It *Hasn't* Changed…

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The Role of Central Banks in Financial Stability: How Has it Changed?

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Road map

- The euro crisis: where are we, how did we get here?
- Alternatives: ‘leveraging’ EFSF, eurobonds, exit of one or more countries
- Breakup of eurozone would be disastrous for ‘strong’ as well as ‘weak’ countries
- The only remaining solution: *ECB as lender of last resort* – that is the key role of the central bank in financial stability, and ***it hasn’t changed***

Where are we?

- Spreads down slightly today: Bund at 1.78, spread for Italy 5.19, Spain 4.21, Belgium 2.72, France 1.70 (1.49 Wednesday)
- Italian debt auction Wednesday ‘successful’: 1-yr paper at 6.09
- No one buying eurozone sovereign debt except ECB (sporadically) and domestic institutions under pressure
- Liquidity crunch: euribor rising, though still nowhere near ‘08-’09 levels – but no funding for banks, esp. in dollars
- Inflation expectations 5-yr 1.81, 10-yr 2.05
- EFSF withdrew bond offering, now says ‘leverage’ possibilities very limited

- France on course to lose AAA
- Deposits in Greek banks falling steadily for several months, starting in other countries deemed at risk
- CDS spreads trending up – but market itself now in question, that is another reason keeping investors out of the markets
- Good news: Papademos in Greece, likely Monti in Italy – but question of ‘legitimacy’ and authority of ‘technocrats’

How did we get here?

- Different stories for Greece, Ireland, Portugal, Spain
- Now Italy and France under pressure – again, very different stories
- But common to all: the euro (monetary union) *not* the cause – although ECB interpretation of its role blocks solution
- Keys to past two years are ECB denial and political indecision, lack of leadership
- ECB unwillingness to admit possibility of debt default for a eurozone country (Trichet, Bini Smaghi,…) – Trichet and Juncker excluded Greek restructuring in *May 2011*

- ECB indeed telling Ireland that it *cannot* restructure debt (where can central bank tell government what it can or cannot do in fiscal matter?) – with threat of withdrawal of repo facilities
- European creditor countries have been bailing out their own banks that made foolish loans to these countries by transferring fiscal costs to debtor country taxpayers – that’s part of the underlying politics
- But the other part is S&M: Deauville October 2010 (PSI), Cannes 25 October 2011 (discarding the taboo)

Ways out

- Recapitalise banks – sure, with what funding?
- Expanding or leveraging EFSF – non-euro countries won't contribute, leveraging through first-loss insurance not credible, leveraging through borrowing from ECB not allowed
- If *e.g.* France downgraded, then EFSF yields rise, value of insurance falls
- Eurobonds involve explicit fiscal integration – not for now
- Exit of Greece, maybe others – but this would be disastrous for exiting countries, would likely lead to breakup, disastrous for the rest – including Germany
- ***ECB accepting explicitly the role of LLR***

LLR comes within the Treaty mandate

In accordance with Article 105(1) of this Treaty, the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community…

5. The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions **and the stability of the financial system.**

Treaty of Maastricht (1992), Article 2 and Protocols Art. 105.5

Back to Bagehot – ‘it hasn’t changed’

- ECB should commit to cap yields paid by solvent countries with unlimited purchases in the secondary market (it is legally barred from purchasing new issues)
- Note: Weber was right about Greece – it wasn’t solvent
- But Italy and France are solvent
- Still, Knot, Weidmann, Praet, and even Draghi have said ECB won’t do it – while they do some purchases without taking explicit responsibility – ‘destructive ambiguity’
- Delay costly – and ultimately, either they do it, or they bear responsibility for demise of euro