To stabilize the Eurozone, the ECB must set aside its fears and start buying governments' bonds

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Government bond markets in Europe remain volatile, with Spanish and Italian bond rates at near unsustainable levels. ***Paul De Grauwe*** *argues that the only institution that can stabilize these markets by buying government bonds is the European Central Bank (ECB). The ECB must now overcome its risk averse nature and take advantage of its virtually infinite resources to help to successfully restore financial stability.*

It is becoming increasingly obvious that the European Central Bank is the only institution that can stabilize the government bond markets in the Eurozone. These bond markets have been gripped again by fear and panic, leading to unsustainable increases in the government bond rates in Spain and Italy. If this is left unchecked, these countries will be pushed into default.

The self-fulfilling nature of these developments is key to understanding the crisis. Spain and Italy are solvent nations. However, fear and panic does two things. First it drives the interest rates on the government bonds of these countries to unsustainable levels. Second, it leads to sudden stops in liquidity making it impossible for the governments of these countries to continue to service their debt. To avoid this they are forced to start excessive austerity programs that lead to deep recessions and a collapse of government tax revenues. As a result the budgetary situation is worsened, not improved. The fear of default creates the conditions where default becomes inevitable. Countries are pushed into a bad equilibrium.

The ECB is the only institution that can prevent panic in the sovereign bond markets from pushing countries into a bad equilibrium, because as a money creating institution it has an infinite capacity to buy government bonds. The fact that resources are infinite is key to be able to stabilize bond rates.

European Central Bank Credit: Jim Woodward (Creative Commons BY)

The ECB is unwilling to stabilize financial markets this way. Many arguments have been given why the ECB should not be a lender of last resort in the government bond markets. Many of them are phony. Some are serious like the moral hazard risk. The latter, however, should be taken care of by separate institutions aimed at controlling excessive government debts and deficits. These are in the process of being set up (European Semester, Fiscal Pact, automatic sanctions, etc.). This disciplining and sanctioning mechanism then should relieve the ECB from its fears for moral hazard (a fear it did not have when it provided €1,000 billion to banks at a low interest rate).

The deeper reason for the ECB's reluctance to be a lender of last resort in the government bond market has to with its business model. This is a model whereby the ECB has as a main concern the defense of the quality of its balance sheet, i.e. a concern to avoid losses and to show positive equity, even if that leads to financial instability.

It is surprising that the ECB attaches such an importance to having sufficient equity. In fact, this insistence is based on a fundamental misunderstanding of the nature of central banking. The central bank creates its own

IOUs. As a result it does not need equity at all to support its activities. Central banks can live without equity because they cannot default. The only support a central bank needs is the political support of the sovereign that guarantees the legal tender nature of the money issued by the central bank. This political support does not need any equity stake of the sovereign. It is quite ludicrous to believe that governments that can, and sometimes do, default are needed to provide the capital of an institution that cannot default.

All this would not be a problem were it not for the fact that the ECB's insistence on having positive equity is in conflict with its responsibility to maintain financial stability. Worse, this insistence has become a source of financial instability. For example, in order to protect its equity, the ECB has insisted on obtaining seniority on its government bond holdings. In doing so, it has made these bonds more risky for the private holders, who have reacted by selling the bonds. This also implies that if the ECB were to take up its responsibility of lender of last resort, it will have to abandon its seniority claim on the government bonds it buys in the market.

The correct business model of the ECB is to pursue financial stability as its primary objective (together with price stability), even if that leads to losses. There is no limit to the size of the losses a central bank can bear, except the one that is imposed by its commitment to maintain price stability. In the present situation the ECB is far from this limit.

A central bank should be willing to take such losses if in doing so it stabilizes financial markets. In fact when it successfully stabilizes financial markets losses may not even appear. Today, the fear of making losses paralyzes the ECB. The ECB should set aside these fears.

Put differently, today investors have become very risk averse, fearing being caught in a crisis that could wipe out their wealth. In such an environment it is important that the central bank is willing to take some risk, thereby offsetting extreme risk aversion in the market. If instead the ECB is equally, if not more risk averse, the financial markets cannot be stabilized. Because of its deep pockets it is the central bank that in times of fear has to stand up fearless. That's the central bank we need. Not one that runs away.

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About the author

Paul De Grauwe – *LSE European Institute*

Professor Paul De Grauwe is the John Paulson Chair in European Political Economy at the LSE's European Institute. Prior to joining LSE, he was Professor of International Economics at the University of Leuven, Belgium. He was a member of the Belgian parliament from 1991 to 2003. His research interests are international monetary relations, monetary integration, theory and empirical analysis of the foreign-exchange markets, and open-economy macroeconomics. His published books include *The Economics of Monetary Union* (OUP, 2010), and (with Marianna Grimaldi), *The Exchange Rate in a Behavioural Finance Framework* (Princeton University Press, 2006).

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