

Have the Hawks Effectively Won the Lender of Last Resort Argument in Europe?

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Despite consistent demands to the contrary from German leaders and economic experts, many analysts still hope that the European Central Bank (ECB) will ultimately step in and perform the traditional Lender of Last Resort function--which at the moment means buying public sector debt directly from governments that cannot find alternative sources of finance. For many Germans this represents yet another triumph of hope over experience (the experience in question being Weimar Republic hyperinflation). Yet the calls on the ECB to buy Italian and Spanish debt persist. Which side will prevail? And even if the German view ultimately doesn't prevail, has enough uncertainty been created that ECB action could be severely compromised?

Tuesday's bloodbath in Eurozone bonds markets means these questions assume greater relevance. Except for German government bonds, yields rose on most eurozone bonds; French and Austrian bonds as well as the usual suspects, Italy and Spain. Investors are demanding a higher return for holding government debt to compensate for both growing doubts about repayment and fears that bond markets might be frozen whenever debt owners want to sell. The higher interest rates feed worries about the capacity of certain sovereigns to repay their borrowings which, in turn, generates greater demands from investors. The preconditions for a vicious cycle of higher interest rates, default, and frozen bond markets are falling into place.

Few doubt that decisive action over the next few weeks will determine whether such a vicious cycle takes off in the near term. The sheer quantity of Italian debt to be refinanced by April 2012--approximately 200 billion euro according to most accounts--focuses the mind on a straightforward question: where is the money going to come from? Most agree that few institutions or governments have such deep pockets. One body, however, doesn't need deep pockets for it can create money without limit. That body is the ECB, hence its centrality in the current debate.

Advocates of mass ECB intervention argue that the expectation of sustained intervention will assure holders of eurozone debt in periphery countries that bond prices will be relatively stable and that debt can be held without worrying about large scale capital losses. Plus by committing to meet the financing needs of periphery country governments over an indefinite time the ECB eliminates the risk of sovereign debt default and associated fears about adverse knock-on effects on the banking system.

Absolutely critical to this strategy's success is the credibility of the ECB's commitment to stick to it for as long as it takes. This is where the German opposition and the recent foot-dragging by the ECB is important. Suppose it was announced tomorrow that the ECB would act aggressively as a Lender of Last Resort. These are scary times and no one should doubt the capacity of scared political leaders to reverse course. But surely there would be doubts as to the real level of German (and other) support for the ECB's new policy.

After all, a lot of the German opposition is based on an apparently-shared reading of its own history (the hyperinflation of the interwar years). Would that reading suddenly change? Looking forward by 2013 there will be a new German government and no

one can guarantee that government's level of support for ECB bond buying. In fact, bond owners cannot be sure that the next German federal election will not be dominated by divisions over the ECB's actions as Lender of Last Resort. Given the strength of current German opposition to further ECB action and these considerations about the future, how credible and how sustainable will any German support for any shift in ECB policy towards directly buying Italian and Spanish government bonds? Ultimately, the very preconditions for the ECB to successfully stabilise Eurozone bond markets could have already been undermined.

Now it is possible to understand the vociferous, almost intransigent, nature of recent German opposition to an expanded ECB. German opponents to greater ECB intervention don't need to win the argument outright. Creating enough doubts over the ECB's ability to fulfil a multi-year programme of bond purchases and support is enough to force bond holders to price in this residual uncertainty, so lowering market expectations as to what widespread ECB bond buying could achieve. The markets won't forget which government is the largest shareholder of the ECB.

These arguments highlight the mountain the ECB will have to climb so as to convince market participants that it is determined to sustain a programme of bond market support. Enough heads may have to roll to persuade market participants. In that respect, it cannot be in Mr. Draghi's long term interests that he was associated with such tepid Italian bond market buying over the past few weeks. Moreover, it is difficult to see how much of the current German government leadership could be seen as dependable supporters of an ECB that did radically switch course.

Europe's monetary policy hawks may well lose the battle and yet win the war. The way opponents to widespread ECB buying of Eurozone government debt have made their case makes it very hard to believe any subsequent *volte face* by currently hawkish governments. Proponents of a Lender of Last Resort function for the ECB really do have their work cut out for them.