost will undoubtedly fall onto taxpayers. Against this backdrop, it becomes a huge risk for the ECB to stake its independence and credibility on the hope that such a solution will be achieved in the near term.

Targeting the spread between German bunds and other eurozone bonds would also significantly undermine the ECB's independence. Ultimately, the spreads are reliant on the fiscal policy and domestic politics of each member state. Any failure or uncertainty in either area spooks markets. As such, the level of ECB bond buying could become almost directly influenced by the political and policy decisions in member states. The ECB is already treading perilously close to this line. One step further and it would cease being the independent central bank that is so essential to future monetary stability, and instead become a fiscal actor highly susceptible to political wrangling.

This also raises questions over the definition of the bond run. It's true that the yields may not currently accurately represent the economic fundamentals of each nation, however they are a result of the markets trying to price in the domestic and European political risk as well as the structural flaws in the eurozone exposed by the current crisis. Using the ECB to try to 'correct' these issues not only damages the price determination mechanism in markets but takes the ECB far beyond its mandate.

Moreover, the German fears over hyperinflation cannot be seen as an anomaly – it is a political reality that goes to the heart of the German post-world war settlement. The day the ECB is turned into a politicised lender of last resort, may also be the day when the Germans start to seriously question whether they wish to be a part of the single currency.

The struggling eurozone countries need to press ahead with economic and institutional reform. But in the longer term it has now got to the point where the eurozone will have to reassess its structure and membership if it is to survive. Having the ECB act as a full lender of last resort will detract from these requirements and may throw up more problems in the longer term; making it ultimately self-defeating.

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