FINANCIAL TIMES

March 12, 2012 5:42 pm

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ECB intervention is the only way to end the crisis

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Since December last year the European Central Bank has injected large amounts of liquidity into the eurozone banking system. These injections were necessary to save Europe's banking system. In addition, these lender of last resort processes, known as longer-term refinancing operations, were instrumental in stabilising the sovereign debt markets in the eurozone. Yet it can now be said they were ill-designed, making it probable that the ECB will have to discontinue them.

What went wrong in the way the ECB designed LTROs? It is important to keep in mind the present crisis in the banking system, which is almost exclusively caused by the sovereign debt crisis that emerged in early 2010. Except for Greece, peripheral European countries were solvent but were caught in a liquidity crisis by bond sales that 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 crisis turned into a banking crisis.

This is because the ECB chose not to intervene at the source of the problem – the sovereign bond markets. It delegated the power to buy government bonds to the banks, trusting they would obey. But the banks themselves were and still are in a state of fear.

The decision to delegate to panicky bankers has had three unfortunate consequences that will become clear now the central bank has completed its second liquidity injection. First, because banks channelled only a fraction of the liquidity they obtained from the ECB into the government bond markets, the ECB had to pour much more liquidity into the system than if it had decided to intervene itself.

Second, new waves of panic may grip the banks again, leading them to 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 bond markets. Will the ECB then again increase its lending to these banks in the hope that frightened bankers will resume their bond purchases?

Third, and most importantly, the 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 have been given unlimited sources of funding to make easy profits. This reduces their incentives to restructure their balance sheets, which would make them more resilient in the future.

True enough, when the ECB intervenes directly in the bond markets, moral hazard risk is created because governments may have fewer incentives to reduce budget deficits. However, this risk has been reduced significantly in the new institutional environment, which gives considerable power to the European Commission to impose austerity programmes. It is a power the Commission has happily embraced to impose excessive austerity in the eurozone and to drive it into a recession.

The LTRO programme 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.

It would help if these German opponents liberated themselves from the damaging dogma that it is a sin to create liquidity to buy government bonds when these bonds appear on the ECB's balance sheet – while believing that the same operation is virtuous when these bonds appear on the balance sheets of banks.

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.

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