

19 December 2011

### **The battle for the heart and soul of the ECB**

The battle over the role of the ECB in the eurozone crisis has become increasingly heated over recent weeks and months, with both Germany and France vehemently arguing their corners. Open Europe has today published a note analysing some of the key points of debate regarding the ECB, focusing on whether it can really provide the solution many have come to expect.

#### **Key points:**

- As things stand the ECB should not, will not and cannot provide the unlimited financial backstop to the eurozone that financial markets seem to be clamouring for. The measures taken at the EU summit on 8 and 9 December are unlikely to supply adequate cover for the ECB to buy the hundreds of billions worth of Spanish and Italian government debt needed to fulfil this role.
- The ECB has taken on large amounts of low quality collateral in return for providing loans to banks, and has seen a massive surge in the number of asset-backed securities it has taken on to its balance-sheet. Though not all of these assets are bad or 'toxic', they are extremely difficult to value. At the same time, the number of banks which are becoming reliant on the ECB is alarming and hopes that the functioning of the European financial markets will ever return to normal are diminishing – creating a long-term threat to Europe's economy.
- Through its government bond buying and liquidity provision to banks, the ECB's exposure to the PIIGS has now reached €705bn, up from €444bn in early summer. This is an increase of over 50% in only six months and shows how, contrary to popular belief, the ECB is already intervening quite heavily in the markets. It also highlights how the eurozone crisis continues to transfer risks away from private creditors to taxpayer-backed institutions. It remains unclear how the ECB would cover losses in the event of a sovereign default.
- The ECB is likely to continue to keep interest rates low and continue to provide cheap credit to banks despite inflation fears in Germany. Currently, given the global slowdown, the different monetary policy needs of eurozone countries are small enough to paper over. However, this will not be the case for long and as German growth picks up the huge flaws in the one-size-fits-all monetary policy will again be horribly exposed.
- Moving forward, the ECB could offer a liquidity boost to Europe's economy but little more. The term 'lender of last resort' is often misused or misunderstood – the ECB cannot fully backstop sovereign states or return them to solvency. At best it could ease the pressure on illiquid states, but even this depends on the legal constraints on the ECB's defined role and being seen to give in to political demands that would hurt the ECB's credibility and independence.

- Even if it can be achieved practically, Quantitative Easing (QE) by the ECB is unlikely to work. Even a €500bn bout of QE – as some have called for – would see only €90bn flow towards Italy, due to the need to spread QE evenly across the eurozone. This would not make a significant dent in Italy's €1.9 trillion of sovereign debt.
- Alternative options such as the ECB lending to the IMF or lending to banks for them to stock up on sovereign debt, are preferable to direct ECB financing of states, since the IMF and banks can apply some conditions and maintain market pressure for reform, but create hazards and complications of their own without offering many additional benefits.
- Instead of arguing about the role of the ECB, EU leaders should focus on pushing ahead with debt restructurings in the eurozone, despite the ECB's objections, and formulate a plan for how to mitigate the ensuing losses both on the ECB's balance sheet and in the private sector. Ultimately, money would be far better used for these ends rather than flooding the eurozone with liquidity and recycling debt – both of which have failed so far.
- The time may come when greater ECB intervention in the sovereign debt markets is unavoidable, but at this point it would be a mechanism to help ease the transition to a new eurozone structure, probably with fewer members and a more clearly defined role for the ECB.

### **What does last week's EU summit agreement mean for the ECB?**

In the run up to the summit it was widely expected that a solid "fiscal compact" would encourage it to, at the very least, step up its purchases of eurozone sovereign debt by assuaging its fears over the lack of conditionality on any funds it provides and the lack of a clear mechanism for winding down such support. However, given the weakness of the agreement and the subsequent reservations expressed by ECB President Mario Draghi, this looks unlikely, at least in the immediate future.

Much of the expectation that the ECB was going to begin buying sovereign bonds on a large scale was based on the comments by Draghi a few weeks ago in which he suggested that if a "fiscal compact" were agreed "other elements would follow". However, he dampened these hopes at the ECB press conference on 8 December when he stated that he was surprised by this interpretation of his comments.<sup>1</sup>

The EU summit of 8 and 9 December failed to agree a robust regime of enforceable automatic sanctions for eurozone countries that break the bloc's budget rules (3% deficit limit, 60% debt-to-GDP ratio and the new 0.5% "structural" deficit limit under the so-called 'golden rule'). As we have argued elsewhere, absent automatic sanctions, the new set of rules, much like those enshrined in the original stability and growth pact, are likely to be subject to political pressure or wrangling, undermining their credibility and effectiveness. This is likely to feed ECB doubts about whether the proposed new Franco-German treaty is up to the task of promoting budget discipline and sound finances.

The ECB is keen on strong budget rules and sanctions as a way to mitigate the potential for 'moral hazard' that comes with large scale ECB bond buying, i.e. if given access to cheap credit from Frankfurt and relieved of market pressure, some governments may be less

---

<sup>1</sup> Introductory statement to the press conference (with Q&A), ECB, 8 December 2011: <http://www.ecb.int/press/pressconf/2011/html/is111208.en.html>

inclined to push for reform. The ECB is also concerned that, just as many banks around the eurozone are now largely dependent on ECB funding to stay afloat, once a government starts to receive large-scale funding, it may be very difficult for that government to come off it. There is, in other words, no exit strategy. As Bundesbank President Jens Weidmann vividly put it last Thursday:

*"It is like an alcoholic saying that 'I need to get a bottle tonight. Starting tomorrow I will be clean and abide by the rules, but I need the bottle tonight'. I don't think it is sensible to give the alcoholic the bottle. He won't have an incentive to solve the problem."*

Weidmann makes a strong point. It is wishful thinking to argue that the ECB can pledge unlimited support to governments and then easily turn off the tap should countries fail to pursue the necessary and pledged reforms set out by the ECB (itself a complicated notion as the ECB is legally prohibited from engaging in fiscal policy) and Berlin/Brussels. Evidence would suggest otherwise. Over the past year the ECB has consistently given in to market pressure (on issues such as bond buying and continuing to accept lower rated sovereign debt as collateral). In addition, imagine the market mayhem that would follow should the ECB all of a sudden withdraw its 'unlimited' support. That would almost certainly be the end of the euro.

The latest commitments to fiscal discipline and greater austerity ultimately differ little from the defunct Stability and Growth Pact.<sup>2</sup> Key questions remain over the implementation of the treaty. How long will countries be given to bring their budgets in line with the requirements? What form, exactly, will sanctions and punishments take? And, possibly most importantly, what will the role of the EU institutions in enforcing the treaty be?

In sum, neither ECB fears of moral hazard nor the lack of an exit strategy were tackled by last week's summit agreement. It, therefore, looks likely that the ECB will remain hesitant about greater intervention.

### **What have recent ECB decisions meant for the eurozone crisis?**

1) 0.25% interest rate cut: With the threat of recession looming large for the eurozone (as a whole) there was little choice but to cut rates, especially since financial markets saw it as a certainty. Inflation is still high in the eurozone on average, but expected to drop in the medium term, while the impact of the cut will take time to filter through.<sup>3</sup> On a micro-level, the cut may relieve some pressure on the high number of individuals and households with variable rate loans and mortgages, particularly in the struggling peripheral countries such as Spain. However, on its own, the cut in rates will make little difference (but may have an impact as a part of a broader strategy).

The decision effectively takes ECB monetary policy back to where it was in April before two rate hikes. In retrospect these past increases were probably the wrong decision, but above all, highlights the unsustainable nature of the eurozone's one-size-fits all interest rate, with Germany rarely having the same needs as some of the struggling economies. Currently, the

---

<sup>2</sup> Open Europe responds to conclusions of 9 December EU summit, 9 December 2011: <http://www.openeurope.org.uk/media-centre/pressrelease.aspx?pressreleaseid=183>

<sup>3</sup> Open Europe blog, 'Draghi's Den', 8 December 2011: <http://openeuropeblog.blogspot.com/2011/12/draghis-den.html>

spread of the crisis to the core countries means this gap is small enough to paper over, but that will not be the case for long and remains a fundamental flaw in the eurozone. In any case, eurozone leaders' continued failure to quell market fears made the ECB's decision to raise rates back in the Spring worse than expected.

2) Long term liquidity to banks (LTRO): The ECB will conduct two three year refinancing operations, to help banks secure longer term financing. This was mostly expected, and it should help banks to secure funding and stabilise financial markets. The hope is that this extra liquidity will lead to increased lending, although the impact of previous bouts of longer term lending on general lending in the wider economy is unclear and much of the shorter term unlimited liquidity is being hoarded by banks (much of it at the ECB itself).<sup>4</sup> There is also some hope that this will trigger increased demand for eurozone sovereign debt, as banks will have some extra funds with which to buy government bonds. However, this is far from certain (discussed in detail below) and could prove counterproductive.

The (LTRO) will be welcomed, as it will reduce the risk of a complete freeze in the bank funding markets next year. But it is not a solution to the solvency problems facing European banks, and, as discussed above, without any plan to wean them off this funding in the future, it further increases the banking sector's reliance on the ECB. The question is how easy it will be to avoid these one-off operations becoming a permanent feature.

#### **Should banks use ECB funding to stock up on sovereign debt?**

One suggestion which has been made, seemingly by French President Nicolas Sarkozy and by French Central Bank Governor Christian Noyer is that the significant lending to banks will allow them to stock up on sovereign debt, helping to ease the eurozone's sovereign debt problems.<sup>5</sup>

Specifically, the idea that the new long term ECB lending could boost banks' purchases of sovereign debt has gained credence, especially since it could further be used as collateral to obtain loans from the ECB. This may sound tempting, but it is far from an ideal situation – loading up an undercapitalised banking sector with risky sovereign debt without a clear solution to the eurozone's fundamental problems is neither a solution nor desirable.

These purchases would need to be hedged and the banks would need to account for the haircuts applied to the bonds (when they are given as collateral).<sup>6</sup> Morgan Stanley estimates that the first offering of long term lending could filter through to a €20bn boost in Italian and Spanish bond purchases – not exactly game changing.<sup>7</sup>

Furthermore, given the fact that banks are facing rising capital requirements, large amounts of maturing debt and continuous inspection (particularly in terms of their exposure to the eurozone crisis), it seems unlikely that this cheap liquidity (which may not last forever) would

<sup>4</sup> Data on use of ECB deposit facility (which has reached record highs recently):

<http://www.ecb.int/mopo/implementation/html/index.en.html>

<sup>5</sup> Cited by *FT Alphaville*, 'The Sarko-Corzine trade', 12 December 2011:

<http://ftalphaville.ft.com/blog/2011/12/12/793471/the-sarko-and-corzine-trade/>

<sup>6</sup> As assets are posted as collateral their value is assessed. The ECB applies haircuts to the value of assets based on their perceived risk and liquidity. Peripheral sovereign debt is subject to fairly large haircuts now, as would be expected, reducing its value as collateral. The higher the haircut the lower the value of the loan the asset can backstop.

<sup>7</sup> Morgan Stanley, '3 year LTRO: policy support just for banks or 'sovereigns too?', MS Research Europe, 15 December 2011.

simply be poured back into uncertain sovereign debt.

Even if this were to happen, it again would not solve the crisis, but simply continue the cycling of debt around the eurozone. It would also offer little help to those already insolvent countries (unless accompanied by the debt restructuring and competitiveness boost which the eurozone has so far been incapable of providing).<sup>8</sup>

A similar problem arose with the introduction of ECB unlimited liquidity, which created perverse incentives for banks, caused them to stock up on peripheral sovereign debt and increased exposure to the crisis.<sup>9</sup> Further reinforcing this well documented sovereign-bank feedback loop, which has seen debt cycling between the two, would only increase interdependence and intertwine their fates.<sup>10</sup>

3) Easing collateral requirements: In order to obtain credit from the ECB, banks have to provide collateral. Leading up to the crisis, there were strict rules to ensure that the collateral that banks posted with the ECB (via national central banks) was of high quality. However, throughout the crisis, the ECB has incrementally loosened these rules as banks, particularly in Ireland, Greece and Portugal, have struggled to put up quality collateral.

Over recent weeks, the ECB has again reduced the rating threshold for certain asset backed securities (ABSs) and allowed national central banks (NCBs) to accept performing credit claims (for example bank loans) as temporary collateral. Both changes do come with strict conditions. However, given the increasing exposure to poor quality collateral, there is cause for concern regarding the strength of ECB's balance sheet. The AFME estimates that the ECB already held €500bn in ABSs on its balance sheet by the end of 2010.<sup>11</sup> Not all of those ABSs are bad or toxic, but they are, by their very nature, highly opaque and difficult to value. Intrinsicly, it is harder for the ECB to judge what 'haircut' to apply to these assets which therefore makes the bank's risk management more difficult. This could also see a rise in the level of securitisation just to gain access to ECB liquidity rather than for public sale –lowering the quality of the securities.<sup>12</sup>

That said, the ECB has already loosened its collateral requirements on sovereign debt and continues to accept Greek debt which is widely expected to take significant write downs. Given the widely reported 'collateral crunch' in the eurozone these mechanisms may help.<sup>13</sup>

<sup>8</sup> Cited by *FT*, 'Doubts over ECB move to boost bond sales', December 15 2011:

<http://www.ft.com/cms/s/0/3772f26e-271d-11e1-b9ec-00144feabdc0.html#axzz1gUv1tigO>

<sup>9</sup> Cited by *FT*, 'Investors worry over cheap ECB money side effects', 10 October 2011:

<http://www.ft.com/cms/s/0/d2f87d16-f339-11e0-8383-00144feab49a.html#axzz1gUv1tigO>

<sup>10</sup> Mody A. and Sandri D., IMF working paper, "The Eurozone Crisis: How Banks and Sovereigns Came to be Joined at the Hip", WP/11/269.

<sup>11</sup> AFME, AFME Securitisation Data Report Q4 2010, see: [www.afme.eu/AFME/.../Securitisation/2010-Q4AFMEESFFINALAFME.pdf](http://www.afme.eu/AFME/.../Securitisation/2010-Q4AFMEESFFINALAFME.pdf)

<sup>12</sup> Institutions may begin creating securities (bundling together of different assets/financial instruments to market the different tiers/tranches of the new security) just to use as collateral to gain loans from the ECB. Anecdotal evidence suggests this may be the case, with AFME figures suggesting that a large number of securities are being created without ever being offered to the open market. This is a concern as securities no longer need to gain the approval of investors but simply need to pass the ECB minimum requirements (which are fairly low now and have been continuously loosened).

<sup>13</sup> The term 'collateral crunch' here refers to the reported shortage of quality collateral in the European financial markets. Banks are said to be running short on assets of high enough quality to gain lending at rates which allow them to continue to finance themselves in the medium to long term. This is exacerbated by the inherent fear and

In any case, if the lack of collateral is as bad as suggested, it is likely banks would be pushed into using the Emergency Liquidity Assistance (ELA) from their national central banks due to a shortage of acceptable collateral – this mechanism is inherently more secret and opaque, so avoiding reliance on the ELA is probably positive.<sup>14</sup>

### Updated exposure of the ECB to PIIGS

ECB exposure (€m)	Greece	Ireland	Portugal	Italy	Spain	Total
<b>Govt. Debt (SMP nominal)</b>	60,000	18,000	20,000	135,717		233,717
<b>Govt. Debt (SMP purchase price)</b>	42,000	14,400	18,000	135,717		210,117
<b>Bank Lending</b>	77,758	102,940	45,539	153,200	116,211	495,648
<b>Total</b>	119,758	117,340	63,539	221,059	184,070	705,765

Source: ECB, National Central banks and Open Europe calculations<sup>15</sup>

Through its bond-buying programme and bank liquidity provisions, ECB exposure to Portugal, Italy, Ireland, Greece and Spain (PIIGS) has reached €706bn, up from €444bn in the early summer. That is a €262bn, over a 50% increase, in only six months. This highlights the reliance on the ECB and the increasing severity of the crisis. Though the perception in the media and elsewhere is quite different, it also points to the fact that the ECB has been far from inactive over the past few months, and yet eurozone leaders have not used the time bought by ECB intervention to find a solution to the crisis. This trend does not bode well for those who call on the ECB to intervene further.

### Can the ECB act as ‘lender of last resort’ for sovereign states?

The term lender of last resort is often misused or misunderstood – it simply means a body which provides liquidity, to illiquid but still solvent financial entities. At best the ECB could provide a short term liquidity boost for countries such as Italy and Spain (which debatably are still solvent) but could do little to help the already insolvent eurozone states. As mentioned above. Without clear conditionality or an exit strategy the moral hazard and risks of such a move would be massive. The ECB’s unlimited bank lending (which incidentally is an example of the ECB filling its valid role as lender of last resort<sup>16</sup>) should be a warning.

---

suspicion which has seen the interbank lending market freeze up. By loosening collateral requirements the ECB will open up a whole new set of assets on bank balance sheets which they can now use to gain funding.

<sup>14</sup> The ELA is lending process which falls outside of the ECB’s and the Eurosystem’s normal monetary operations. It allows NCBs to lend to their domestic banks when they literally have nowhere else to turn for funding. It has very low requirements in terms of collateral and the terms applied (i.e. maturity and rates) are at the discretion of the NCB. It also does not have to be publicly declared, making it incredibly opaque and secretive. The ECB does have to approve the process (at least tacitly) and can vote to restrict if the Governing Council of the ECB believes it may impact on the broader monetary policy aims of the eurozone. For a full discussion of the ELA, see here: [http://worldcommercereview.com/publications/article\\_pdf/472](http://worldcommercereview.com/publications/article_pdf/472)

<sup>15</sup> For Italy, Spain and Ireland the lending figures are for 31 November 2011, while the rest are for 31 October. All data is taken from the national central bank balance sheets see: Greece

([http://www.bankofgreece.gr/BogEkdoseis/financialstat201108\\_en.pdf](http://www.bankofgreece.gr/BogEkdoseis/financialstat201108_en.pdf)), Ireland

([http://www.centralbank.ie/polstats/stats/cmab/Documents/ie\\_table\\_a.2\\_financial\\_statement\\_of\\_the\\_central\\_bank\\_of\\_ireland.xls](http://www.centralbank.ie/polstats/stats/cmab/Documents/ie_table_a.2_financial_statement_of_the_central_bank_of_ireland.xls)), Italy

([http://www.bancaditalia.it/statistiche/SDDS/stat\\_fin/Aggregati\\_riserve/ris0911/ris201110en.pdf](http://www.bancaditalia.it/statistiche/SDDS/stat_fin/Aggregati_riserve/ris0911/ris201110en.pdf)), Portugal

(<http://www.bportugal.pt/en-US/Estatisticas/PublicacoesEstatisticas/BolEstatistico/Publicacoes/B2.pdf>), Spain

(<http://www.bde.es/webbde/es/estadis/infoest/aa101b.pdf>).

<sup>16</sup> The ECB defined lender of last resort role is to help ensure stability in the financial system and provide lending to illiquid financial institutions which find themselves unable to borrow due to the problems in the wider financial system. The ECB is doing this by providing unlimited liquidity (now both short and long term) and loosening other aspects of monetary policy. Ultimately, the focus is for the ECB to mitigate the impact of wider financial problems on the lending operations in the eurozone.

ECB liquidity has created a set of so-called zombie banks which cannot be weaned off ECB support without huge market disruption – repeating this situation for sovereign states could be going down a path of no return.

Ultimately, the ECB is legally constrained, as has been widely documented and there continues to be massive opposition in Germany to the ECB stepping in on a larger scale.<sup>17</sup> As Bundesbank President Jens Weidmann put it recently, “I think the idea is astonishing that one can win confidence by breaking rules.”

### **Targeting the spread**

Another suggestion which has been widely touted as a way to ease the crisis is for the ECB to announce that it will target the spread between bunds and other eurozone bonds, keeping it under a desired ceiling via an aggressive bond-buying programme. Let’s be clear, this would directly threaten the ECB’s independence.

Ultimately, bond spreads are reliant on the fiscal policy and domestic politics of each member state. Any failure or uncertainty in either area spooks the markets. As such, the level of ECB bond buying could become directly influenced by 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 monetary stability, and instead become a fiscal actor highly susceptible to political pressure.

Naturally, the ECB already has processes for deciding its limited bond purchases, which may involve targeting yields in some manner. Ultimately, though, the ECB could never publicly announce its system for judging interventions for fear of creating a direct link to fiscal policies and politics.

### **Would ECB Quantitative Easing (QE) help at all?**

A whole range of commentators and investors are now calling on the ECB to engage in the same policy of “quantitative easing” (QE) which the Bank of England and Federal Reserve have pursued. This, it is argued, is one of the few remaining ways out of this crisis. But is this really possible? Putting aside the questionable impact of QE on economic growth and assuming QE could be justified on monetary policy grounds (despite its real target being to tackle the sovereign debt crisis which is the domain of fiscal policy therefore taking the ECB beyond its mandate), it still looks unlikely that QE could be targeted to have the desired impact in the eurozone countries that might benefit.<sup>18</sup>

To illustrate: let us say that the ECB committed to €500bn worth of QE. This would have to be enacted by the national central banks (NCBs), since they conduct the practical day to day functioning of monetary policy. It would be shared out between the NCBs according to their capital shares in the ECB.<sup>19</sup>

---

<sup>17</sup> See Open Europe’s paper ‘A House built on sand’, for a fuller analysis of this issue and the problems facing the ECB: <http://www.openeurope.org.uk/research/ECBandtheeuro.pdf>

<sup>18</sup> Open Europe blog, ‘Could the ECB perform QE?’, 5 August 2011:

<http://openeuropeblog.blogspot.com/2011/08/could-ecb-actually-perform-ge-even-if.html>

<sup>19</sup> QE would need to be spread around the NCBs since they enact policy on behalf of the ECB. As such the direct interaction with markets and banks is handled by the NCBs. There is also the concern that if the QE was not spread evenly or proportionately, it may undermine the stability of the euro itself. Flooding money into one

ECB Capital Share (%)		Share of QE (€bn)
Austria	2.78	13.9
Belgium	3.47	17.35
Cyprus	0.2	1
Estonia	0.26	1.3
Finland	1.79	8.95
France	20.32	101.6
Germany	27.06	135.3
Greece	2.81	14.05
Ireland	1.59	7.95
Italy	17.86	89.3
Luxembourg	0.25	1.25
Malta	0.09	0.45
Netherlands	5.7	28.5
Portugal	2.5	12.5
Slovakia	0.99	4.95
Slovenia	0.47	2.35
Spain	11.87	59.35

Source: ECB and Open Europe calculations<sup>20</sup>

As the table above shows, such a plan would result in only €89bn flowing to Italy and €59bn to Spain, despite a huge €500bn commitment. Given their funding needs of at least €280bn and €135bn respectively next year, this would make little difference. Whether or not you believe Italy and Spain are fundamentally solvent (or just facing a liquidity crisis), QE of this size would ultimately not bring down yields far enough, for long enough, to halt the current problems they face. Remember, the ECB has already bought a total of €135bn worth of Italian and Spanish debt without fundamentally altering the market pressure these two countries are under. The overall total of QE needed to have a substantial impact on these economies would be so large and create such distortions in the stable countries that it would be self-defeating.

In our example, a massive €135bn would flow into Germany, the country with the greatest fear of inflation and the most realistic chance of facing high inflation in the immediate future. Just how much Germany still fears inflation was highlighted by the lack of unanimity in last week's decision to cut interest rates, to which Bundesbank President Jens Weidmann is reported to have objected.<sup>21</sup> A bout of ECB QE may not only be ineffective economically, but may prove a huge political own-goal as it could radically undermine Germany's commitment to the entire euro project.

In other words, QE is not the answer to the long term eurozone crisis, in any shape or form. It could help soothe the financial markets and counter deflationary forces (by boosting liquidity) but it doesn't tackle any of the underlying problems during the crisis – divergence, lack of

---

specific region of the euro may undermine the premise that a euro is worth the same everywhere but would also be directly helping to finance specific states and therefore would have no grounding in monetary policy.

<sup>20</sup> ECB capital contributions taken from ECB capital key, see:

<http://www.ecb.int/ecb/orga/capital/html/index.en.html>

<sup>21</sup> Cited by the FT Money supply blog, 'Draghi's different interest rate style', 9 December 2011:

<http://blogs.ft.com/money-supply/2011/12/09/draghis-different-interest-rate-style/#axzz1gKLjvM5H>

competitiveness and cultural and social differences. This does drive home one point – whatever solution is envisaged, Germany will have to foot the bill in some form or another, whether this be through direct transfers or by accepting higher inflation, for example.

### **The German question: How deep does the ECB red line run?**

Many commentators and analysts expect that Germany will eventually put aside its 'ideological' objections once practical demands make ECB intervention unavoidable. But it is also at that point when Germany's role and position in the eurozone will be put in jeopardy. What is not fully appreciated around Europe is that the conviction that a central bank should be strong, trusted and independent is not an academic, technical discussion merely amongst the country's economic elite – it is a practical concern for the German electorate.

There was no better illustration of this than Bild – Germany's (and the world's) most widely-read tabloid running a half-page article on page 2, arguing that the independence of the Federal Reserve and the Bank of England had been undermined after both institutions gave into political will during the crisis. The article stressed that the ECB should not give into French demands for greater ECB action and warned of inflation, making it tantamount to direct transfers involving Eurobonds. The fact that a widely read tabloid tackled such a complex issue shows just how important this issue is for the wider German public.<sup>22</sup>

For well-known historical reasons, Germany fears inflation, and any inflation that did occur in the eurozone would hit German savers the hardest (not just as the strongest economy but due to the higher saving rate). Once that line has been crossed it would become a very real political consideration for Germany, as to whether they want to stay in a currency union where the central bank, of which they are the largest backers, openly bails out sovereign states.

### **ECB lending to the IMF**

One proposal at the EU summit included €150bn in eurozone lending to the IMF, through national central banks.<sup>23</sup> Draghi made it clear in an 8 December meeting that if this was earmarked specifically to lend exclusively to eurozone countries, it would be in breach of the EU Treaties.

Despite this, ECB lending to the IMF in some fashion is not the worst idea out there, since the IMF may be able to impose conditions on the ECB funds which the central bank itself could not (as highlighted above). It would also most likely not be de jure illegal, but does raise questions over ECB's control of its balance sheet. Who will have final say on use of funds? ECB and IMF have already strongly disagreed over private sector involvement in the second Greek bailout.<sup>24</sup>

Even with this extra funding, IMF capacity falls well short of helping Italy and Spain who's funding needs top €1.7 trillion over the next three years. Again, this would just be a boost in

---

<sup>22</sup> Open Europe blog, 'Eurobonds or ECB...either way Germany has to pay the bill', 23 November 2011: <http://openeuropeblog.blogspot.com/2011/11/eurobonds-or-ecb-either-way-germany-has.html>

<sup>23</sup> To read our full take on this issue see Open Europe blog, 'ECB lending to the IMF', 2 December 2011: <http://openeuropeblog.blogspot.com/2011/12/ecb-lending-to-imf.html>

<sup>24</sup> Greece Debt Sustainability Analysis, leaked troika report, 21 October 2011: footnote p.7 - "The ECB does not agree with the inclusion of these illustrative scenarios concerning a deeper PSI in this report."

short term liquidity not a solution alone – as of yet no clear additional policies which suggest it will be worthwhile.

## **Conclusion**

As things stand the ECB should not, will not and cannot offer the solution to the eurozone crisis which financial markets are clamouring for in terms of an unlimited financial backstop.

The ECB cannot do so for a number of reasons: the legal constraints of the treaties; even a large bout of QE would not be effective and any support it does provide only tackles superficial liquidity issues, not the underlying structural flaws in the eurozone.

It will not, due to stringent German opposition, along with the Bundesbank principles upon which the ECB was founded, and the fact that eurozone leaders continue to fail to fundamentally tackle the eurozone crisis or lay down the fiscal structure which would impose conditionality on ECB lending (which the ECB lacks the capacity to do).

Finally, it should not intervene on a massive scale as it would raise huge questions regarding its independence and credibility. Consider where we are now, if the ECB changes its stance it would be seen to have given in to the will of politicians and markets. This would surely top off a series of U-turns by the ECB over the past year, such as accepting lower rated sovereign debt as collateral and starting, as well as later reviving, its purchases of government debt.

That said, if the eurozone crisis continues to worsen, there will be a point where the ECB cannot completely put off intervening. However, by this point ECB funding would ultimately only be a stop gap on the path to a new restructured eurozone, most likely with fewer members and probably following the default of at least one member.