Moral hazard will result from ECB bond buying

by Otmar Issing

Financial Times
November 30, 2011

In providing advances to the banking system to stay a panic, a central bank should follow two rules.

“First, that these loans should only be made at a very high rate of interest. This will operate as a heavy fine on unreasonable timidity, and will prevent the greatest number of applications by persons who do not require it …
Secondly, that at this rate these advances should be made on all good banking securities, and as largely as the public ask for them.”

This is the original definition of the role of the central bank as lender of last resort by Walter Bagehot in his famous book Lombard Street (1873).

Should the European Central Bank be this lender of last resort? The answer can only be a clear yes. Does the ECB act according to this principle? Yes, again. Indeed, for understandable reasons, the ECB is going far beyond what Bagehot asked the central bank to do in times of panic. Not only is it offering unlimited liquidity to the banking system. But the supply of central bank money is provided on extremely low interest rates, not on a penalty rate. And who would characterize the collateral accepted by the ECB as comprising only “good banking securities”?

So, why is there pressure on the ECB to act as lender of last resort? Because this term is used, or one should say badly misused, for totally different actions: namely a commitment of the central bank in principle to make unlimited purchases of government bonds. The argument for this request is often explained like this. Whereas, for example, the public debt to gross domestic product ratio for Spain is much lower than that for the US or the UK, the interest rate for Spanish sovereign bonds is much higher than for these countries. The reason is seen in the fact that the Federal Reserve and the Bank of England, “if needed”, can buy unlimited amounts of their sovereign bonds. In contrast, Spain does not have this option as it is a member of the euro area and has no access to the money printing machine. So, the argument goes, if the ECB would only commit itself to play the same role for Spanish – and for all the other governments of the euro area – sovereign bond interest rates would fall substantially.

If there is such a panacea to solve the eurozone problems, why not use it? To answer this question we have to look at two different dimensions of the problem. Firstly, the broader aspect: Should a central bank act as the ultimate buyer of public debt? (One should not disguise it under the term of lender of last resort). Solvency of a sovereign debtor is traditionally defined as the state being able to service its debt by collecting taxes. Bringing this issue into the domain of the central bank means transferring an obligation of public finance into a monetary phenomenon. Nota bene: not of monetary policy!

All the arguments in favour of such a “solution” of the public debt problem imply that the central bank will be taken hostage by politics (history provides us with a number of bad examples). How would investors react to such a new regime? Would they expect higher inflation in the future? If so, what would be the effect on long term interest rates? If those rates rose substantially this would lead to new problems for the sustainability of public finance. It is futile to speculate on a possible spiral of dangerous developments, but ignoring this risk is irresponsible. Stressing the role of the central bank as the ultimate buyer of public debt should be seen as an indication of the pathological state of public finances not as a sign of strength.

Secondly, the situation in the euro area is fundamentally different from the US or the UK. No one would argue that the Fed should guarantee the debt of individual states. No need because there are strict limits for debt financing by US states. This is also a fundamental principle of European Monetary Union (EMU) as it was designed by the Maastricht treaty and presented to the people in countries getting the euro as the currency.

This is not a flaw in the institutional arrangement of EMU, but the prohibition of monetary financing is an indispensable element for a stable currency. Pressing the ECB into the role of ultimate buyer of public debt of individual member states would create the biggest conceivable moral hazard.

On top of these alarming economic and monetary consequences, providing monetary financing would break the law – a constitution ratified by all governments and parliaments. Should one be surprised that a number of well-known economists ignore legal principles? Who is disappointed by the fact that numerous politicians and European bureaucrats press hard on the ECB to violate the law? Now even some central bankers follow this line. Imagine: unelected technocrats, as they are often called, lifting themselves above the law.

This happens when big ideas are floated, e.g. to strengthen the rules of the Stability and Growth Pact and even to advance EMU in the direction of a fiscal union. How credible is an announcement of “strict future rules” if at present violation of law is so widely not only accepted, but requested by academics, politicians and even central bankers? Will the future new rules survive the next crisis? And what about investors and markets? Is it risky to predict that a crisis will occur again when the credibility of the central bank and solvency of public finance will be anew at stake? And that speculation will be blamed for conspiring against an otherwise stable arrangement?

If the ECB goes in the direction of becoming the ultimate buyer of the public debt of member states detailed consequences are hard to predict. However, one thing seems to be certain. It would be a daunting challenge to restore credibility.