The European Central Bank has delegated its lender of last resort duty to panicky bankers who are the slaves of market sentiments. Pumping in over 1,000 billion Euros this way has not stabilized Europe's sovereign debt markets.

Since December 2011 the European Central Bank (ECB) has pumped two waves of extra liquidity into the European banking system, in an effort to keep it afloat – and persuade backs to invest in sovereign debt. Yet Paul De Grauwe *argues that these banks are still wracked with uncertainty, which may lead to further sell-offs of this debt – the very opposite of the ECB's intent. The ECB could have avoided much of the crisis by being a lender of last resort in direct support of Eurozone governments with sovereign debt crises.*

What can a trillion Euros buy these days? Not a lot if you are the European Central Bank (ECB), which administers monetary policy for the 17 Eurozone member states. In December last year the Bank injected massive amounts of liquidity into the Eurozone banking system, €489 billion. Then, at the end of February this year the ECB created another €529 billion to help out the banking system. There can be little doubt that these injections were necessary to prevent a liquidity squeeze from bringing down the banking system.

As always when central banks use their 'lender of last resort' function one hears loud complaints that these operations will lead to 'moral hazard' risk, i.e. that banks will have incentives to take on more risk, preparing the road to the next crisis. This risk is real, yet should be set aside by the central bank. In moments of crisis the central bank has to choose between two evils. The first one is an imminent collapse of the banking system; the other one is the evil of future moral hazard. A responsible central bank will always want to avoid the first evil.

While the lender of last resort operations of the ECB were necessary and helped to stabilize the government bond markets in the Eurozone, they were also ill designed. The bad design of these operations also explains why the ECB was forced to throw hundreds of billions of euros into the banking system, thereby dramatically increasing its balance sheet.

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 Eurozone banking system is almost exclusively caused by the sovereign debt crisis that emerged in early 2010. After the Greek debacle, exposing the insolvency of the Greek sovereign, investors were caught by panic and started to sell the sovereign bonds of other 'peripheral' countries in the Eurozone. I would argue that these countries were solvent, but 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 crisis turned into a banking crisis.

The response of the ECB at that time

should have been to provide liquidity support in the secondary markets of sovereign bonds, so as to put a floor on the prices of these bonds. The guiding principle of the ECB should have been to provide lender of last resort support to governments that the Bank deemed to be solvent, but illiquid. Clearly this would have excluded Greece, but not countries like Ireland, Italy, Spain and Portugal. A clear commitment by the ECB that it would not tolerate a price decline below a certain level would have prevented the massive price declines of the sovereign bonds of the latter countries. It would also have prevented the banking crisis. There can be little doubt that the ECB had the capacity to put a floor on the bond prices, and that the sheer trust in the markets that the Bank could achieve this would have made it possible for the ECB to reach this result with minimal use of money creation.

European Central Bank Credit: Jim Woodward
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The ECB chose not to do so. The arguments that were used to justify inaction are the same one hears today after the massive support of the banking system, i.e. moral hazard and inflation risk. Only now, I would suggest, these arguments carry more weight because the intervention is so much more massive today than if the ECB had intervened earlier in the government bond markets.

It is in this sense that the lender of last resort activities have been ill-designed. Instead of intervening at the source of the problem (that is, the sovereign bond markets) the European Central Bank allowed the crisis to become a banking crisis. And when the latter effect emerged, ECB decided to delegate the power to buy government bonds to the banks, trusting that the latter would show the right judgment to buy these bonds. But the banks themselves were and are still in a state of fear and panic, and their judgment should not be trusted.

The unhappy decision of the ECB to delegate the decision to buy government bonds to panicky bankers has had two unfortunate consequences. The first consequence was 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. As an example, if the banks used only half of the liquidity to buy government bonds, the ECB had to create two euros to make sure one euro would find its way into the sovereign bond market. This would be a very ineffective policy.

Secondly, and possibly even more important, as the liquidity support in the sovereign debt markets now depends on the judgment of bankers who have not yet liberated themselves from fear and panic, doubts continue to exist as to the continuing liquidity support that these bankers will provide. New waves of panic may grip the bankers again, leading them to massively sell 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.

It is quite unfortunate that the ECB has delegated its lender of last resort duty to bankers who themselves are the slaves of market sentiments. In doing so, doubts continue to exist as to the stability of the sovereign debt markets in the Eurozone. These doubts can only go away when the ECB takes over the lead position and intervenes directly in the sovereign bond markets.

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